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Investment Insights

Disciplined Risk Management

Connecting the Dots: From Dovish Hike to Hawkish Pause

For the first time in the last eleven meetings spanning more than fifteen months, the FOMC left the fed funds rate unchanged. While it was a widely expected policy decision, financial markets were initially caught off guard by the committee's expectation for the future path of monetary policy as expressed in the so-called "dot plot," formally known as The Summary of Economic Projections.

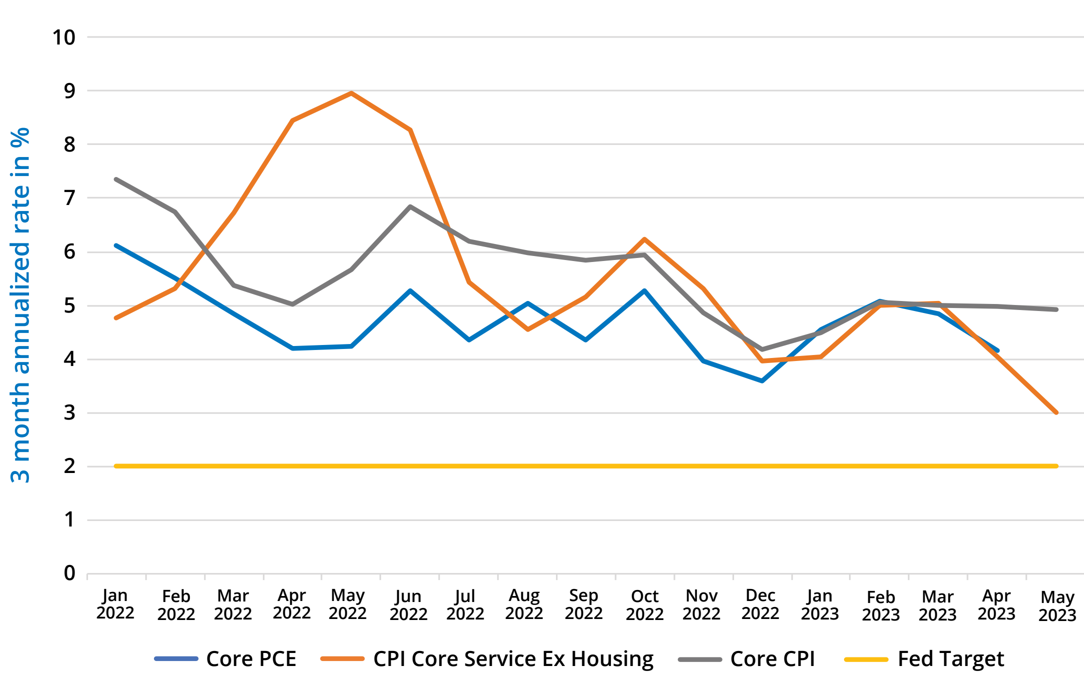
The median forecast of participants for fed funds target rate at the end of the year was increased 0.50% from the prior forecast released at the March meeting. Supporting the anticipation of a higher terminal fed funds rate was an upgrade to the Committee's forecast for both economic growth and inflation this year, as well as a decrease in the expected unemployment rate at year end.

Although the decision to not hike rates this meeting was unanimous, it was somewhat perplexing given the expectation for future rate hikes to come this year. It begged the question: Why wait?

This was a question that was quickly raised and addressed at the press conference. First, Powell made note of the slow progress in their preferred inflation measure, the Core Personal Consumption Expenditures (PCE) Index, to justify the adjustment to the Committee's forward guidance. Unlike the broader measure of inflation that includes energy and food prices and has seen more substantial deceleration, the core reading has remained stubbornly elevated, to the dismay of policymakers.

May's Core Consumer Price Index (a close cousin of Core PCE), released the day before the conclusion of the meeting, indicated inflation was still running significantly higher than the central bank's 2% target, despite the rapid tightening of monetary policy.

Core Inflation



Source: Bloomberg, BEA, BLS, 6/14/23

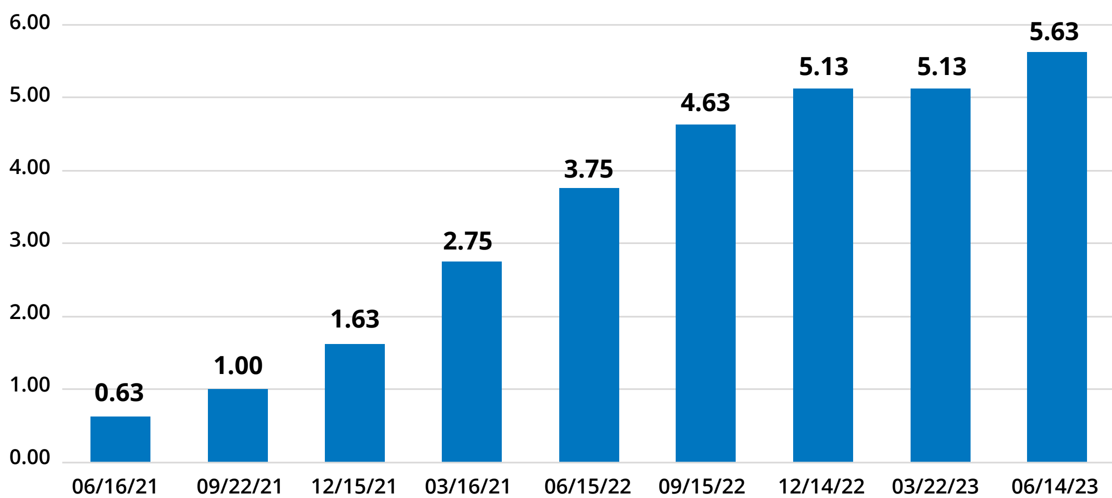
If there was a silver lining in that report from the Fed's perspective, it was that the services ex-housing – or "super core"— component maintained a disinflationary trend. Powell and his colleagues at the Fed have taken keen interest in this narrow measure of inflation because labor makes up a significant portion of the input cost. The trailing three-month annualized rate of this component of CPI is at its lowest level since October 2021.

Conditional Hawkishness

Powell made sure to emphasize that no decision had been made, but declared the July meeting was a "live meeting," suggesting another hike is possible. To that end, he continued to stress the Committee's need to assess incoming data and recalibrate accordingly. Citing the long and variable lags with which monetary policy impacts the economy, along with unusually high inaccuracy of forecasting this cycle, Powell opened the door for those who were looking for some dovish hope. After initially selling off on the reaction to the dot plot, equity markets recovered during the press conference as Powell carefully qualified the Committee's projections.

Indeed, the Fed has lacked prescience lately. In March 2022, when the Fed began raising rates, the dot plot indicated participants expected Fed Funds to end this year at just 2.75%.

FOMC Projections For The Target Fed Funds Rate YE 2023



Source: Bloomberg, The Federal Reserve, 6/14/23

Takeaway

Investors should be comforted by understanding there is nothing holding the FOMC to their revised projection knowing there is always room for the hawkish impulse to fade if conditions change. Forward guidance is a soft form of a policy tool that the Fed will use to manage market expectations, which can impact financial conditions and, in turn, help achieve the goal of restoring price stability. As one financial media pundit put it: "talk is cheap." However, it would be unwise to doubt the Fed's resolve and overestimate their patience.

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