TAKE FIVE with Bill Emmons

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Fed Signals March Rate Hike While Markets Expect Many More to Come

Transcript

Bill Emmons: Hi, I'm Bill Emmons, and I'd like to talk about the FOMC meeting that took place January 25 and 26. At this meeting, the Fed signaled an increase in the Fed funds target range in March. Meanwhile, financial markets appear to be expecting many more rate hikes to come. So, at this meeting, the FOMC left all of their interest rate targets unchanged; it also confirmed the bond taper will end in March—that is what was decided last December—and the Fed's economic outlook remains bullish. The economy, according to the FOMC, is likely to resume strong growth after the Omicron wave passes, and inflation is expected to come down later this year.

As for the near-term outlook for monetary policy, the Fed funds target range almost certainly will increase in March; we don't know how much, probably a quarter point. The balance sheet will probably stabilize in March, although from the press conference, it was very clear that the FOMC has made no plans yet about when or at what pace they might reduce it. And the chairman reiterated that the Fed funds target range remains the primary tool of monetary policy.

So, looking back at 2021 and what we expected throughout the year—a year ago, the median member of the FOMC expected economic growth to be a bit over 4 %; it turned out to be 5.5%, so stronger than what was expected. Unemployment also expected to be 5 percent in the fourth quarter of this year turned out to be only 4.2 %; so stronger than expected—a tighter labor market. Inflation, conversely, was expected only to be 1.8 percent; of course, that turned out to be quite low, that forecast. It now looks like 5.5 %. And I'll emphasize that this momentum of stronger-than-expected growth and especially tighter labor markets, as well as higher-than-expected inflation, has continued up to the present moment.

If you go back just five weeks ago, when the December projections were made, you can see that the unemployment rate projection was 4.3%; it actually turned out to be 4.2%. Inflation was expected to be 5.3%; it turned out to be a bit stronger at 5.5 %. So, even as we move into 2022, those dominant trends continue.

At the press conference, Chairman Powell surprised financial markets with some comments that really were strong guidance toward higher rates this year and in future years. I'm showing here changes on the single day of that press conference in Treasury yields, both in the nominal and the inflation index markets. You can see at the two-year maturity, which is a very good indicator of the near-term outlook for Fed policy, an 11 basis point increase on one day, which is about a two-standard deviation move. In the inflation index markets, there was a 13 basis point, one-day change, in the five-year yield; that's very clearly signaling that markets were surprised at how aggressive the Fed commentary was coming out of this meeting.

So, now looking at the futures markets, you can actually map out what the pace of rate increases appears to be for 2022. It looks now like the Fed is likely to raise rates a ¼ point in March, in May, in June, maybe not in July, but again in September, and for that fifth increase, which was not previously expected, in December of 25 basis points. That would bring a 125 basis point increase—quite a bit faster than was expected very recently.

So, is the Fed behind the curve? Financial markets certainly think so. Rate expectations have been rising very rapidly. On inflation, probably yes, even by the Fed's own admission. Taken from the FOMC statement, you find that supply-and-demand imbalances related to the pandemic and the reopening of the economy have continued to contribute to elevated levels of inflation. So, by putting the word "demand" in there, which is what the Fed effects show, there's a recognition that partly the Fed has not tamped down on those inflationary pressures.

On growth, however, I don't think it's necessarily true that the Fed believes that we're behind the curve. The committee believes that healthy economic growth will resume as Omicron wanes and hopefully many workers rejoin the labor force, taking some of the heat out of the economy.

So, the implications for banks are clearly that the Fed has begun a tightening cycle; it could lift short-term rates by 125 basis points this year; in fact, in less than a year, and that's much more rapid than we saw in the 2015–18 tightening cycle. Of course, banks generally welcome higher rates as net interest margins expand, certainly starting from such a low level; and the strengthening economy, I think, should support borrowers' credit quality. The risk, as we've said before, is that tightening financial conditions—if it's disorderly, if it happens faster than expected—could disrupt financial markets and possibly even the wider economy, resulting in a hard landing.

So, what should we expect? The Omicron wave has slowed the economy late in the fourth quarter. Certainly, we will see that in first quarter numbers, but strong growth should resume soon if, and that's a big if, COVID concerns abate. Inflation measures could get worse before they get better. I think we see that from this continuing momentum in inflation. Financial markets, meanwhile, will be volatile as investor expectations adjust to what has really revealed itself as an aggressive turn by the Fed.

So, bottom line, I think economic and financial conditions are favorable for banks at this point, and we'll keep our fingers crossed that everything works out in 2022.

Thanks for listening, and we'll see you next time.

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