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The March Fed Meeting: Powell takes the mic with a hike

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WHAT HAPPENED?

The first meeting of the Jerome Powell-led Federal Open Market Committee (FOMC) ended as expected, with a 25 basis point increase in the Fed's target benchmark interest rate (the fed funds rate) and a modest upward revision to its plans for future hikes. The Fed foresees two additional rate hikes this year and slightly increased its expectation for hikes in 2019 and 2020, making the overall path steeper with a higher peak.

This more hawkish blueprint is justified by committee members' expectations for a higher mix of growth and inflation (as measured by the Fed's preferred inflation gauge, the core PCE Index) over the balance of the decade. The FOMC's statement categorized the U.S. economy as having "strengthened in recent months." However, it also acknowledged that growth in household spending and business fixed investment, which together comprise a large majority of U.S. GDP, has slowed in the first quarter. The softness in private sector data may

KEY POINTS

- On March 21, the Federal Reserve (Fed) raised the fed funds rate by 25 basis points (0.25%), to a target range of 1.50% to 1.75%. This is the first hike of 2018 and sixth of the current cycle.
- The move was widely expected, given the recent strength in employment data, small rise in inflation and significant new federal stimulus in the pipeline.
- In its accompanying statement, the Fed appeared more upbeat about the current economic expansion. Fed officials believe the unemployment rate will fall further to 3.8% this year from February's 17-year-low of 4.1%.
- The Fed's median forecast for the fed funds rate was unchanged for 2018 at 2.1%, but rose to 2.9% (from 2.7%) in 2019 and 3.4% (from 3.1%) in 2020.
- We still anticipate three more 25 basis point rate increases this year, which should not derail the current economic expansion or the equity bull market.

explain why the Fed neglected to raise its forecast for 2018 rate hikes to four from three as we expected it to.

In his first post-meeting press conference as Chair, Powell made note that fiscal stimulus and consumer confidence contributed to his positive economic outlook. He also referred to protectionist trade policies as “a low-profile risk that has become a more prominent risk to the outlook.”

WHY DOES THE FED’S ACTION MATTER?

A decision not to raise rates at this meeting would have come as a shock. Even so, today’s move is yet another reminder that the Fed’s primary aim is to raise interest rates to a more “normal” level before the economy overheats. Officials now believe the balance of risks has shifted slightly from too-low growth to too-high inflation, as the U.S. economy gathers steam and receives an additional push from fiscal policy. At its current planned pace of hikes, the Fed will reach its definition of a “neutral” target rate by the end of next year, and exceed it in 2020.

WHAT WAS THE MARKET REACTION?

It is important for any new Fed Chair to appear sure-footed from the get-go, and Powell delivered on that front. The Fed’s practice of telegraphing its policy changes has, over time, created less market volatility on FOMC meeting dates. Powell went a step further last month by suggesting in his Congressional testimony that, since December, evolving circumstances may have led to an acceleration of his personal projections for policy rate increases. This view allowed the markets to price in a steeper path of rate hikes in the median fed funds rate projection (dot plot) ahead of the March meeting.

Perhaps sensing that this tightening cycle may be steeper and longer than first anticipated stocks have been particularly jittery of late when faced with the prospect of more rate increases. This has made calibrating communication all the more delicate for the Fed. Stocks initially rose when the Fed declined to raise its forecast for 2018 hikes, but they quickly retreated from those session highs when it became clear that the overall path of rate increases has become more hawkish through 2020.

WHAT IS OUR OUTLOOK?

While the Fed currently projects only two more rate hikes in 2018, we still believe it will raise its target range three more times before year end. Household incomes and corporate profits are on the upswing, and the pass-through from a tight labor market to higher consumer prices may begin to show up later this year. But while the extra economic fuel from tax cuts and new federal spending may present a challenge for the Fed at some point, there appears to be little threat of overheating in the near term.

Despite the recent concerns in financial markets about rising interest rates, we do not think this pace of hikes, which remains gradual by historical standards, will sink the economic expansion or the equity bull market, at least not this year. Financial conditions are still loose, and growth in the rest of the world continues to pick up.

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Definitions

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%

The **core PCE price index** is defined as personal consumption expenditures prices (excluding food and energy). The index measures the prices paid by consumers for goods and services without the volatility caused by movements in food and energy prices to reveal underlying inflation trends.

Sources

Federal Reserve Statement, March 2018.

Bloomberg.

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