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75 but not so sunny for the September FOMC

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- Following Jackson Hole, we noted that Chair Powell's speech indicated his preference for another 75bp rate increase at the September FOMC meeting (see "Powell predicts "some pain" along path to price stability"). With recent Fedspeak echoing these hawkish comments and incoming data doing nothing to dissuade officials from another super-sized hike, we expect the Fed to deliver a third 75bp increase at the September FOMC meeting.
- Further out, we maintain the contours of our existing monetary policy view. In particular, we continue to expect the Fed to downshift to 50bps in November and further to 25bps in December. We also continue to expect a terminal rate of 4.1% in early 2023, though with a 75bp hike in September this peak would be pulled forward to the February meeting.
- Inflation failing to ease along the timeline we anticipate could well require a higher peak rate during this cycle. Either way, we continue to expect that the achievement of the Fed's 2% inflation objective is likely to only come from a recession around mid-2023 triggered by the Fed's aggressive tightening.

75 but not so sunny for the September FOMC

Following Jackson Hole, we noted that Chair Powell's speech indicated his preference for another 75bp rate increase at the September FOMC meeting (see "Powell predicts "some pain" along path to price stability"). In particular, by stating "at some point, as the stance of monetary policy tightens further, it likely will become appropriate to slow the pace of increases", the Chair implied that this was not the point. Since that speech, Powell's colleagues have broadly echoed a similar hawkish message that has emphasized their commitment to do what it takes to tame inflation. Indeed, some dovish-leaning officials that previously preferred downshifting in September recently expressed greater openness to another jumbo hike (e.g., Chicago's Evans). Moreover, recent data have done nothing to dissuade the Fed from undertaking another 75bp increase. Recent labor market data continue to show elevated labor demand and a very tight labor market that continues to produce solid job gains without clear progress towards correcting "unhealthy" imbalances. While the August CPI report has the potential to impact the September decision, it would likely require a surprisingly large downside miss to push the Committee towards a smaller rate increase. Indeed, our expectations for a +0.3% August core CPI would have the year-over-year rate tick up a tenth to 6.0%.

With this backdrop, we expect the Fed to follow through on recent communications and deliver another 75bp increase at the September FOMC meeting. This would also be consistent with market expectations, thus affirming the market's perception of the Fed's reaction function. Further out, we maintain the contours of our existing monetary policy view. In particular, we continue to expect the Fed to downshift to 50bps in November and further to 25bps in December. This decelerating path will require clear evidence that inflation has downshifted and that the labor market has begun to loosen. While our base case anticipates these conditions will be in place, failure to meet these conditions could easily lead to another 50bp rate increase in December.

Beyond these data requirements, we have also begun to hear some dovish arguments emerge from Fed officials that could gain greater prominence by the end of the year as long as the inflation data allow. For example, Governor Brainard recently indicated that two-sided risks will emerge at some point in this tightening cycle – an argument heard in the minutes to the July FOMC meeting -- as she focused on a number of reasons for inflation to moderate. Chicago Fed President Evans recently argued that over-tightening risks could rise as the fed funds rate moves beyond 3.5%. And several officials, including Chair Powell at the July FOMC meeting, have noted that the typical lags in monetary policy will continue to exert a drag on the economy well into next year, an important consideration for a Committee that has recently delivered the sharpest tightening since Volcker (see "DB shadow fed funds rate hit 4%").

We also continue to expect the fed funds rate to peak at 4.1% in early 2023, though with a 75bp hike in September this timing would get pushed forward to the February meeting. With our inflation forecasts moderating recently, additional front loading of hikes does not necessarily need to be matched with a higher terminal rate. For example, Cleveland Fed President Mester indicated that she would like to see the fed funds rate somewhere north of 50bps above year-ahead inflation projections, consistent with our existing view. In addition, the global backdrop has deteriorated recently, particularly with energy concerns in Europe (see "Germany Blog: NS1 shutoff – a deeper recession in 2023"). Directionally, this should weigh on inflation both through the drag from a stronger dollar and the potential for softer external demand.

However, failure for inflation to ease along the timeline we anticipate or positive developments on the global geopolitics front could well require a higher peak rate during this cycle. Either way, we continue to expect that the achievement of the Fed's 2% inflation objective is likely to only come from a recession around mid-2023 triggered by the Fed's aggressive tightening.

Appendix 1

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