Daiwa Capital Markets

U.S. FOMC Review

- FOMC: tight alignment in views; more tightening needed; economy resilient

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Monetary Policy

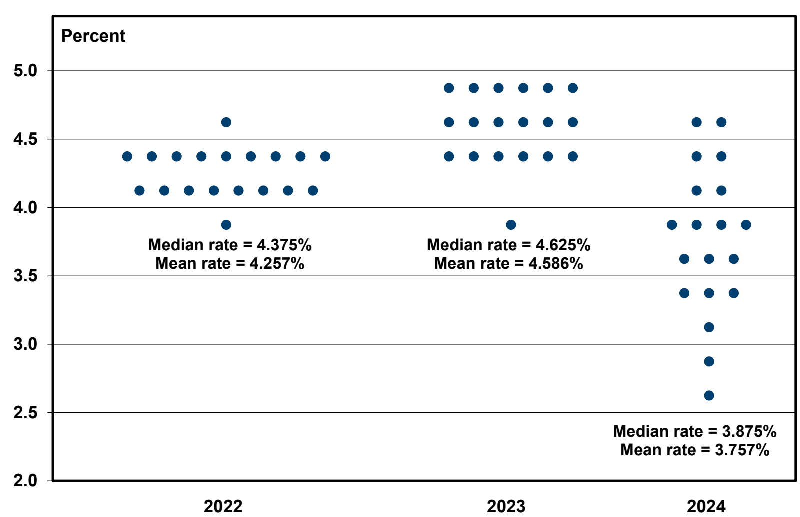
The policy decision of the Federal Open Market Committee was in line with market expectations -- a 75 basis point hike in the federal funds rate to a range of 3.00 to 3.25 percent. The policy statement also did not involve surprises, as the wording was nearly identical to that in July.

The outlook for policy, though, might surprise some market participants, as the dot plot shows considerable tightening at the next two meetings. The median dot shows a year-end federal funds rate of 4.375 percent, implying a 75 basis point shift in November and 50 basis point change in December. However, one might also envision changes of 50 basis points at each of the next two meetings, as there is about an even split among policymakers for year-end rates at 4.125 percent and 4.375 percent (chart).

Market participants are likely to be most surprised about the dim prospects for rate cuts next year. Before today's meeting, futures contracts for the federal funds rate were showing an expectation of rate cuts beginning in mid-2023. However, the dot plot shows no hint of easing next year, as one policy dove has policy steady throughout next year, while other officials show steady or tighter policy. Public statements of Fed officials have emphasized that they intend to remain restrictive for an extended period, and the dot plot is consistent with such a strategy.

Chair Powell indicated in his press briefing that the FOMC has now moved into the low end of the range of restrictive stances, and officials plan to stay in restrictive territory throughout next year. Despite the tight stance, policymakers see a reasonably good performance in the economy. The Summary of Economic Projections (SEP) shows that Fed officials expect growth to total 0.2 percent over the four quarters of this year. With the economy having contracted 1.1 percent in the first half, the Fed view involves growth of 1.5 percent in the second half. Not too bad. The economy remains in positive territory next year with expected growth of 1.2 percent. This pace is below the economy's potential (which is 1.8 percent in the Fed's view), suggesting that the unemployment rate is likely to be climbing. However, the change is moderate in the Fed's projection, moving to 4.4 percent at the end of next year (table, next page).

FOMC Rate View: Year-End 2022, 2023, 2024*



** Each dot represents the expected federal funds rate of a Fed official at the ends of 2022, 2023, and 2024.*
Source: Federal Open Market Committee, Summary of Economic Projections, September 2022

The press briefing was filled with questions on when the Fed might stop tightening and what factors will lead the Fed to end its string of rate hikes. Chair Powell indicated the Fed wants to see a better balance between supply and demand in the labor market and a meaningful reduction in the inflation rate. The SEP offers hints into specifics of what the Fed might like to see. Core PCE inflation slows to 3.1 percent next year, but there is no easing from the Fed. Rate cuts begin in 2024, when the core PCE inflation rate eases to 2.3 percent. Inflation is still above 2.0 percent when easing begins, but given the lags in monetary policy, Fed officials will be confident that inflation will return to 2.0 percent.

Economic Projections of the FOMC, September 2022*

	2022	2023	2024	2025	Longer Run
Change in Real GDP	0.2	1.2	1.7	1.8	1.8
June projection	1.7	1.7	1.9	--	1.8
Unemployment Rate	3.8	4.4	4.4	4.3	4.0
June projection	3.7	3.9	4.1	--	4.0
PCE Inflation	5.4	2.8	2.3	2.0	2.0
June projection	5.2	2.6	2.2	--	2.0
Core PCE Inflation	4.5	3.1	2.3	2.1	--
June projection	4.3	2.7	2.3	--	--
Federal Funds Rate	4.4	4.6	3.9	2.9	2.5
June projection	3.4	3.8	3.4	--	2.5

** Median projections*

Source: Federal Open Market Committee, Summary of Economic Projections, September 2022