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Fed's downshift suggests rapid tightening cycle is nearing an end

- Today's 25 bp hike is the smallest since tightening cycle began last March
- Slower pace casts doubt on above-5% terminal fed funds rate
- Powell says "disinflationary process has started" but "the job is not fully done"

What did the Fed do today?

It raised the fed funds target range by 25 bps to 4.50-4.75%, a smaller increase than December's 50 bp hike and the first 'normal-sized' move since the tightening cycle kicked off last March. Today's downshift was widely expected after a number of FOMC speakers came out in favour of a slower pace of rate hikes. The policy statement featured more changes than at recent meetings, acknowledging that "inflation has eased somewhat but remains elevated" and removing reference to some of the key drivers of inflation. Guidance that "ongoing" rate increases will be appropriate was unchanged though the statement now references the "extent" (rather than "pace") of further hikes, suggesting 25 bps should be the default going forward. The Fed didn't update its economic projections, so December's forecasts and dot plot are still the latest.

Why the downshift?

Key economic indicators like GDP, payrolls and unemployment have remained firm, and comments on the macro backdrop at the beginning of today's policy statement were unchanged. But a slew of other data, from consumer spending and housing to industrial production and business surveys, point to a slowdown in economic activity as the impact of past rate hikes continues to build. Wage growth appears to have peaked despite persistent labour market tightness, and inflation is moving in the right direction. The recent pace of increase (3-month annualized) in both headline and core PCE deflators suggests clear downside risk to the Fed's 2023 inflation forecasts, which were puzzlingly revised higher in December. Chair Powell noted that "the disinflationary process has started"—in fact he referenced "disinflation" 13 times in his press conference, by our count—but that there's still work to do.

Is the tightening cycle almost done?

Today's statement continues to make clear that the Fed isn't done yet, and December's dot plot showed the vast majority of FOMC participants (17 of 19) thought fed funds would have to rise above 5% this year. But at a slower 25 bp pace that

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would mean the Fed continuing to hike through early-May, an unlikely prospect if the economic outlook softens further and inflation continues to moderate as we expect. Chair Powell offered much less pushback against market pricing (for a sub-5% terminal rate and cuts in H2/23) than at recent meetings, saying divergence relative to the Fed's dot plot reflected the market's assumption that inflation will come down faster than the Fed has assumed. We're on the side of the market, expecting a 25 bp hike in March will be the last of this tightening cycle, leaving terminal fed funds at 4.75-5.00%. Our forecast assumes 50 bps of rate cuts in H2/23 as a mild recession and slower inflation justify the Fed beginning to dial back from the current, restrictive setting.