Fed Policy: Patience Is a Virtue

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Following its March meeting, the Federal Open Market Committee (FOMC) released a statement and summary of economic projections (SEP). Meaningful upgrades to the Fed's real U.S. GDP growth forecasts translated into only modest upward revisions to the medium-term core inflation forecasts and no change to the projected median policy rate path.

In our view, these changes illustrate the Fed's commitment to its new monetary policy strategy. Before hiking interest rates, FOMC members want to see an inclusive recovery: A 3.5% unemployment rate by itself isn't sufficient to hike rates, and actual and sustainable inflation above 2% is necessary. The Fed's messaging also clearly indicates that inflationary pressures that may develop in 2021 (resulting from shipping bottlenecks or other temporary factors) will not be enough for the Fed to hike rates.

All of this should help keep inflation expectations anchored, and could have the added benefit of further limiting longer-term scarring in the economy.

A brighter outlook

Since December 2020, several developments led Fed officials to upgrade their economic outlooks: positive economic data, encouraging health trends (COVID-19 vaccinations, caseloads, and hospitalizations) leading to fewer restrictions, and most importantly, the surge in federal spending on COVID-19 relief. The Fed's median 2021 real GDP forecast rose to 6.5% (versus 4.2% projected in December), and the unemployment rate forecast was revised down to 4.5% for 2021. Upgrades to the 2022–2023 projections were more modest, but we note the FOMC forecasts the unemployment rate will reach its pre-pandemic level by the end of 2023.

The Fed's revised growth outlook did not translate into a large upward revision to their expected path of inflation. (For details on the factors we think will keep inflation in check, please read our February blog post.) Nonetheless, the median forecast did include a small inflation overshoot (to an annualized rate of 2.1%) beyond the Fed's 2% target projected in 2023. (The Fed's preferred inflation measure is PCE – personal consumption expenditures.) The Fed acknowledged the possibility of temporarily higher inflation this year due to the speed of the recovery, relatively low consumer goods inventories, and global freight bottlenecks. However, it also confirmed that it will not tighten monetary policy in reaction to that. Consistent with this, in recent speeches, the FOMC leadership has emphasized secular disinflationary pressures, including advances in technology and the flatness of the Phillips curve, to explain why market participants shouldn't assume the Fed will be quick to hike interest rates in response to incipient inflation signals.

Despite the brighter economic outlook, the median fed funds rate expectation for 2023 remained unchanged at 0.125%. Several members revised higher their rate projections; however, a majority of the FOMC still expects it will be appropriate for the fed funds rate to remain at the effective lower bound through 2023.

Monetary policy: Why rush?

Consistent with its new monetary policy strategy, the Fed's projections confirm that merely projecting economic outcomes is not enough to change the stance of monetary policy. Unlike past cycles, when it started hiking rates in *anticipation* of higher inflation, the Fed now sees greater potential benefits to the economy of waiting to see actual inflation sustainably achieve its target.

Last year, the Fed revised its longer-term monetary policy strategy to focus on a more inclusive measure of maximum employment. The Fed considers a broad array of statistics – including female labor force participation, minority unemployment, and the real wage growth of low-income jobs – to gauge when maximum employment is actually reached. Wednesday's SEP suggests that the published unemployment rate may decline below the 3.5% pre-pandemic level before this occurs, and it appears Fed officials fully expect to push the labor market as far as they can to ensure inflation sustainably hits their 2% long-run

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goal. According to PIMCO forecasts, these goals won’t be reached until mid to late 2023 at the earliest.

More dovish than the market

The distribution of the FOMC forecasts for interest rates shifted higher, but it was still well short of current market pricing. As a result, this SEP should help anchor rate expectations, and limit the extent to which the market prematurely or excessively tightens financial conditions. Despite the rise in rates over the last few months, a broader measure of financial conditions – which includes equities, the U.S. dollar, and credit spreads – suggests that financial conditions haven’t materially tightened, in our view. And although we expect financial conditions to gradually tighten as the U.S. economy continues to recover, the FOMC would want to limit overshoots so as not to inhibit the recovery today.

Fed balance sheet: No taper talk until June at least

In his press conference, Fed Chair Jerome Powell didn’t provide many details on the Fed’s asset purchase programs, including when they are likely to begin to slow. Instead, he said it was “not yet” time to talk about tapering. Perhaps at the June 2021 meeting, the FOMC will begin discussing the details for winding down the programs. Until then, we believe the FOMC wants to ensure monetary conditions remain accommodative so that the economy can make substantial progress.

Key takeaways

The communications coming out of the March FOMC meeting reiterated the Fed’s commitment its new monetary policy framework, and should help anchor interest rates (including market pricing of the rate path) and limit excessive tightening in financial conditions. And while we think some tightening in conditions is consistent with the improving economy, we believe that the Fed’s messages have so far been effective in limiting an unwelcome overshoot.

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