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The Fed's September meeting: still going strong

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KEY POINTS:

- On September 26, the Federal Reserve (Fed) raised its target benchmark interest rate, the fed funds rate, by 25 basis points (0.25%), to a target range of 2.00% to 2.25%. This is the third hike of 2018 and eighth of the current cycle.
- New forecasts showed the Fed solidifying around a fourth rate increase this year, reflecting a slight upgrade to its growth outlook.
- In its accompanying statement, the Fed maintained an upbeat view of the U.S. economy and did not specifically mention trade risks.
- We anticipate another 25-basis-point hike in December and at least two more in 2019.
- Stocks, bonds and currencies did not react meaningfully following the outcome of the meeting, which was largely telegraphed.

WHAT HAPPENED?

The Federal Open Market Committee (FOMC)—the group within the Federal Reserve that sets monetary policy—voted to raise its target fed funds interest rate by 25 basis points, to a range of 2.00% to 2.25%. This is the FOMC's eighth hike since 2015. Compared to June, the median FOMC member—as shown in the Fed's summary of economic projections—has become more optimistic about growth and more supportive of further rate hikes through 2019. While the Fed's median forecasts for interest rate increases have not changed since last quarter, there is now a broader consensus on the FOMC for an additional hike this year and multiple increases in 2019.

In his third press conference as Fed Chairman, Jerome Powell emphasized the FOMC's assessment that the U.S. economy is strong, supported by fiscal stimulus and not yet harmed in aggregate by new tariffs.

WHY DOES THE FED'S ACTION MATTER?

The Fed essentially confirmed what economic observers already knew: U.S. growth has strengthened this year, thanks to a combination of cyclical forces and fiscal stimulus. As a result, further tightening is needed to keep the risk of high inflation roughly balanced with the risk of declining growth and, in turn, higher unemployment.

With core PCE inflation hovering around the Fed's 2% target and unemployment still below 4%, the Fed's dual mandate is largely fulfilled. It still faces two broad challenges, however. First, the Fed must decide when to stop raising interest rates to avoid pulling the reins too hard on growth. Second, it must correctly gauge the sum total of its tightening measures, including both higher rates and the declining size of its balance sheet, which expanded greatly in response to liquidity needs during and after the financial crisis.

WHAT WAS THE MARKET REACTION?

Today's rate decision had been priced into financial markets for months, and there was little change in interest rates or equity markets following the release of the statement and updated forecasts.

Markets may have been surprised by the new forecasts for 2021, which showed slowing growth and a roughly equal number of members forecasting rate cuts as rate hikes. In fact, only a slim majority of the FOMC believes any rate hikes will be warranted beyond 2019.

> *The market reflects a nearly 50% chance the Fed will hike at least three more times by mid-2019.*

WHAT IS OUR OUTLOOK?

In the weeks leading up to this meeting, bond markets appeared to be getting the message that interest rates will be rising further in the coming quarters. The fed funds futures market now reflects a nearly 50% probability that the Fed will hike at least three more times before mid-2019. This would bring its target range close to its current estimate of the longer-run fed funds rate, often called the "neutral" rate. That seems like a convenient place for the Fed to pause for a breath or two, assuming risks to the economy don't look all that different nine months from now than they do today.

We expect inflation to remain benign—near 2%—and unemployment to hold at its current level or perhaps move a bit lower. That will justify another interest-rate increase in December and at least two more in 2019.

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Glossary

The **Federal Open Market Committee (FOMC)** holds eight regularly scheduled meetings per year to review economic and financial conditions, determine the appropriate stance of monetary policy and assess the risks to its long-run goals of price stability and sustainable economic growth.

A **basis point** is a common unit of measure for interest rates and other percentages in finance. One basis point is equal to 1/100th of 1%, or 0.01%.

Sources

Federal Reserve Statement, September 2018.

Bloomberg.

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