First Trust
ECONOMIC RESEARCH REPORT
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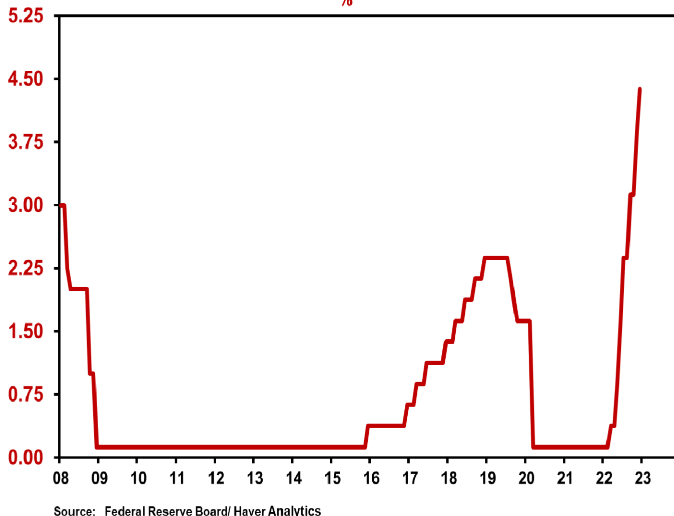
More Work to Do

The Fed downshifted to smaller rate hikes but isn't close to done. In contrast to the 75 basis point rate hikes at each of the last four meetings, the Federal Reserve raised short-term rates by only 50 bps today, as expected. However, the Fed made it clear in its projections and at the press conference that it is tilted toward further rate hikes in the months ahead and more rate hikes than the markets have been pricing in.

Today's Fed statement was virtually identical to the one in November. The economic projections released at the same time brought a lot more to digest. Economic growth expectations were raised modestly for this year, but 2023 growth was cut from the 1.2% real (inflation adjusted) rate the Fed forecast in September down to 0.5%. At the same time, 2023 PCE inflation expectations were raised to 3.1% (we would take the over) from 2.8% and the unemployment rate moved to 4.6% from 4.4%.



Despite the weaker growth and employment outlook, the dot plot showed a higher path for rates, with the median for finishing 2023 at 5.125% versus September's 4.875% forecast. The Fed is clearly showing that, despite pain on the employment side of the dual mandate, inflation is the priority. And a look at the distribution of rate hike forecasts for 2023 and beyond shows that many members believe a higher end point for rates will likely be appropriate. Case in point, while the 2023 median dot stands at 5.125%, seven FOMC members believe the rate should end the year even higher, while just two believe rates should end lower.

During the press conference, Powell was pressed for more details on what the path forward will look like. Nick Timiraos – the Wall Street Journal's Fed reporter who many watch as an unofficial mouthpiece for Powell and Co. – asked if the Fed can now transition to 25 bps hikes moving forward until they reach their terminal rate. While Powell wouldn't commit to the size of the next hike that will likely come early February, he suggested that the Fed has now moved to a stage where smaller hikes look appropriate as they close in on the terminal rate. Powell was also asked when rate cuts could come into play. Again, he remained non-committal, but did say that the dot plots for 2023 do not include any rate cuts between now and the end of next year.

Finally, Powell was asked directly if a recession in 2023 would cause the Fed to start easing policy sooner, to which he stated that they are tasked with promoting maximum employment and price stability (inflation). The employment market is running hot, while inflation is well above the Fed's target. In other words, the Fed is comfortable continuing to raise rates even as unemployment rises, at least modestly. While they aren't forecasting a recession in the year ahead (and we are), it doesn't change their priorities.

The bottom line is that it's good the Fed has prioritized the fight against inflation, but the necessary path to get there will likely bring volatility, and short-term pain, to the financial markets. We expect the markets will end next year largely flat from where we stand today, but the market could see notable pullbacks along the way. The economic medicine, while bitter, is part of the price we pay for the policy mistakes made over the past few years.

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Text of the Federal Reserve's Statement:

Recent indicators point to modest growth in spending and production. Job gains have been robust in recent months, and the unemployment rate has remained low. Inflation remains elevated, reflecting supply and demand imbalances related to the pandemic, higher food and energy prices, and broader price pressures.

Russia's war against Ukraine is causing tremendous human and economic hardship. The war and related events are contributing to upward pressure on inflation and are weighing on global economic activity. The Committee is highly attentive to inflation risks.

The Committee seeks to achieve maximum employment and inflation at the rate of 2 percent over the longer run. In support of these goals, the Committee decided to raise the target range for the federal funds rate to 4-1/4 to 4-1/2 percent. The Committee anticipates that ongoing increases in the target range will be appropriate in order to attain a

stance of monetary policy that is sufficiently restrictive to return inflation to 2 percent over time. In determining the pace of future increases in the target range, the Committee will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, and economic and financial developments. In addition, the Committee will continue reducing its holdings of Treasury securities and agency debt and agency mortgage-backed securities, as described in the Plans for Reducing the Size of the Federal Reserve's Balance Sheet that were issued in May. The Committee is strongly committed to returning inflation to its 2 percent objective.

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; Michael S. Barr; Michelle W. Bowman; Lael Brainard; James Bullard; Susan M. Collins; Lisa D. Cook; Esther L. George; Philip N. Jefferson; Loretta J. Mester; and Christopher J. Waller.

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