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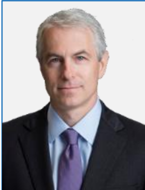
A Close VIEW

June FOMC Meeting: Short-Term Surprise, Long-Term Benefits

JUNE 20, 2021



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Communications at the June FOMC meeting were more hawkish than the market expected, but align with our own thinking on the likely path of policy rates. The shift in tone may ultimately prove beneficial: By demonstrating sensitivity to upside inflation risks, the Committee can more firmly anchor long-run inflation expectations at its two percent objective, limiting the need for sharper policy responses down the road. Meanwhile, financial and monetary conditions should remain accommodative for quite some time. Accordingly, portfolio positioning continues to balance evolving economic conditions with current valuations that reflect a healthy fundamental backdrop but with less margin for error.

Last week's FOMC meeting represented a fairly hawkish shift in the monetary policy outlook relative to market expectations. Before the meeting, the investment community generally expected the Committee to revise its economic projections to reflect stronger growth and higher inflation this year, but make limited revisions for 2022 and 2023. Most market debate centered on whether any upward revision to inflation projections for those years would lead the median Committee participant to raise their policy rate projection to reflect a single 25-basis point rate hike in 2023. Instead, the median projection for the policy rate at the end of 2023 was revised higher by 50 basis points, with now 13 Committee members expecting a rate increase in 2023, compared to just seven in the March projections. A number of Committee participants also shifted their projections to show the start of tightening occurring next year, although not enough to move the median.

The Committee's new projections are closely aligned with our own thinking. For some time now, we have been forecasting that policy tightening would start in 2023, given our view that it will take two more years for the economy to reach maximum employment. Still, we find the new projections noteworthy because the upward revision to interest rate projections was sizable relative to changes in the Committee's projections for growth, inflation and the unemployment rate, as seen in Figure 1. There are a few lessons for this apparent discrepancy.

FIGURE 1: MEDIAN COMMITTEE ECONOMIC PROJECTIONS, JUNE 2021

	Median		
Variable	2021	2022	2023
CHANGES IN REAL GDP	7.0	3.3	2.4
MARCH PROJECTION	6.5	3.3	2.2
UNEMPLOYMENT RATE	4.5	3.8	3.5
MARCH PROJECTION	4.5	3.9	3.5
PCE INFLATION	3.4	2.1	2.2
MARCH PROJECTION	2.4	2.0	2.1
CORE PCE INFLATION	3.0	2.1	2.1
MARCH PROJECTION	2.2	2.0	2.1
FEDERAL FUNDS RATE	0.1	0.1	0.6
MARCH PROJECTION	0.1	0.1	0.1

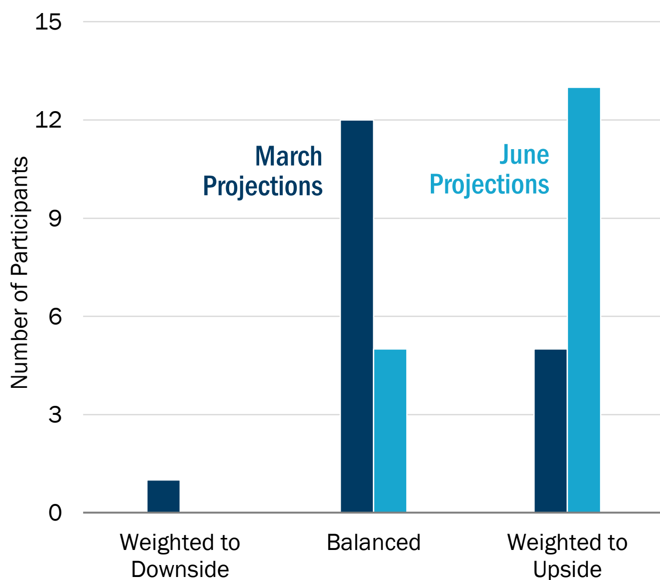
Source: "Summary of Economic Projections," Board of Governors of the Federal Reserve System, June 2021.

