MACRO STRATEGY

Predicting the Pivot: Why 2%?

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The December Summary of Economic Projections (SEP) suggested the Federal Open Market Committee (FOMC) would hike rates another 75 basis points (bps), with the peak fed funds target rate at 5.00%–5.25%. The rate would remain at that level through the end of 2023 before declining by 100 bps per year in both 2024 and 2025. These expectations are based on the Committee's view that their policy tightening will only result in an increase in the unemployment rate of less than one percentage point (to 4.6%) even as inflation remains above target through 2025.

Devil in the Details

Interestingly, the SEP provides some possible insight into the Fed's tolerance for inflation above 2%. In 2024, the Fed is expected to cut rates by 100 bps, even as inflation (both core and total) will have only declined to 2.5% by year-end. This would suggest that the upper end of the Fed's tolerance band for inflation is at or around the 3.1% – 3.5% shown as year-end 2023 projections for headline and core, respectively. Even as the Committee signals rate cuts, the "longer-run" projection for headline inflation remains at 2.0%.

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What's so Magical About 2% Anyway?

There is nothing special about 2% versus any other target the Fed could have chosen, when, in early 2012, the Committee noted that "inflation at the rate of 2%, as measured by the annual change in the price index for personal consumption expenditures, is most consistent over the longer run with the Federal Reserve's statutory mandate".[1] In 2016, the target was further clarified when it was noted that "The Committee would be concerned if inflation were running persistently above or below this objective."[2] In other words, the target has symmetrical tolerance bands.

There are three reasons generally given for a positive inflation target (rather than zero): First, measurement bias, meaning that measures of inflation are imperfect and likely to have a slight upward bias; second, maintaining the ability to lower rates in a downturn, as a higher inflation rate tends typically aligns with higher interest rates; third, a positive target reduces the risk of deflation, which some economists view as potentially being worse than inflation.

Can They Hold the Line?

We believe that the Fed's projections suggest a willingness to cut rates if needed, and we also believe that the increase in the unemployment rate is likely to be more significant than the Fed expects. Monetary policy works with a lag and, absent certain interest-rate sensitive sectors, employment seems not to have responded to the policy tightening to date. However, history has shown that when unemployment begins to move higher, it typically moves quickly. A rapid increase in the unemployment rate has the potential to prompt a Fed pivot.

At the same time, we would acknowledge the Fed is likely to be reluctant to be proactive, given the potential for any action to be misinterpreted as being "soft on inflation." A rate cut that was seen as premature, or seen as working against controlling inflation, could result in having to accept much slower growth than would otherwise be the case. As such, we expect the Fed to be reactive, not proactive, resulting in rate cuts in late 2023.

All About the Vol

Former Fed Governor Mishkin argued that "If it were no more difficult to stabilize the inflation rate at a 4% level than at a 2% level, then I think the case for raising the inflation target to 4% would be much stronger. However, the history of the inflation process suggests that this is not the case."[3] Research has shown that, on a global basis, "the level and variance of inflation are highly correlated"[4] and that, as a result, an inflation target is harder to maintain. Interestingly, the focus on an inflation target may also have negative consequences on growth as "inflation volatility is also robustly negatively correlated with growth, even after the effect of the level of inflation is controlled for."[5] As such, we can surmise

that the Fed does not see any regime that is zero cost. The key instead seems to lie in the relative trade-off between growth and inflation.

Prepping for the Potential Pivot

The Federal Reserve appears to have little incentive to shift a target rate that they feel has served the economy well over the years. Nevertheless, we should watch for a shift in how they present their inflation concerns. For example, a shift toward new or more forward-looking measures of inflation pressures or efforts to refocus the market on their exact target—the core Personal Consumption Expenditure Deflator—could allow the Fed to manage market expectations in a manner that could achieve the same result. This may free the FOMC to aim for a soft landing rather than continuing to hike rates while looking into the rearview mirror, especially if the unemployment rate has begun moving higher.

How the resolution of the disconnect between the Fed's projections and market expectations occurs seems to be a question of timing. Both the Fed and markets predict a peak in fed funds before a gradual decline, the key difference appears to be when rate cuts are expected to begin to occur—in 2023 or in 2024. In turn, the timing may depend on whether the market would allow the Fed to move earlier without shifting financial conditions in a way the Fed may view as counterproductive to their predominate goal at the time—lowering inflation or limiting a rise in unemployment.

Endnotes

[1] https://www.federalreserve.gov/monetarypolicy/files/FOMC_LongerRunGoals_201201.pdf

[2] https://www.federalreserve.gov/newsevents/pressreleases/monetary20160127b.htm

[3] https://www.nber.org/system/files/working_papers/w16755/w16755.pdf

[4] https://www.federalreserve.gov/pubs/feds/2004/200443/200443pap.pdf

[5] https://www.federalreserve.gov/pubs/feds/1996/199619/199619pap.pdf

Author

DREW T. MATUS
Chief Market Strategist

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