

Economic Pulse

September 26, 2018

The surprise from the Fed

While a 25 bps increase in the Fed Funds rate had been well-telegraphed in advance of today's decision, the surprise from the Federal Reserve came in their forecasts for 2021. (In their June projections, the Fed's forecasts extended only through 2020.)

The Committee appears to be forecasting the perfect "soft landing" by 2021, yet appears concerned enough about inflation that they anticipate another five rate increases over the next nine quarters. Could the Federal Reserve be worried about the impact on inflation from tariffs and fiscal policy changes?

Third Time's a Charm: What's in Store After the Third Rate Hike This Year?

Today's rate decision had been widely anticipated by market participants. As a result, there was little change to Treasury yields following the 25 bps increase in the Fed Funds target to a range of 2.00% to 2.25%: 2-year yields remained around 2.83% and 10-year yields held between 3.06% and 3.08%. Most of the forecasts from the quarterly economic projections of the Federal Reserve members were unchanged from June, although **expectations for GDP growth for 2018 and 2019 were revised slightly higher** (from 2.8% to 3.1% for 2018 growth, and from 2.4% to 2.5% for 2019 growth.) However, **expectations for inflation were unchanged, with core PCE and PCE inflation projected to end 2018, 2019, 2020 and 2021 between 2% and 2.1%—exactly in line with the Fed's longer-run forecast for PCE.** If growth is scheduled to gradually slow to its longer-run rate (*Table 1 on the following page*) and inflation is projected to increase in line with the Fed's "unofficial" target of 2%, why has the Committee penciled in an additional 25 bps of tightening in 2018, 75 bps of additional tightening in 2019, and a further 25 bps in 2020? **Because policy rates are still accommodative, even though today's FOMC statement explicitly removed the phrase "the stance of monetary policy remains accommodative"—a phrase that had been included in the FOMC statement as recently as last month. It would be hard to argue otherwise, when inflation-adjusted Fed Funds are at zero.** Chairman Powell said as much when he noted that the "useful life" of the word "accommodative," which had been introduced in 2015, was "over," but then back-pedaled later in the press conference, and stated that the change in wording "does not signal any change in the likely path of policy."

Something doesn't sit quite right.

GDP growth, while running above trend, is scheduled to fall back to its longer-run rate by 2021, even as inflation is not expected to accelerate beyond the Fed's target. With no acceleration in inflation, why do we need five additional rate hikes? It's clear that the Fed is more worried about inflation than their forecasts suggest, particularly against the backdrop of an inflation trajectory that has been steadily climbing higher (*Chart 1 on the following page*). Core PCE inflation is at 7-year highs, and when asked about the impact from tariffs on inflation and growth, Chairman Powell responded that "we've been hearing a rising chorus of concerns from businesses all over the country about disruption of supply chains and material cost increases." It may be too soon to see any negative effects in the economic data, but in order to justify the Fed's latest forecast, we'll either need to see more inflation (which would justify rates being tightened above the Fed's longer-run level) or a more rapid slowing in economic growth, in which case, a further five rate hikes may prove too aggressive.

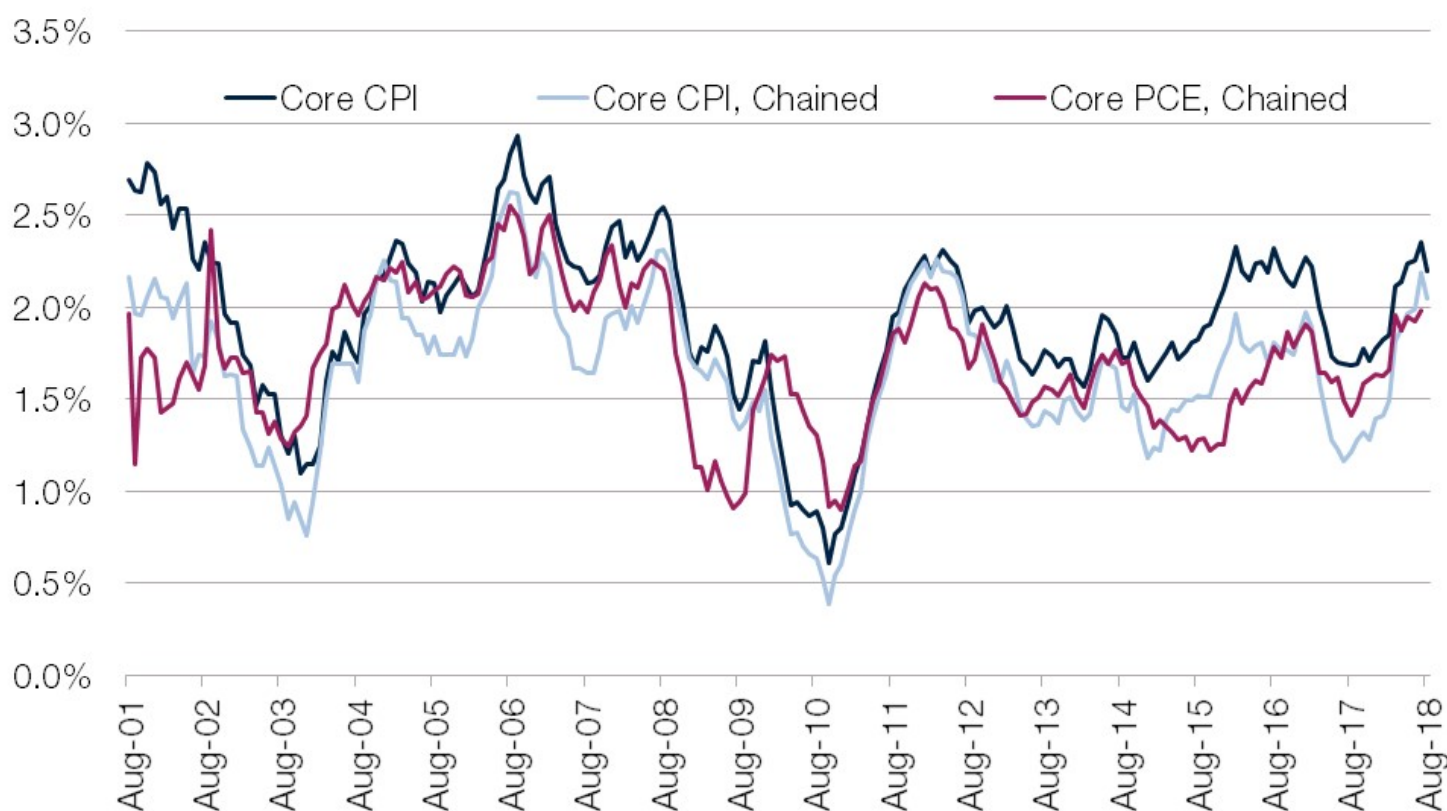
If it sounds too good to be true...perhaps it is?