First, the Committee may be less tolerant of inflation above its objective than the market had thought. Since moving to Flexible Average Inflation Targeting (FAIT) last fall, the Committee has stated it would not increase the policy rate until the economy reaches maximum employment and "inflation has risen to 2 percent and is on track to moderately exceed 2 percent for some time." Judging by the new projections, inflation of 2.1 to 2.2 percent over 2022 and 2023 meets this definition of a moderate inflation overshoot. We suspect that this is a lower inflation threshold than investors anticipated. For example, in a recent Federal Reserve Bank of New York

survey of market participants, the median respondent anticipated a 2.3 percent headline PCE inflation rate at time of liftoff, and the 25th and 75th percentile responses were for inflation of 2.2 and 2.5 percent, respectively.[1]

Second, the Committee's projections likely reflect risk management considerations. While the Committee anticipates that inflation will settle in the 2.1 to 2.2 percent range once transitory prices pressures wane, strong aggregate demand and a tightening labor market increase the odds of inflation winding up even higher. In the Q&A portion of his post-meeting press briefing, Chair Powell acknowledged that such considerations can impact Committee participants' projections for appropriate policy. Note, too, that participants' assessment of inflation risks around their base-case projections have shifted significantly to the upside since March, as Figure 2 shows.

FIGURE 2: PARTICIPANTS' ASSESSMENT OF RISKS AROUND THEIR INFLATION PROJECTIONS



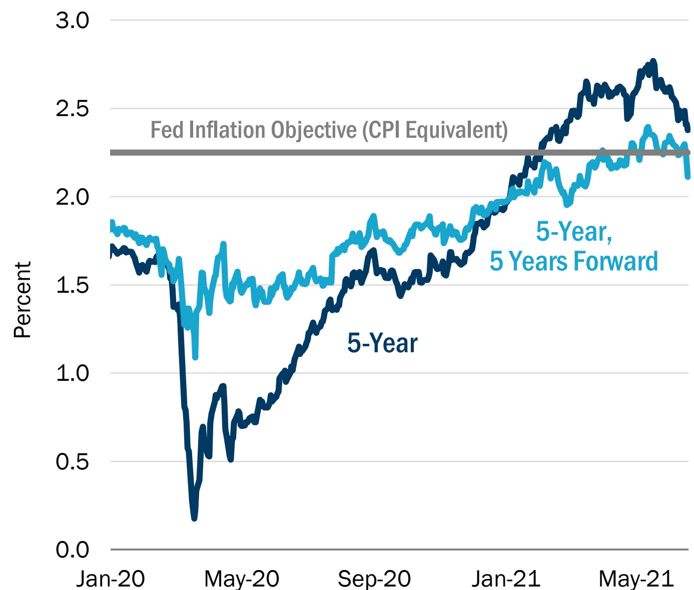
Source: "Summary of Economic Projections," Board of Governors of the Federal Reserve System, June 2021.

Greater clarity about the FOMC's tolerance for inflation above two percent, along with the Committee's incorporation of risk-management considerations in its policy projections, have led to a modest tightening of financial conditions since the meeting – higher real Treasury yields, lower stock prices and US dollar appreciation against a wide range of currencies. But over time, the FOMC's new stance may prove beneficial to the economy. By projecting rate increases in 2023 with inflation just moderately above two percent, the Committee's communications reinforce its inflation-fighting credentials and ensure that long-run inflation expectations remain well-anchored near its two percent objective. This reduces the risk that it will have to make sharper policy adjustments down the road to re-anchor expectations. Meanwhile, the policy stance remains highly accommodative, with no softening of the commitment to keep the policy rate at its effective lower bound until maximum employment conditions are achieved.

At the same time, there are risks related to the FOMC's communications. The Committee has opted for a flexible version of average inflation targeting, with no specific rule for balancing prior periods of weak inflation with stronger inflation outcomes in the future. In opting for discretion, the Committee runs the risk of diminishing the new strategy's usefulness. For example, some market observers may view the June FOMC communications as an overreaction to the recent (and likely transitory) surge in inflation, and a weak commitment to engineering a sustained inflation overshoot. Indeed, during the press briefing Powell was asked if there is much practical difference between FAIT and the Committee's prior strategy.

But we do not think recent communications will meaningfully dilute the effectiveness of FAIT. All FOMC participants have signed on to the new strategy; any movement away from the strategy would represent a significant blow to the Committee's credibility. FOMC participants are acutely aware of this. In addition, we see no lessening of the Committee's commitment to achieving maximum employment and the benefits it can bring to low-and moderate-income communities. That "broad-based and inclusive goal," as the Committee's strategy statement puts it, remains a good ways off.[2] And that remains the main message from the Committee's communications: Policymakers have grown more optimistic about the outlook and while they may be more attuned to rising inflation risks, in all likelihood the days of tighter policy are still far in the future.

FIGURE 3: INFLATION BREAKEVENS DERIVED FROM TIPS AND NOMINAL TREASURY SECURITIES



Source: Bloomberg

1. "Responses to the Survey of Market Participants," Federal Reserve Bank of New York, March 2021.
2. "Statement on Longer-Run Goals and Monetary Policy Strategy," Board of Governors of the Federal Reserve System, January 2021.

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