US Daily: December FOMC Recap: Hawkish Signals Point to March Liftoff and Earlier Start to Balance Sheet Runoff (Mericle/Hatzius)

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- Two surprises from the December FOMC meeting reinforced our relatively hawkish Fed views. First, the FOMC revised its statement to drop its previous intention to maintain an accommodative policy stance in order to keep inflation above 2 percent for some time. This implies that the goals of the new average inflation targeting framework have been met, and that the reaction function will look more traditional and prescribe a steadier pace of tightening. Second, Chair Powell sounded hawkish on inflation and the labor market, suggesting that he might conclude that the maximum employment requirement for liftoff has been met even earlier than we thought.
- We continue to expect three rate hikes in 2022. We have pulled forward our forecast of the timing of liftoff slightly from May to March, though we see it as a close call, and we expect this to be followed by hikes in June and September. In light of this slightly earlier timing of hikes and Powell's comments about balance sheet runoff, we now expect that runoff will begin in 2022Q4 (vs. 2023H1 previously) and will substitute for a hike that quarter, though that is not assured.
- We also continue to expect a terminal rate of 2.5-2.75%, though we now expect the FOMC to get there a bit more quickly with three hikes per year in 2023 and 2024 (vs. two previously). We had inferred from the September dots that the Fed leadership envisioned hiking two times per year for reasons related to the new framework, but the changes to the statement imply that the framework is no longer a reason for a slow pace. We forecast three hikes per year instead of last cycle's default pace of four because we continue to expect growth and inflation to moderate by the end of 2022, which should reduce the urgency to raise the funds rate. Our medium-term Fed call was already more hawkish than market pricing, and these changes have widened the gap.

December FOMC Recap: Hawkish Signals Point to March Liftoff and Earlier Start to Balance Sheet Runoff

Two surprises from the December FOMC meeting yesterday reinforced our relatively hawkish Fed views.

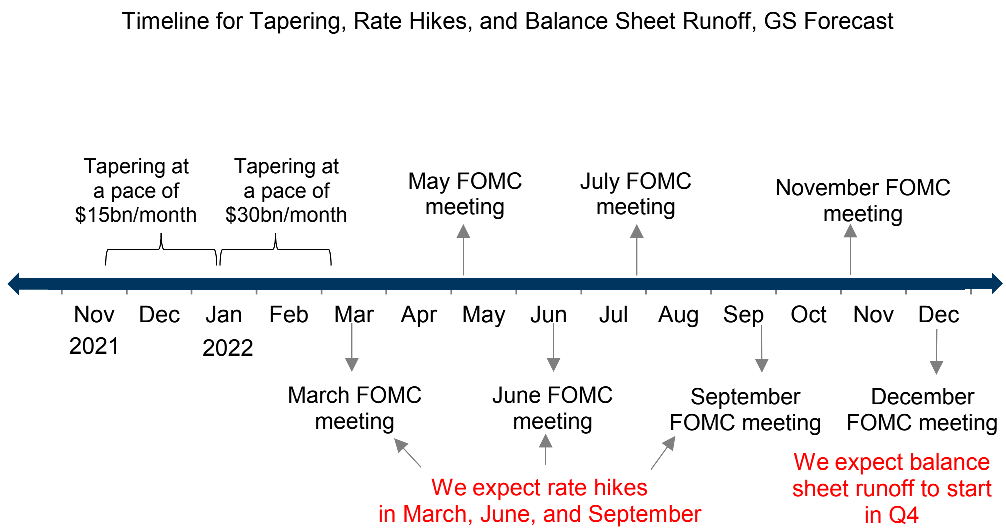
First, the FOMC revised its post-meeting statement to remove language stating that "With inflation having run persistently below [2 percent] ... the Committee will aim to achieve inflation moderately above 2 percent for some time so that inflation averages 2 percent over time and longer-term inflation expectations remain well anchored at 2 percent. The Committee expects to maintain an accommodative stance of monetary policy until these outcomes are achieved." We warned in recent FOMC previews that this language was outdated, but we were unsure how substantially the FOMC would revise it. The change implies that the FOMC now views the goals of the new average inflation targeting framework as having been met, and that there is therefore no further need to keep policy accommodative in order to aim for inflation above 2% this cycle. This suggests that the reaction function will look more traditional going forward and will prescribe a steadier pace of tightening toward neutral.

Second, Chair Powell sounded hawkish on inflation and the labor market. On inflation, Powell said that there's a "real risk" that "inflation may be more persistent and that may be putting inflation expectations under pressure, and that the risk of higher inflation becoming entrenched has increased." He also expressed concern that elevated wage and rent growth and future virus waves could add further to inflationary pressure. On the labor market, Powell noted that indicators such as wage growth and the quit rate suggest that the labor market is very tight. He emphasized that the participation rate is depressed for many reasons but not because of a lack of stimulus and job opportunities—a key argument that we made for an earlier liftoff—and said that "the maximum level of employment that's consistent with price stability evolves over time." These comments suggest that he might conclude that the maximum employment requirement for liftoff has been met even a bit earlier than we thought.

