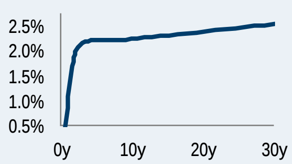
March 16, 2022

AHEAD, WARP FACTOR SEVEN

- The Federal Reserve raised overnight interest rates 25bps to a range of 0.25–0.50%, the first change in the policy rate in two years
- QE bond buying ended, but the FOMC has not listed a date by which they will permit their balance sheet to begin declining
- Although we anticipate a series of 25bps rate hikes in 2022, the markets will have to price a chance of 50bps as Powell seeks "flexibility"
- An updated quarterly dot plot indicates a median forecast among Fed officials for 7 hikes in 2022 and 3 in 2023, a substantial increase

Treas.	2.15PM	1.45PM	Chg.
3mo	0.45	0.43	+0.01
2yr	1.99	1.87	+0.12
5yr	2.22	2.14	+0.08
10yr	2.24	2.18	+0.06
30yr	2.54	2.49	+0.05
3m/2s	154	144	+10
2s/10s	25	31	-(6)
2s/30s	55	61	-(7)



Today, the Federal Reserve embarked on its first new tightening cycle since 2015, and its first change in interest rates since the emergency rate cuts of March 2020. This will be the 12th Fed tightening cycle in contemporary economic history, but it seems likely at this point, it will end up nothing like the usual five-year mission. One thing we have learned about the post-COVID economy is that everything seems to happen faster than it used to. Recession and rebound, fear and optimism, deflation and inflation are all coming fast and furious and it seems a fair assessment that the coming hiking cycle will function the same way as well.

Economic data since the FOMC met in January has been mixed on growth and decidedly more problematic on inflation. On the growth side, employment gains continue at a solid pace, though apparently not fast enough to bring new workers into the economy. Still, consumer incomes are growing healthily—at least on a nominal basis. Consumer spending has been unusually choppy, however, reflecting perhaps worries about higher living costs. Business capex is on the upswing, and, despite some initial worries from higher mortgage rates, the housing markets are continuing to exhibit strength amid insufficient supply of single-family homes. Most of the worries, quite reasonably, lie on the inflation side. Higher inflation has persisted now for two months longer than we originally anticipated, and it has broadened beyond initially impacted sectors as well. While factors such as used car pricing are likely to retreat into 2022, Fed policymakers are very much on guard for the prospect that temporary inflation becomes endemic via higher inflation expectations. And that's the crux of the matter. How many rate hikes do we need to convince consumers and businesses that inflation will be, in the future, a nonissue?

The FOMC statement has been facing its own version of shrinkflation in recent months and is only about three-quarters its 2021 length. Once again, the FOMC described job gains enthusiastically, calling them "strong"—a slight upgrade from the recent "solid." The statement devoted significantly more space to inflation, noting there are worrying "broader price pressures." In addition, the Fed warned that the Ukraine conflict could both cause "upward pressure on inflation and weight on economic activity," an unwelcome combination. It should not be lost on market participants that decades of central bank doctrine indicate, that when mandates conflict, a central bank needs to worry about inflation first.

In addition to the statement, the March meeting includes updated economic projections and the dot plot representing policymakers' expectations for rate hikes or cuts. March's dots point again to a steeper path of policy with seven rate hikes in 2022, three rate hikes in 2023, and nothing in 2024. Our own forecast is for 3-4 hikes in 2022 (March/May/June, then pause for balance sheet runoff), but given the unusual economic climate, wide error bands are appropriate around any inflation-based forecast.

Initial market response to the statement had rates higher across curve, with the 2-to-3-year area leading the way, but even the long end weaker. Equities gave up morning gains, though the usual caveat is that Powell's press conference has been more impactful for equities than the policy statement in recent months. To misquote the great Captain Kirk, "with any Fed rate hike mission, the greatest danger facing us is ourselves, an irrational fear of the unknown. But there's no such thing as the unknown — only things temporarily hidden, temporarily not understood."

FEDERAL RESERVE press release

• Fed again enthusiastic about job gains—"strong" this time

• Reference to Ukraine conflict worries on both inflation and growth

• Balance sheet winddown begins only "at a coming meeting;" next option is May

• Bullard dissents from the 25bps hike preferring 50bps.

Indicators of economic activity and employment have continued to strengthen. Job gains have been strong in recent months, and the unemployment rate has declined substantially. Inflation remains elevated, reflecting supply and demand imbalances related to the pandemic, higher energy prices, and broader price pressures.

The invasion of Ukraine by Russia is causing tremendous human and economic hardship. The implications for the U.S. economy are highly uncertain, but in the near term the invasion and related events are likely to create additional upward pressure on inflation and weigh on economic activity.

The Committee seeks to achieve maximum employment and inflation at the rate of 2 percent over the longer run. With appropriate firming in the stance of monetary policy, the Committee expects inflation to return to its 2 percent objective and the labor market to remain strong. In support of these goals, the Committee decided to raise the target range for the federal funds rate to 1/4 to 1/2 percent and anticipates that ongoing increases in the target range will be appropriate. In addition, the Committee expects to begin reducing its holdings of Treasury securities and agency debt and agency mortgage-backed securities at a coming meeting.

In assessing the appropriate stance of monetary policy, the Committee will continue to monitor the implications of incoming information for the economic outlook. The Committee would be prepared to adjust the stance of monetary policy as appropriate if risks emerge that could impede the attainment of the Committee's goals. The Committee's assessments will take into account a wide range of information, including readings on public health, labor market conditions, inflation pressures and inflation expectations, and financial and international developments.

