June 15, 2022

Fed steps up its inflation fight with 75 bp hike

- The Fed accelerated its tightening cycle with a 75 bp hike
- Larger move follows yet another inflation surprise, rising inflation expectations
- Fed funds seen rising above 3% later this year and close to 4% next year

Today's 75 bp hike would have come as a shock—a 50 bp increase was unanimously expected as of last week—were it not for media reports from Fed insiders earlier this week suggesting the central bank was weighing a larger move. As of May the Fed wasn't "actively considering" a 75 bp hike but last week's upside surprise on CPI and a worrying rise in medium-term inflation expectations increased the committee's urgency to withdraw accommodation. While the market was leaning heavily toward another 75 bp hike in July, Chair Powell was non-committal saying he doesn't expect moves of this size to be common and that the Fed would likely be contemplating a 50 or 75 bp move at its next meeting.

Regardless of the size of the next hike, a series rate increases is expected over the second half of this year with the committee's dot plot now showing a median fed funds rate of 3.25-3.50% by year end. That's 150 bps higher than projected in March. Next year's median was revised 100 bps higher and at 3.75% is close to market expectations. Our forecast has been for fed funds to peak closer to 3%. As usual, Chair Powell emphasized monetary policy is not on a pre-set course and the pace of rate hikes will depend on incoming data and the evolving economic outlook. The committee wants to see compelling evidence that inflation is coming down before thinking about pausing its tightening cycle. We think the Fed's end of year forecast for PCE inflation looks a bit high but in any case the risks around our fed funds forecast are tilted heavily to the upside.

The last time the Fed hiked by 75 bps was in 1994 as part of the "soft landing" tightening cycle in the mid-90s. The committee is hoping to pull that off again but has its work cut out—inflation back then was hovering around 3%, a far cry from today's above-8% pace. Indeed, Chair Powell acknowledged the path to a soft landing is becoming more challenging with factors outside the Fed's control—Russia-Ukraine, supply chain disruptions—continuing to exert upward pressure on prices. As such, the policy statement no longer said that with appropriate monetary policy it expects inflation to return to target and the labour market to remain strong. The jobless rate is now seen rising gradually over the next few years to 4.1% by 2024 which would still be close to its estimated longer-run level and consistent with a soft landing. But if the Fed follows through with the path laid out in the dot plot we think it's hard to see growth remaining as firm or unemployment as low as the Fed is projecting.

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