We continue to expect three rate hikes in 2022. We have pulled forward our forecast of the timing of liftoff slightly from May to March, though we see it as a close call. We continue to expect inflation to get worse before it gets better, and the FOMC will likely be as concerned, or more concerned, in March relative to today. The leadership will surely want to show that it is responding in some way at the March meeting, though this could be either a rate hike or a hint in the statement that a hike in coming at the next meeting in May. We expect additional hikes in June and September.

In light of this slightly earlier timing of hikes and Powell's comment that differences with the economic situation last cycle could influence thinking about balance sheet policy, we now expect runoff to begin in 2022Q4 (vs. 2023H1 previously). We noted recently in a report on balance sheet runoff that it began last cycle when normalization of the funds rate was "well under way," which meant four hikes then but might mean three this cycle because the FOMC's neutral rate estimate is now lower. We could even imagine runoff starting after just one or two hikes. We assume that runoff will substitute for a hike in whichever quarter it begins, but that is not assured. If liftoff does not come until May, the FOMC might be a bit more likely to announce the start of runoff between hikes and still hike three times next year.

Exhibit 1: We Now Expect Hikes in March, June, and September 2022 and Balance Sheet Runoff in Q4



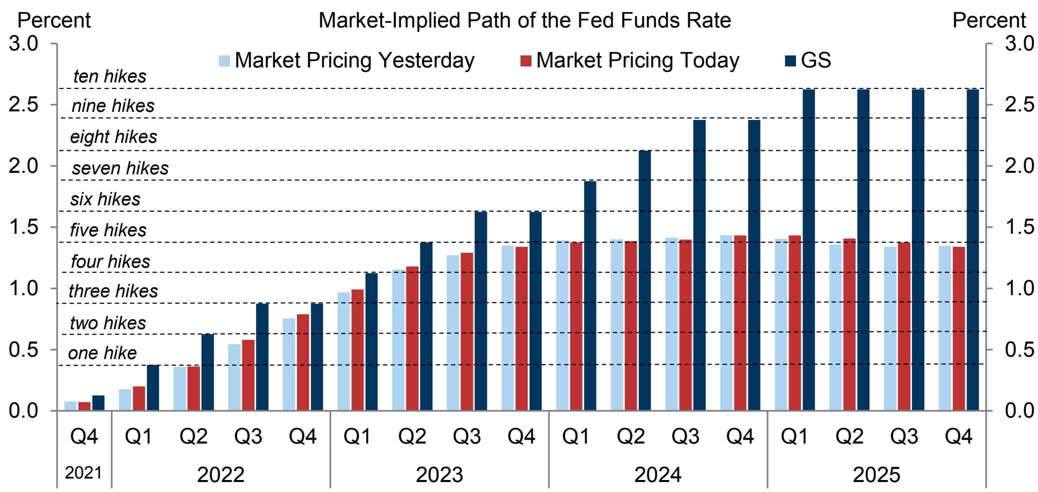
Source: Goldman Sachs Global Investment Research

We continue to see a terminal funds rate of 2.5-2.75%, though we now expect the FOMC to get there a bit more quickly with three hikes per year in 2023 and 2024 (vs. two previously). We had inferred from the September dots that Chair Powell and Governor Brainard expected just two hikes per year down the road in an environment where inflation is at or moderately above 2%, a slow pace that we assumed reflected considerations related to the Fed's new framework. We were not sure if they still took that view, and we noted that many other participants did not. In light of the changes to the December statement, it seems clear that the FOMC no longer sees the new framework as calling for a slow pace. We are also struck that a large majority, 16 out of 18 participants, expect at least 3 hikes in 2023.

Why three hikes per year instead of a steadier once-a-quarter pace? The main reason is that we continue to expect that over the course of 2022, growth will slow to only modestly above the economy's potential growth rate and inflation will fall to more comfortable levels. This should reduce the urgency to get on with raising the funds rate, and we are therefore penciling in occasional one-quarter pauses to allow for periods when the data come in a bit softer. A second reason is that new appointments to the FOMC are likely to tilt the committee in a slightly more dovish direction next year. Finally, Powell seemed to imply that uncertainty about the neutral rate led the Fed to hike a bit too much last cycle, and this could lead the FOMC to tread more carefully once the funds rate reaches a higher level.

Our medium-term Fed call was already more hawkish than market pricing before yesterday's meeting, and the changes we have made widen the gap. Exhibit 2 shows that market pricing moved up only modestly yesterday. As Chair Powell noted, the flatness of the curve in 2024 and beyond might reflect spillover effects from foreign bond markets or other factors distinct from monetary policy expectations. But in any case, we expect the Fed to ultimately tighten substantially more than is currently priced.

Exhibit 2: Our Fed Forecast Is Now Well Above Market Pricing



Source: Goldman Sachs Global Investment Research

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