Fed Hawks Hatch

June 17, 2021

by Brian Wesbury, Robert Stein
of First Trust Advisors

As expected, the Federal Reserve made no significant changes to monetary policy today. However, the Fed took some big steps toward laying the groundwork for changes to policy it will make in the future.

When it comes to short-term interest rates, the "dot plot" from the Fed now shows seven policymakers in favor of at least one 25 basis point rate hike in 2022, up from only four policymakers back in March. While those seven are still a minority of Fed policymakers, that was not the case for the following year. For 2023, a majority of policymakers – thirteen of eighteen – think the Fed will raise interest rates versus only seven of eighteen back in March. Moreover, the "median dot" now suggests the Fed would raise rates twice (for a total of 50 bp) in 2023.

In addition, according to Chairman Jerome Powell, the Fed is now officially "talking about talking" about tapering its balance sheet purchases. For the time being it will keep buying a total of $120 billion in Treasury and mortgage securities per month and Powell made it clear at the press conference that the Fed will only start tapering after it provides notice "as far in advance as possible." We think that notice will be provided by this Fall, with tapering starting by the beginning of 2022, maybe sooner.

These changes by the Fed, its willingness to signal some rate hikes in 2023 and to talk more openly about the possibility of tapering, are consistent with some changes to its economic forecast, which showed upward revisions to its projections for both real economic growth and inflation for 2021. The Fed lifted its real GDP forecast for this year to 7.0% (previously 6.5%) and its PCE inflation forecast to 3.4% (previously 2.4%). Forecasts for other years were little changed.

In terms of the Fed statement, policymakers made the language more optimistic by deleting some older stale wording about "tremendous human and economic hardship" as well as the "ongoing" public health crisis.

In addition, the Fed made some changes that hinted at problems with all the liquidity in the financial system, including lifting the interest rate it pays banks on reserves to 0.15% (previously 0.10%). The Fed said the goal was to help it keep trading in the federal funds market near the Fed's target for short-term rates. But we think the goal is to make it more attractive for banks to hold cash, given that, in the current environment, with massive liquidity swirling around the financial system, when banks hold more cash they have a greater risk of running afoul of regulatory guidelines.
