MACRO RESEARCH

A Close VIEW

Markets are Still Not Pricing in Enough Monetary Policy Tightening

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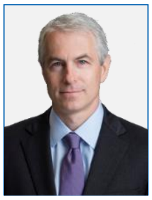

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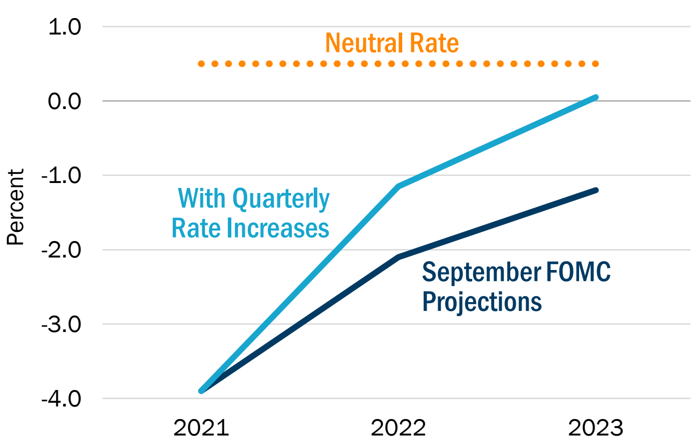
An accelerated tapering of asset purchases gives the FOMC the option of three to four quarterly policy rate increases next year. A steady dose of rate increases would reflect the Committee's growing focus on the risk that inflation pressures may persist. But despite the pivot on tapering and the Committee's emphasis on inflation risks, markets continue to price an overly shallow path for policy rates over the next few years.

The last few weeks have seen a remarkable pivot by Federal Reserve policy-makers. Just a month after announcing a pace of asset purchase reductions that would wind down quantitative easing by the middle of next year, several FOMC participants across the hawk-dove spectrum have raised the idea of speeding up the tapering process. Chair Powell essentially removed all doubt about the Committee's intentions during his November 30 testimony to the Senate Banking Committee, commenting that it is "appropriate to consider wrapping up the taper of our asset purchases . . . perhaps a few months earlier."

FIGURE 1: PROJECTED REAL POLICY RATE PATHS



Source: Board of Governors of the Federal Reserve System, Federal Reserve Bank of New York, MacKay Shields

The Committee now appears intent on ending asset purchases by the end of the first quarter, which would give them the option of three or four quarterly policy rate increases next year. At the latest, the Committee will likely begin raising rates by the June meeting, and a March liftoff for the policy rate is a very real possibility.

In fact, given what is motivating the Committee's pivot on tapering, a March liftoff looks increasingly likely. Specifically, the Committee is facing the reality that the policy rate remains far below a neutral setting at a time when inflation expectations have firmed meaningfully, inflation pressures have broadened out, and the labor market looks sets to remain tight for the foreseeable future.

The Committee has plenty of catching-up to do. Figure 1 shows two paths for the policy rate through the end of 2023. One path uses the median FOMC participant's projected rate path as published at the time of the September Committee meeting. The other assumes quarterly policy rate increases of 25 basis points throughout 2022 and 2023. Both rate paths are depicted in real terms, net of core PCE inflation forecasts from the Federal Reserve Bank of New York's November Survey of Primary Dealers.[1] Even with quarterly rate increases over the next two years, the real policy rate would barely exceed zero by the end of 2023. Arguably, this would still be an accommodative policy setting: after subtracting out the Committee's inflation objective, the median FOMC

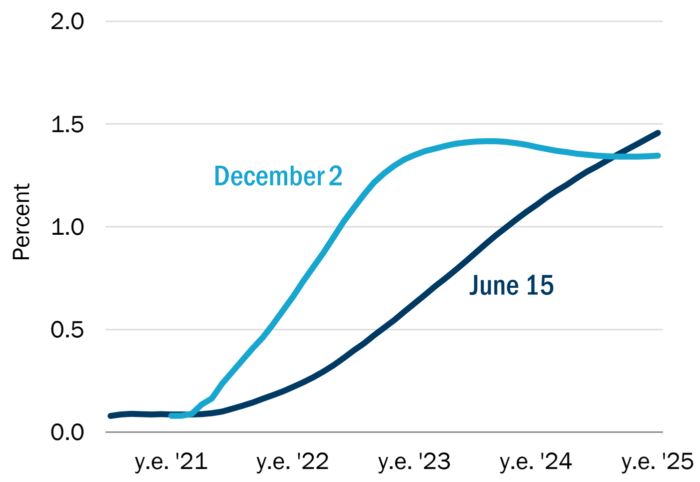
1. I use the Primary Dealer inflation forecasts rather than the FOMC's as they are more recent, and the FOMC is likely to raise its inflation projections in its next set of projections, to be released after this month's FOMC meeting. The median Primary Dealer Q4/Q4 inflation forecasts for 2021, 2022 and 2023 are 4.0%, 2.4% and 2.2%.

participant's 2.5% estimate for the longer run federal funds rate suggests a neutral real policy rate of fifty basis points.