If the Fed's policy projections materialize, look for the perfect "soft landing": a gradual slowing in growth with no rise in the unemployment rate and no acceleration or deceleration from 2 per cent inflation.

Table 1: Central Tendency Projections of Federal Reserve Board Members and Presidents, September 2018 (in per cent)

Variable	2018	2019	2020	2021	Longer Run
Change in real GDP, %	3.0 to 3.2 ≈ ↑	2.4 to 2.7 ≈ ↑	1.8 to 2.1 ≈ ↑	1.6 to 2.0	1.8 to 2.0 ≈
June Projection	2.7 to 3.0	2.2 to 2.6	1.8 to 2.0	n/a	1.8 to 2.0
Unemployment rate, %	3.7 ≈	3.4 to 3.6 ≈ ↑	3.4 to 3.8 ≈ ↑	3.5 to 4.0	4.3 to 4.6 ≈
June Projection	3.6 to 3.7	3.4 to 3.5	3.4 to 3.7	n/a	4.3 to 4.6
PCE inflation, %	2.0 to 2.1 ≈	2.0 to 2.1 ≈ ↓	2.1 to 2.2 ≈	2.0 to 2.2	2.0 ≈
June Projection	2.0 to 2.1	2.0 to 2.2	2.1 to 2.2	n/a	2.0
Core PCE inflation, %	1.9 to 2.0 ≈	2.0 to 2.1 ≈ ↓	2.1 to 2.2 ≈	2.0 to 2.2	n/a
June Projection	1.9 to 2.0	2.0 to 2.2	2.1 to 2.2	n/a	n/a
Fed Funds (average)	2.31% ↑	3.02% ↑	3.28% ≈ ↓	3.23%	2.88% ≈
June Projection	2.24%	2.96%	3.31%	n/a	2.87%
Fed Funds (median)	2.38% ≈	3.13% ≈	3.38% ≈	3.38%	3.00% ↑
June Projection	2.38%	3.13%	3.38%	n/a	2.88%

Source: Federal Reserve

Chart 1: Measures of Inflation, 12-Month Changes (in per cent)

Source: Bureau of Labor Statistics and Bureau of Economic Analysis

Chained inflation measures incorporate the effect of substitution bias, i.e., the ability of consumers to purchase more of those goods that have risen relatively less in price.

From the FOMC Press Release**Labor Market**

August: "...the labor market has **continued to strengthen** and that economic activity has been rising at a **strong rate**. Job gains have been strong, on average, in recent months, and the unemployment rate has stayed low."

September: No change.

Recent Data

August: "Household spending and business fixed investment have **grown strongly**."

September: No change.

Inflation

August: "On a 12-month basis, both overall inflation and inflation for items other than food and energy **remain near 2 percent**. Indicators of **longer-term inflation expectations are little changed**, on balance."

September: No change.

Current Policy Stance/Future Bias

August: "The stance of monetary policy **remains accommodative**..."

September: Comment removed; no reference to the current state of monetary policy. Note that the longer-run range for the Federal Funds rate as estimated by the Committee is 2.5% - 3.5% (with a median of 3.0%)—above the current range of 2.00% to 2.25% after today's rate increase.

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