Voting for the monetary policy action were Jerome H. Powell, Chair; John C. Williams, Vice Chair; Michelle W. Bowman; Lael Brainard; Esther L. George; Patrick Harker; Loretta J. Mester; and Christopher J. Waller. Voting against this action was James Bullard, who preferred at this meeting to raise the target range for the federal funds rate by 0.5 percentage point to 1/2 to 3/4 percent. Patrick Harker voted as an alternate member at this meeting

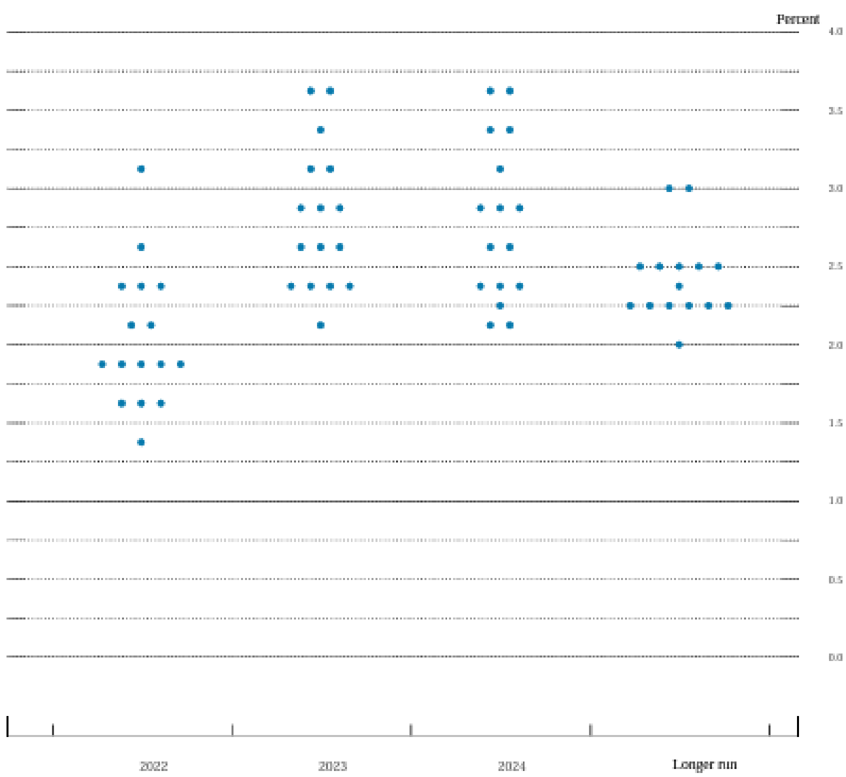
• Economic projections incl. slower GDP growth and higher inflation than Dec. projections, but still low unemployment

Percent

Variable	Median[1] 2022	Median[1] 2023	Median[1] 2024	Median[1] Longer run	Central Tendency[2] 2022	Central Tendency[2] 2023	Central Tendency[2] 2024	Central Tendency[2] Longer run	Range[3] 2022	Range[3] 2023	Range[3] 2024	Range[3] Longer run
Change in real GDP	2.8	2.2	2.0	1.8	2.5–3.0	2.1–2.5	1.8–2.0	1.8–2.0	2.1–3.3	2.0–2.9	1.5–2.5	1.6–2.2
December projection	4.0	2.2	2.0	1.8	3.6–4.5	2.0–2.5	1.8–2.0	1.8–2.0	3.2–4.6	1.8–2.8	1.7–2.3	1.6–2.2
Unemployment rate	3.5	3.5	3.6	4.0	3.4–3.6	3.3–3.6	3.2–3.7	3.5–4.2	3.1–4.0	3.1–4.0	3.1–4.0	3.5–4.3
December projection	3.5	3.5	3.5	4.0	3.4–3.7	3.2–3.6	3.2–3.7	3.8–4.2	3.0–4.0	2.8–4.0	3.1–4.0	3.5–4.3
PCE inflation	4.3	2.7	2.3	2.0	4.1–4.7	2.3–3.0	2.1–2.4	2.0	3.7–5.5	2.2–3.5	2.0–3.0	2.0
December projection	2.6	2.3	2.1	2.0	2.2–3.0	2.1–2.5	2.0–2.2	2.0	2.0–3.2	2.0–2.5	2.0–2.2	2.0
Core PCE inflation[4]	4.1	2.6	2.3		3.9–4.4	2.4–3.0	2.1–2.4		3.6–4.5	2.1–3.5	2.0–3.0	
December projection	2.7	2.3	2.1		2.5–3.0	2.1–2.4	2.0–2.2		2.4–3.2	2.0–2.5	2.0–2.3	
Memo: Projected appropriate policy path												
Federal funds rate	1.9	2.8	2.8	2.4	1.6–2.4	2.4–3.1	2.4–3.4	2.3–2.5	1.4–3.1	2.1–3.6	2.1–3.6	2.0–3.0
December projection	0.9	1.6	2.1	2.5	0.6–0.9	1.4–1.9	1.9–2.9	2.3–2.5	0.4–1.1	1.1–2.1	1.9–3.1	2.0–3.0

• Dots moved up a great deal in 2022, with a range of 4 – 10 rate hikes (a median of 7).

• The dot-projected path suggests a steep and short hiking cycle



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