U.S. REACT: Fed Will Wait See the Whites of Inflation's Eyes (1)
2020-09-16 19:38:23.904 GMT

By Yelena Shulyatyeva (Economist), Andrew Husby (Economist) and Eliza Winger (Associate)

(Bloomberg Economics) -- The Federal Reserve followed through on the change to its framework by significantly revamping the policy statement to include amended forward guidance.

Not only did the Fed say that inflation will need to reach 2% and stay on track to "moderately exceed" that level for some time, but policy makers also conditioned the takeoff in rates on the return to full employment. The updated statement made it official -- the Fed does not anticipate raising rates until it sees inflation actually moving.

Swiftness came at the expense of two members dissenting over the language details; there was simply too little time for the Committee to reach a full consensus between the Fed's Jackson Hole revamp last month and the latest meeting.

We expect the key determinant of how much inflation the Fed tolerates will be the stability of inflation expectations when it rises above 2% on a sustained basis. Once inflation expectations move higher, the Fed will not hesitate to raise rates.

A brighter economic outlook was not paired with any pulling-forward of rate-hike projections -- in fact the opposite. The FOMC is signaling via projections and upgraded forward guidance that it does not expect to raise rates even if the jobless rate hits 4%. When unemployment hit that mark during the last expansion, the funds rate was already above 1% and steadily rising.

* The Fed updated policy guidance after adopting its new inflation-targeting framework. New guidance entails achieving both inflation and the full employment targets.
* The Fed's assessment of "considerable risks" surrounding the economic outlook over the medium term remained in the statement, signaling that officials have not taken much comfort from recent better-than-expected activity and labor market data.
* The Summary of Economic Projections, which extended forecasts into 2023, included an upgrade to GDP growth in 2020 and a downgrade to the unemployment rate throughout the horizon. The lack of action on the fiscal-aid front likely led to less

optimistic projections for 2021 and 2022. The fed funds rate central tendency forecast indicates rates remaining at the zero-lower bound in 2023.
* Assuming the economy rebounds by 28% annualized in the second quarter, as we project, U.S. GDP will need to grow by 3.4% in the fourth quarter to achieve the Fed's forecast of -3.7% for the full year. This is slightly above our projections for growth of 2.5% in the fourth quarter and -4.0% for the year.

GDP to Return to Pre-Crisis Level in 2021

Interest Rates Unchanged

The vote to hold the federal funds rate steady at 0.00% to 0.25% was 8-2. Dallas Fed President Robert Kaplan dissented, preferring to retain "greater policy rate flexibility." And Minneapolis Fed President Neel Kashkari also dissented in favor of maintaining "the current target range until core inflation has reached 2% on a sustained basis."

Economic, Inflation Assessment: No Adjustment

The Fed made no changes to the economic or inflation assessment relative to the July statement. The rebound in the stock market and better-than-expected economic data did not justify any changes in how the Fed views the economic outlook.

Dot Plot Shows No Hike Through 2023

The dot plot shows that, despite significant upgrades for growth and inflation, the Fed is set to stand pat on rates through 2023. One member sees a rate hike in 2022, compared to two in June. Participants did not shift their assessments of the longer-run neutral funds rate, with the median still 2.5%, and no change in the distribution. The introduction of 2023 changes little -- only four participants indicated a rate hike would be appropriate in order to achieve the set of economic projections they outlined.

SEP: Sharp Upgrades

The Summary of Economic Projections reflects a stronger economic performance and lower joblessness since guidance was last published in June. The 2020 median GDP projection is now -3.7% (vs. -6.5% prior), core inflation is seen at 1.5% (vs. 1.0% prior) and the unemployment rate is expected to be 7.6% (vs. 9.3% prior).

GDP Upgraded, But Only in 2020

The top of the central tendency range for core inflation -- omitting the three highest and lowest projections -- only touches 2% in 2023. A minimal change in the distribution suggests the Phillips Curve, the posited link between inflation and unemployment, is being set by the wayside.

Market Reaction: Dovish Move Ebbs

The FOMC statement made clearer that the Committee is prepared to remain on hold well into 2023. The dovish tilt was reflected in higher equity prices and steeper yield curve over the 30-minute window starting five minutes prior to the release. Yet no one expected the Fed to move any time soon, and reassurance about the path of rates three years hence changes the near-term calculus very little. Moves ebbed over the course of the press conference -- the S&P 500 retreated well below pre-statement levels by the time Powell wrapped up, after rising as much as 0.6%.

Bloomberg Economics U.S. Forecast Table

To contact the economists on this analysis:
Yelena Shulyatyeva (Economist) in New York at yshulyatyev2@bloomberg.net;
Andrew Husby (Economist) in New York at ahusby1@bloomberg.net;
Eliza Winger (Associate) in New York at ewinger4@bloomberg.net
To contact the editor responsible for this analysis:
James Callan at jcallan2@bloomberg.net

To view this story in Bloomberg click here:
https://blinks.bloomberg.com/news/stories/QGRNC2T1UM0W