Scotiabank

GLOBAL ECONOMICS

SCOTIA FLASH

November 2, 2022

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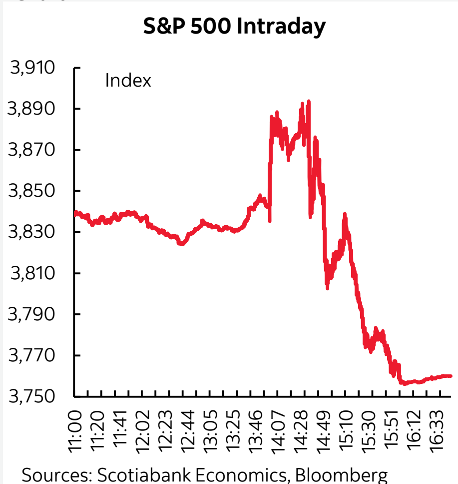
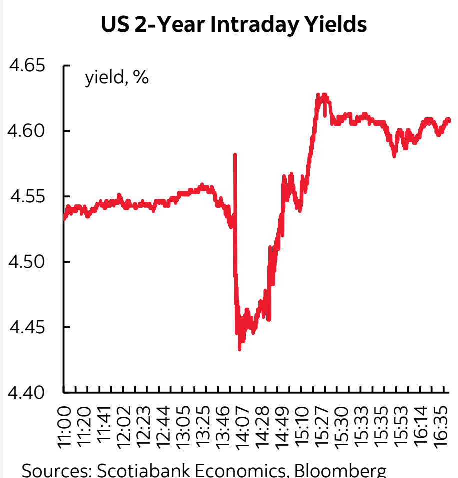
Chart 1



Sources: Scotiabank Economics, Bloomberg

Chart 2



Sources: Scotiabank Economics, Bloomberg

The Fed's Great PivNot

- **The Fed hiked 75bps with ongoing hike guidance…**
- **…and markets initially reacted dovishly to the statement…**
- **..only to reverse that reaction in the press conference…**
- **…as Powell said the terminal rate would move higher than previously thought…**
- **…and that it is "very" premature to expect a pause**

Markets took down two different sets of messages from the FOMC this afternoon. The statement reeled in the doves by largely stating the obvious to which they initially overreacted in my opinion, only to clip their wings in the press conference with two powerful comments. Markets were whipsawed by the overall communications by at first pushing yields and the dollar lower and stocks higher post-statement and then reversing those moves and then some during and after the press conference to end up with an overall hawkish interpretation. Charts 1–3 shows some of the movements in markets.

I'll review the statement changes first and then what was said during the press conference.

STATEMENT CHANGES

The statement was largely a carbon copy of the September statement as shown in the accompanying statement comparison, except for the insertion of the following part with emphasis added upon the new text:

> "The Committee anticipates that ongoing increases in the target range will be appropriate ***in order to attain a stance of monetary policy that is sufficiently restrictive to return inflation to 2 percent over time. In determining the pace of future increases in the target range, the Committee will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, and economic and financial developments."***

Yields and the dollar sank and stocks rallied when they saw reference to taking lags into account. That gave me a sense of unease in that there is nothing about this paragraph that should be particularly surprising. As the Fed approaches its terminal rate it was thought to shift toward a protracted pause in order to assess the lagging effects of policy tightening.

Furthermore, against the very small tail of dovish voices, they did not hike by less than 75bps and they did not drop rate hike guidance or aggressively signal a coming end to hikes. Why markets reacted to the statement the way they did at first is something I can't fully comprehend.

Otherwise, there were no changes to balance sheet guidance or the description of current conditions which was expected and the statement was unanimous.

THE PRESS CONFERENCE

The press conference started off reinforcing this market reaction when Chair Powell said that they will continue to tighten "purposefully" versus "expeditiously" as previously guided. That sounded a little less aggressive.

All that changed as Powell said two key things. One flagged that the terminal rate is likely higher than judged in the September dot plot. The other is that it is very premature to be thinking about or talking about pausing the Fed's rate hikes.