The implication is that quarterly interest rate increases over the next two years might be the bare minimum required to position monetary policy for the risk that inflation remains well above the Committee's two percent inflation objective. This is especially the case given the lags with which changes in monetary policy affect the economy. In addition, monetary policy works not just through short-term interest rates, but through its effect on broader financial conditions, including the level of long-term interest rates, credit spreads, equity prices and the exchange value of the dollar. Recent history contains a number of examples where modest and predictable interest rate increases did little to tighten financial conditions.[2] Thus a faster pace of rate increases might eventually be needed to bring about a broader tightening in financial conditions.

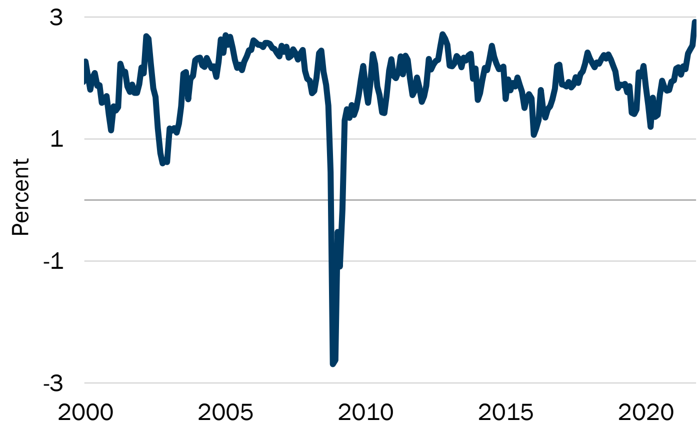
Money markets now discount liftoff around the middle of next year, but still underprice the likely path of rates thereafter. As seen in Figure 2, since policy communications first began to tilt in a more hawkish direction at the June FOMC meeting, the forward overnight indexed swap (OIS) curve has priced a higher path for rates over the next two years. But the market-implied rate path remains far short of what is required to return policy to a neutral setting over that horizon. In addition, the market-implied rate path discounts no additional rate increases beyond mid-2023, suggesting a negative real policy rate for years to come. In addition, compared to the OIS curve in mid-June, the curve currently suggests that more tightening in the near term could lead to less tightening down the road.

FIGURE 2: FORWARD 1-MONTH OIS RATES



Source: Bloomberg, MacKay Shields

FIGURE 3: 1-YEAR INFLATION BREAKEVEN, 4 YEARS FORWARD



Source: Bloomberg, MacKay Shields. Through November 30, 2021.

The current shape of the OIS curve is difficult to square with surveys that suggest expectations for firm inflation over the next several years, results which would presumably lead to a much higher path for policy rates. A few explanations come to mind. One possibility is that market prices reflect a broad range of investor views, and investors expectations might be skewed toward lower inflation outcomes in the years ahead. But prices for nominal and inflation-protected Treasury securities suggest that investors increasingly require greater compensation for inflation several years in the future (Figure 3).

A second possibility is that investors strongly anchor their policy expectations to the Committee's quarterly projections. Thus even if market expectations are rising, they may not drift much above the Committee's projections. If this is the case, forthcoming revisions to the Committee's projections, including at the December meeting, could open the door for further market repricing of the rate path.

A third possibility is that on average, market participants judge the neutral policy rate to be far lower than the median Committee participant's estimate of 2.5 percent. There is some survey evidence that market participants indeed have a lower estimate of neutral.[3] This lower estimate of the neutral rate may reflect a pessimistic assessment of trend growth, or perhaps a view that economic or market fragilities will eventually lead the FOMC to halt rate increases early.[4] Still, at the end of the day, if the Committee believes that the neutral rate is over two percent, it is very likely to aim for this level so long as it remains focused on the risk of stubbornly high inflation. And markets remain far off from pricing in this path for policy.

2. Most of the 2004–2006 period saw very accommodative financial conditions, despite a steady dose of policy rate increases. Similar conditions prevailed for much of 2016 and 2017, during the prior tightening cycle.
3. Committee participants' estimates of the "longer run" or neutral Federal funds rate range from two to three percent, with a median of 2.5 percent. In contrast, the median respondent to the Federal Reserve Bank of New York's November survey of market participants submitted a longer run policy rate estimate of 2.0 percent. The 25th and 75th percentile submissions were 1.75 and 2.5 percent, respectively.
4. Another possibility is that investors believe the Committee will eventually set aside its commitment to two percent inflation, accepting elevated inflation in exchange for stronger growth and an even tighter labor market. However, this explanation is not consistent with generally well-anchored long-term inflation expectations, and the recent flattening of the yield curve. Chair Powell has also made the comment that achieving maximum employment on a sustainable basis requires adherence to the current price stability objective.