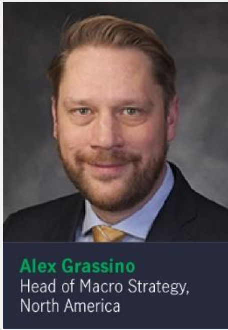

The US Federal Reserve's (Fed's) decision on 21 September to raise US interest rates by 75 basis points (bps) to 3%-3.25% was well priced into the markets and, therefore, should come as little surprise to investors. The accompanying statement also contained little new information. Why did the markets react so strongly?

The Fed remains hawkish, but easing could occur before the end of 2023

The devil, as the saying goes, is very much in the details. In this instance, we're referring to the underlying message from the Fed. The announcement was accompanied by the FOMC's latest economic projections, which included its closely watched Federal funds rate projections (the dot plot). It's fair to say that the latest projections and Fed Chair Jerome Powell's post-meeting press conference cemented an increasingly negative outlook.

What did we learn from the Fed's latest projections?

- **The forecasts painted a gloomier picture**—GDP growth forecasts for 2022 and 2023 were ratcheted down materially to 0.2% and 1.2% respectively on a year-over-year basis, down from 1.7% for both years. Meanwhile, projections for unemployment and inflation were revised modestly higher. While the Fed's updated outlook might not seem all that controversial relative to market consensus, recall that until recently, the central bank had painted a reasonably benign picture of the US economy.

- **The Federal funds rate is expected to stay higher for longer**—The Fed's median estimates of where the Federal funds rate will be by the end of 2022 has been pushed up by a full percentage point to 4.4%. Crucially, Fed officials now expect the benchmark policy rate to hit 4.6% in 2023 before easing.

- **Hawkish comments from Chair Powell**—The hawkish message that was implicit in the projected estimates was made explicit by Chair Powell during the press conference, during which he confirmed that the Fed's first priority was to get inflation back to its target rate of 2%, and reiterated the central bank's commitment to achieving that goal even if it meant compromising economic growth to get there.

Fed officials have turned more hawkish since June

FOMC projections	Projected interest rate—median (%)		
	2022	2023	2024
June	3.4	3.8	3.4
September	**4.4**	**4.6**	**3.9**

Source: US Federal Reserve, 21 September, 2022. FOMC refers to the Federal Open Market Committee.

What's changed?

We think two factors contributed to the Fed's increasingly hawkish tone: First, although the employment picture had shown signs of softening earlier in the summer, recent data suggested that the labour market has strengthened since then. Second—and more important, in our view—was August's outsized 0.6% (on a month-over-month basis) increase in core CPI.

Prior to the release of August's CPI data, we had envisioned a more modest path that would have seen policy rates peak at 3.5%, with the final hike for this cycle arriving just before year end. Now, we expect Federal funds rate to hit 4.25% in early 2023; with the possibility of an additional 25bps added to the peak rate should forthcoming inflation data remain stubbornly strong. Should that happen, our forecast will mirror the Fed's own projections. In other words, we're now in data-dependent territory.

The way we see it, inflationary pressure will have to come back down to a more manageable pace (e.g., staying in the 0.2% to 0.3% range for a several months) before the Fed begins to consider pausing rate hikes. Put differently, there probably isn't enough time between now and the next Fed meeting for inflation data to weaken sufficiently to reasonably justify a modest 25bps rate-hike in November—meaning that once again, the next hike is highly likely to be material. That said, the Fed could potentially provide the markets with a festive surprise in December and signal a willingness to slow the pace of hikes should upcoming economic data unfold in the right way (i.e., weaken significantly). That's about as optimistic as we'd get.

We expect the Fed to start easing in 2023

We do, however, have higher conviction that the Fed will begin easing before the end of 2023 for two reasons:

1. We expect inflation to moderate to a point where it's not as acutely troubling it is now by Q2 2023. There's currently evidence that supply chain constraints are beginning to unwind. Further, the expected disinflationary pressure that's typically associated with an inventory correction has yet to materialize—that should also contribute to putting a lid on inflation. Finally, key commodity prices have also started to ease. As these factors kick in, the Fed should have the breathing room that it needs to stop hiking and assess the impact that tighter monetary policy has had on the economy.

2. In our view, monetary easing will only occur when growth concerns supersede anxiety about inflation. While Chair Powell has been clear about the risks of easing prematurely, the reality is that most forecasters—ourselves included—expect the US economy to slip into recession during the first half of 2023. As such, the temptation to ease as soon as is plausible will likely increase over the coming months.

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