Fed's Claws Back Credibility with a More Hawkish Policy Shift

Scott McIntyre

As expected, Fed policy-makers emerged from their two-day FOMC meeting this afternoon to announce a doubling of the taper pace they'd declared in November. The vote was unanimous. At the quicker pace, the Fed would wrap up its QE purchases before March.

Committee members also released an updated "dot plot" indicating *three rate increases in 2022 and three more in 2023*. All 18 committee members now expect at least one quarter point hike next year, and in fact all but one member expect two or more. Just three months ago, the dot plot showed an even-split between those members expecting a single quarter point hike in the fourth quarter of 2022 and those expecting the first hike in the first quarter of 2023. The difference-maker since September has been an unsettling increase in the rate of inflation.

The official statement, released at the conclusion of the meeting, indicated the Fed's inflation mandate has already been met, leaving its employment mandate as the remaining hurdle to raising rates. The unemployment rate forecast for the end of next year was lowered from 3.8% to 3.5%. At that point, the Fed would have more than achieved its employment objective. It doesn't sound like a return to the pre-pandemic labor market participation rate is a requirement for maximum employment.

The initial market reaction was relatively calm, suggesting the Fed got it right. Bond yields climbed (slightly) higher across the curve while the major stocks indexes reversed course and turned sharply positive.

In the press conference that followed, Powell asserted yet again that the committee would not begin raising rates until the taper was complete. When asked about the timing of those rate hikes, Powell made it clear that no decision had been made, but did not expect a lengthy delay. With the more aggressive taper, the FOMC has now responded to inflation concerns and will have at least three or four months to gauge the impact of the Omicron variant and see whether price pressures abate.

Powell emphasized that consumer demand was "very strong" and the consumer is fundamental healthy. Since spending drives GDP growth, this admission suggests a healthy economy in 2022. Pointing to the elevated quits rate, Powell said the labor market was already very tight. He believes the biggest threats to getting back to maximum employment are the risk that higher inflation becomes entrenched, and the uncertain evolution of the Omicron variant.

Powell repeated the Fed would remain flexible and reiterated that the committee was prepared to use all its tools to achieve its goals. These words were comforting as stock gains increased while Powell spoke. However, It isn't clear that bonds (especially on the short end) have internalized the new interest rate projections.

If the labor market improves faster than expected next year, the bond market could anticipate an earlier liftoff. If growth were to slow in 2022 and inflation retreated, anticipated liftoff could fall back.

Market Indications as of 3:11 PM Central Time

DOW Up 383 to 35,927 (HIGH: 36,432)
NASDAQ Up 328 to 15,566 (HIGH: 16,057)
S&P 500 Up 72 to 4,706 (HIGH: 4,712)

1-Yr T-bill current yield 0.26%; opening yield 0.23%
2-Yr T-note current yield 0.66%; opening yield 0.66%
3-Yr T-note current yield 0.97%; opening yield 0.97%
5-Yr T-note current yield 1.24%; opening yield 1.24%
10-Yr T-note current yield 1.46%; opening yield 1.44%
30-Yr T-bond current yield 1.87%; opening yield 1.82%

Read more Economic Commentary