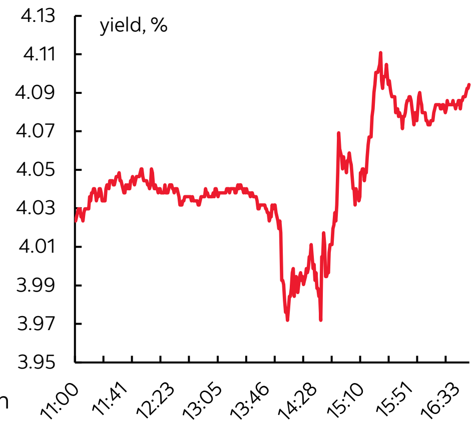
When asked whether the bias is against another 75bps increase in December in favour of slowing the pace, Powell didn't exactly shut the door on another mega move in December:

> "That time is coming and it may come as soon as the next meeting or the one after it."

When asked about how high they may go before pausing this is where things really began to change in markets:

> "On how high to raise the policy rate we are saying sufficiently restrictive in order to achieve our 2% inflation target over time. ***We think there is some ground to cover before we meet that test. We may ultimately move to higher levels than we thought at the time of the September meeting. That level is uncertain and we will find it over time.***"

Chart 3



Sources: Scotiabank Economics, Bloomberg

This was explicitly reinforced with the comment that "the ultimate level of interest rates will be higher than previously expected" and then repeating that the next dot plot will move higher than the September one. Recall that the September dot plot had equal numbers of dots by FOMC participants at 4.5%, 4.75% and 5% policy rate peaks with a median projection of 4¾% and so Powell is guiding that the median is likely to hit 5% or higher which implies there may be several participants above such a level.

Powell upped the ante even further when he said that:

> "it is very premature to be thinking about or talking about pausing our rate hikes. We have a ways to go. We need ongoing rate hikes to get to that level of sufficiently restrictive."

And so "very premature" indicates that they are likely several meetings away from tossing in the towel on rate hikes at a minimum. This probably further slants the risks to our 5% terminal rate forecast higher rather than lower.

He also rejected the notion that they have overtightened by pointing to where inflation is.

OTHER TOPICS

There were a few other more tangential matters that were touched upon.

When asked whether he has changed his assessment of whether the risk of under doing it exceeds the risks of over doing it, Chair Powell said no and because it's easier to reverse tightening later than it is to deal with the consequences of failing to get inflation under control.

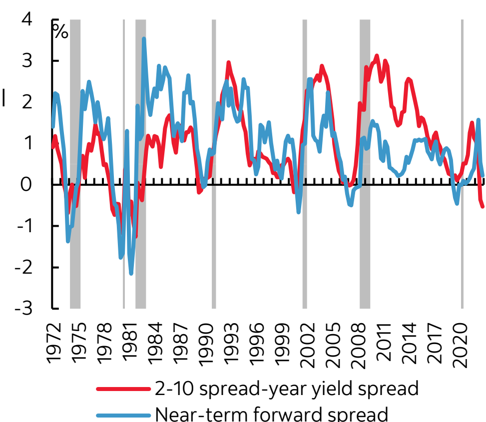
Asked whether he sees evidence that inflation is at risk of becoming entrenched, Powell hedged his arguments by saying that "Longer-term inflation expectations have moved down. We don't have a scientific way of saying at what point inflation has become entrenched. We have to use our tools to get inflation down."

Powell repeated that the window for a soft landing has narrowed but is still possible while sounding as skeptical as he did during the September press conference.

On whether owners' equivalent rent will start to put downward pressure upon inflation into 2023, Powell reminded listens that CPI captures OER and general housing measures for everyone, whereas it's important to remember that private rent measures indicate that marginal pressures may be ebbing. He noted that there is still pipeline pressure moving through rent increases.

Powell was asked whether inversion of the Fed's preferred measure of the yield curve that has turned very flat (chart 4) would still be interpreted by him as signalling a likely rate cut. His answer was that they continue to monitor this measure but that it also matters why it is inverting and emphasized its inflation signals which seemed to be an attempt to distance himself from his earlier comments.

Chart 4



Sources: Scotiabank Economics, Federal Reserve.

