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TAKE FIVE with Bill Emmons

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Historic Fed Battle with Inflation Continues

Transcript

Bill Emmons: Hi. I'm Bill Emmons, and I'd like to talk about the FOMC meeting that took place September 20 and 21. It's now clear that the Fed is engaged in a historic battle against inflation, and it's going to continue. So, the meeting takeaways included—for the third straight meeting—the Fed raised its interest rate targets by 75 basis points. That brings the fed funds target range to 3–3¼%. Quantitative tightening, the shrinking of the Fed's balance sheet, continues with the target of $95 billion per month, although we haven't reached that pace yet. And probably the most important thing that came out of this meeting—the Fed's economic outlook has deteriorated sharply.

So, let me highlight two aspects of that. First, economic growth in 2022 was expected, as the year began, to be 4%. But now, it's expected to be close to zero. Inflation, meanwhile, that was expected as we began the year to be about 2.5%, now is expected to be well over 5%. And looking into '23 and '24, the FOMC projects below-trend growth and above-target inflation for both those years. So, not surprisingly, the near-term outlook for monetary policy includes the continuation of aggressive tightening. And now, the Fed sees the fed funds rate at about 4.4% at the end of this year. And looking into next year, that rate could go even higher. The projection is for 4.6% at the end of 2023. And it's really interesting to note that just 18 months ago, that expectation for 2023 was that the rate would be zero.

So, first, let's look at the economic growth projections that come out of the quarterly summary of economic projections. As I said, beginning this year, 2022 economic growth was expected to be about 4% and at each successive quarterly meeting, quarterly projections, that was reduced until now it's 0.2% for this year. And those expectations for 2023 and '24 also have been pushed down to below what we think is the longer-run, steady-state level of about 1.8%.

In terms of unemployment, it increased. The expectation for this year is about 3.8% in the fourth quarter, and then 4.4% in both 2023 and '24, which is above the long-run projected level of about 4%. But, on inflation, probably the most important, most discouraging aspect, is we expected inflation coming into this year to be about 2.5%, 2.6%. It's now projected to be 5.4%, significantly worse than we would like to see. Looking into 2023 and '24, that above-target inflation is projected to continue. So, this means that the Fed needs to push up interest rates aggressively.

This picture shows at each of those quarterly projection periods, what the path of the fed funds rate was expected to be. And just between June and September, in the most recent period, the projection for the fed funds rate at the end of this year moved up from 3.4% to 4.4%. So, you can see a very aggressive increase in tightening. And that moves up to 4.6% next year and then begins to decline in 2024.

So, this is a historic rapid increase in interest rates. The one-year Treasury yield is a good way to capture the market's expectation of where the short rate is going to be over the next year. And you can see that over the last year, this increased 400 basis points…a full four percentage points…and that's the most aggressive tightening since 1981. That was during the period of Paul Volcker's war on inflation when the one-year yield rose eight percentage points in a single year.

As I've shown before, this continues a sequence of increases in interest rate targets. Beginning in March, the Fed moved up the rate 25, and then has pushed up to 50, and now 75-basis point increases. The market expectation is that there will be another 75-basis point increase in November, followed by 50 basis points in December, and a 25-basis point increase in February. That would bring us to the 4.5–4.75 % range by early next year.

Implications for banks? Well, this is the most aggressive rate-hiking cycle we've seen in 40 years. It has reduced the market value of fixed-income securities at all maturities. And most banks now have substantial unrealized securities losses. The policy tightening has inverted the yield curve, suggesting an imminent recession. Quantitative tightening, although it's not up-to-speed quite yet, is draining reserves from the banking system. And we expect that that will amplify the tightening of financial conditions that higher interest rates are producing.

Also, borrowers' credit quality will certainly be tested this year and next year by higher refinancing rates on their loans and the rapidly slowing economy. What should we expect? I think it's clear. The Fed remains behind the curve on inflation and is racing to catch up. We should expect aggressive rate hikes to continue into 2023.

Based on previous experience, the full economic impacts of tighter monetary policy have not yet been felt. When they hit, the downturn could be rapid, and it could be deep. And unless price and wage pressures relent soon, which I consider an unlikely event, the Fed's battle against inflation will continue, and it will inflict severe pain on some households, some businesses, and possibly banks.

Thanks for listening. And we'll see you next time.

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