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Fed revises key forecasts: growth, inflation, rate increases

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KEY POINTS:

- U.S. Federal Reserve (Fed) leaves the fed funds rate unchanged near the zero bound
- Dot plot forecasts of committee members shows median expectations are for two rate increases in 2023 – up from one in the previous FOMC meeting
- Timeline for a reduction in the Fed's asset purchase program remains uncertain
- Committee member estimates for 2021 gross domestic product (GDP) and personal consumption expenditures (PCE) have both been revised higher

The June 15-16 Federal Open Markets Committee (FOMC) meeting resulted in little policy change as expected. The Federal Reserve left the fed funds rate in the 0.0%-0.25% corridor, and importantly, did not update its guidance on a timeline for tapering its asset purchase program. There were, however, some finer points pertaining to economic forecasts and the Fed's expectations for future rate hikes that caught the eye of James Camp, CFA, Managing Director of Fixed Income and Strategic Income at Eagle Asset Management

"The Fed's outlook for future rate hikes, economic growth, and inflation forecasts is telling," Camp said. Committee members now predict two rates hikes in 2023, up from one expected hike at the last FOMC meeting. The Fed also revised 2021 economic growth and inflation expectations higher. "Not only did committee members acknowledge higher than anticipated economic growth and inflation data, they also acknowledged initial taper discussions and removed key phrases from prior FOMC meetings that kept tapering six months out, increasing the odds that announcements come in September after the Jackson Hole meeting," Camp said.

The immediate market response was a sharp jump higher in bond yields and a decline in stock prices.

"The dot plots varied widely across committee members, highlighting the challenges of economic forecasting when the data are still incredibly distorted as a result of the pandemic and subsequent monetary and fiscal policies," Camp said. "The bond market had been pricing in subdued long-run inflation expectations prior to this most recent FOMC meeting, a view that frankly our team did not share. The sharp jump in bond yields after the event indicates to our team that the market is pricing in inflation expectations that may be stickier than the Fed would lead investors to believe."

When asked in the press conference about when the current inflationary forces might abate, Fed Chairman Jerome Powell reiterated that these forces are transitory but the Fed doesn't know exactly when these forces will subside.

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>
> — James Camp, CFA

"It seems a bit contradictory to say inflation is transitory while in the same breath stating no one knows when these inflationary forces will dissipate," Camp said. "While we likely witnessed the peak in year-over-year inflation readings in the May data, we believe inflation could remain elevated for some time, providing upward pressure on bond yields. The Fed is slowly taking its foot off the gas pedal, in large measure because of robust growth and building inflation headwinds. The outcome of the meeting is in line with our themes of less than transitory inflation and excess liquidity, which has created dislocations in certain markets."

While generally relegated to the more esoteric corners of the money market fund and cash fund markets, two interbank lending rates – the Interest Rate on Excess Reserves (IOER) and the Overnight Reverse Repo Program (ON RRP) – were both increased by 0.05%. Camp said this is inconsequential for most investors, but it's a healthy development for banks and money market funds.

"The current glut of cash in the banking system has depressed ultra-short yields to unsustainably low levels, with the four-week Treasury bill dipping below 0.00% several times this quarter," Camp said. "This is highly indicative of excess liquidity unable to find investable assets in the cash markets. This tweak to administered rates provides a minimal lift to ultra-short rates, but it does keep the financial plumbing in the banking system running smoothly."

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Eagle Asset Management is built on the cornerstones of intelligence, experience, and conviction, driven by research and active portfolio managers. Our long-tenured investment teams manage a diverse suite of fundamental equity and fixed income strategies designed to meet the long-term goals of institutional and individual investors. Our teams have the autonomy to pursue investment decisions guided by their individual philosophies and strategies.

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The U.S. Federal Reserve dot plot is a chart summarizing the Federal Open Market Committee's (FOMC) outlook for the federal funds rate. Each dot represents the interest rate forecasted by one of the 12 members of the committee.

Interest Rate on Excess Reserves (IOER) is the interest paid by the U.S. Federal Reserve on balances that are above the level of reserves a bank is required to hold.

Overnight Reverse Repo Program (ON RRP) is used to supplement the Federal Reserve's primary monetary policy tool, interest on excess reserves (IOER) for depository institutions, to help control short-term interest rates.

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