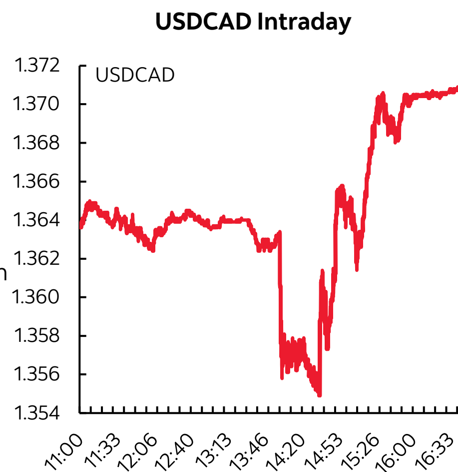
Powell was asked to revisit past comments about an overheated labour market and concluded by saying "It's not obvious there is a gradual softening" and repeating that the job market is in a state of excess demand and is "very, very strong."

He was also then asked about wage-price spiral concerns and said he doesn't see that yet but that this can tend to be recognized when it is too late.

BANK OF CANADA IMPLICATIONS

With the Fed saying it is "very premature" to think about pausing and that they will raise the estimates for the terminal rate that were provided only last month, it has the feel of positioning the Bank of Canada as having prematurely opened up a negative rate differential to the Federal Reserve if they are truly focused upon the effects on the Canadian dollar and import price pass through effects. CAD depreciated by about three-quarters of a cent to the USD by the conclusion of the communications (chart 5).

Chart 5



Sources: Scotiabank Economics, Bloomberg

RELEASE DATE: November 2, 2022

Recent indicators point to modest growth in spending and production. Job gains have been robust in recent months, and the unemployment rate has remained low. Inflation remains elevated, reflecting supply and demand imbalances related to the pandemic, higher food and energy prices, and broader price pressures.

Russia's war against Ukraine is causing tremendous human and economic hardship. The war and related events are creating additional upward pressure on inflation and are weighing on global economic activity. The Committee is highly attentive to inflation risks.

The Committee seeks to achieve maximum employment and inflation at the rate of 2 percent over the longer run. In support of these goals, the Committee decided to raise the target range for the federal funds rate to 3-3/4 to 4 percent. The Committee anticipates that ongoing increases in the target range will be appropriate ***in order to attain a stance of monetary policy that is sufficiently restrictive to return inflation to 2 percent over time. In determining the pace of future increases in the target range, the Committee will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, and economic and financial developments.*** In addition, the Committee will continue reducing its holdings of Treasury securities and agency debt and agency mortgage-backed securities, as described in the Plans for Reducing the Size of the Federal Reserve's Balance Sheet that were issued in May. The Committee is strongly committed to returning inflation to its 2 percent objective.

In assessing the appropriate stance of monetary policy, the Committee will continue to monitor the implications of incoming information for the economic outlook. The Committee would be prepared to adjust the stance of monetary policy as appropriate if risks emerge that could impede the attainment of the Committee's goals. The Committee's assessments will take into account a wide range of information, including readings on public health, labor market conditions, inflation pressures and inflation expectations, and financial and international developments.

Voting for the monetary policy action were Jerome H. Powell, Chair; John C. Williams, Vice Chair; Michael S. Barr; Michelle W. Bowman; Lael Brainard; James Bullard; Susan M. Collins; Lisa D. Cook; Esther L. George; Philip N. Jefferson; Loretta J. Mester; and Christopher J. Waller.

RELEASE DATE: September 21, 2022

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Russia's war against Ukraine is causing tremendous human and economic hardship. The war and related events are creating additional upward pressure on inflation and are weighing on global economic activity. The Committee is highly attentive to inflation risks.

The Committee seeks to achieve maximum employment and inflation at the rate of 2 percent over the longer run. In support of these goals, the Committee decided to raise the target range for the federal funds rate to 3 to 3-1/4 percent and anticipates that ongoing increases in the target range will be appropriate. In addition, the Committee will continue reducing its holdings of Treasury securities and agency debt and agency mortgage-backed securities, as described in the Plans for Reducing the Size of the Federal Reserve's Balance Sheet that were issued in May. The Committee is strongly committed to returning inflation to its 2 percent objective.

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