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Fed announcement: Believe you can and you're halfway there

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Teddy Roosevelt once said, “Believe you can and you're halfway there.” That might be a great summary of Powell's thoughts on the Fed's plans to start normalizing monetary policy this year. The Fed Chair framed the hurdle to cut rates in today's press conference as based on the need to achieve greater confidence that inflation is sustainably at 2 percent. He qualified that meant seeing inflation readings continue at the level they have been for the past six months. Our take is that the Fed is about halfway there and wants to see about another half year or so of sequential inflation data around its target. The most important takeaway however is the Fed believes it will get there and doesn't view the strong growth as a hurdle to normalization.

Why is that? Powell described a mixture of supply-side improvements (from supply chain normalization and labour supply gains) and restrictive monetary policy as being the secret sauce to inflation progress. The former force has been the more important of the two and as he seemed to imply, a boost to growth. He was generally dismissive of the idea that an opening of further slack in the labour market was needed to get inflation down as well. Underlying the Chair's view is likely a sense that the US economy as returned to a point where the relationship between slack and inflation is very weak. In that world view ─ known to economists as the flat Philips Curve ─ large swings in output or the labour market don't transmit into large swings in inflation. Inflation expectations actually pins down inflation to its target as households, firms and markets expect the economy and inflation to normalize, a point Powell also acknowledged.

Hence, that is also why the Chair seems very focused on the Fed's dual mandate. He started out of gate by focusing on exactly that and at multiple times stressed the need to keep the labour market and growth strong. Restrictive policy settings will still weaken the economy and the Fed wants to avoid a situation where they comprise on their employment mandate. That being said, we don't see the Fed has in a difficult spot on the labor market yet. The labour market is still fairly tight and a broad range of measures of labour market tightness are still pointing towards some degree of excess demand, something Powell also acknowledged. The labor supply story likely has also run its course and that could be another sticky point for wage growth normalization down the road and ultimately, cyclically sensitive parts of inflation. Services ex. shelter inflation has improved but is still running fairly hot and to bring inflation sustainable to 2% will require at least some more normalization of the labor market as goods disinflation starts to ease up.

So the big question is when will the Fed start to move? The Chair very kindly ruled out March for everyone and narrowed down our data-watching tasks primarily to inflation with the dovish talk on growth and labor. But clearly the door seems open to a move after that meeting and hence, there is some upside risk to our July call. However, the reality is the Fed truly doesn't know right now whether to start easing in May, June or July at this point. Powell spoke about the risks of moving too soon and too late, and the balance of risk there seems to seem to be tilted towards moving too soon because of the uncertainty about where rates need to end up. The Fed does not have a good sense of where neutral is but seems to implicitly believe it is higher. Also, the economy does not appear to cracking under the weight of restrictive policy right now at all. All of this leads down to the same path of a careful and gradual easing path that is very squarely data-dependent.

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