First Trust
ECONOMIC RESEARCH REPORT

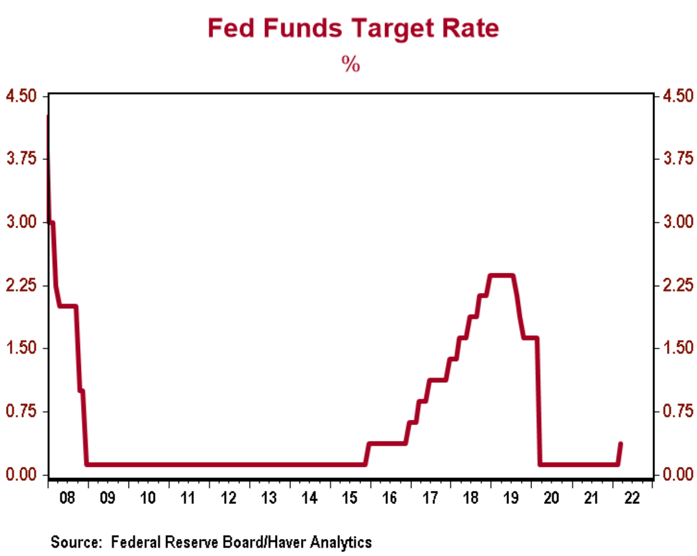
Brian S. Wesbury – *Chief Economist*
Robert Stein, CFA – *Dep. Chief Economist*
Strider Elass – *Senior Economist*
Andrew Opdyke, CFA – *Senior Economist*

March 16th, 2022 • 630.517.7756 • www.ftportfolios.com

Powell Channels Volcker

As expected, the Federal Reserve raised short-term rates by one quarter of a percentage point (25 basis points) earlier today, the first rate hike since the end of 2018. Even more important, the Fed signaled a new level of hawkishness in terms of future rate hikes as well as Quantitative Tightening.

The "dot plot," which show the pace of rate hikes anticipated by policymakers, suggests the median Fed official thinks short-term rates will go up 1.75 percentage points this year, which would be consistent with one 25 bp rate hikes at each and every meeting for the remainder of the year. This would also be consistent with the new language in the Fed's statement that it anticipates rate hikes will be "ongoing." Notably, this would also mean the Fed is prepared to keep raising rates through the mid-term election season, without pausing.



In addition, the median "dot" suggests another 75 - 100 bp in rate hikes in 2023, which would take short-term rates to a peak of about 2.75%. That, in turn, is slightly above the median estimate for the average short-term rate over the long run. In other words, the Fed now thinks it'll overshoot on rates, although not by much.

But the Fed didn't only change policy on rate hikes, it also shifted earlier the timing on Quantitative Tightening by saying it "expects to begin reducing [its balance sheet] at a coming meeting." It looks like the Fed will start QT in May unless the economy runs into some unexpected headwinds. Notably, Powell said at the press conference that QT will be faster than it was back in 2018-2019. The fastest pace in that cycle was $50 billion per month. Look for a pace of around $75 – 100 billion per month in this cycle.

The dramatic turn in the projected pace of rate hikes and the earlier schedule for QT was accompanied by some big changes to the forecast for the economy this year. Expected real GDP growth was downgraded to 2.8% from 4.0%, while expected PCE inflation was lifted to 4.3% from a prior estimate of 2.6%. However, the real GDP growth forecast for 2023 and beyond wasn't changed and the upward revisions to the inflation forecast for 2023-24 were modest.

Is the Fed worried that removing accommodation will cause a recession? Not yet. At the post-meeting press conference, Powell said that the odds of a recession are not "elevated" over the next year and the economy can "flourish" even as the Fed becomes less accommodative. Powell thinks he can engineer a "soft landing." We will see. He is likely right about 2022, itself. A federal funds rate below 2.0% is not tight. But wrestling inflation down to 2.0% is going to be tough to do without the Fed eventually getting tight enough to cause a recession.

This does not mean it's time to get bearish on equities. Economic growth continues, corporate profits are very high, and long-term interest rates, although they've moved up recently, are still low enough to make equities relatively attractive. In a better world, the Fed would operate in the background and investors could ignore it. Unfortunately, for the time being, investors are going to have to pay attention to the direction and pace of changes to monetary policy.

We believe today's policy shifts are long overdue. Consumer prices rose 7.0% last year and the year-ago comparison should peak near 9.0% sometime in the next month or so. The Fed is well behind the curve and has its work cut out for it.

Brian S. Wesbury, *Chief Economist*
Robert Stein, *Deputy Chief Economist*

Text of the Federal Reserve's Statement:

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.

.