CIBC CAPITAL MARKETS

Economics

ECONOMIC FLASH!

economics.cibccm.com

November 1, 2023

Fed announcement: Is it a bird? Is it a plane? No, it's the supply-side!

Ali Jaffery ali.jaffery@cibc.com

As widely expected, the Fed opted to hold rates keeping range up to 5.50%. While the statement was broadly unchanged and maintained the data-dependent character, Powell struck a more dovish tone in the Q&A in our view. He certainly kept the door open to further rate hikes saying clearly that he was "not confident" that the current level of monetary policy was restrictive enough and that the tightening in financial conditions would need to prove persistent in order to substitute or alter the path of future monetary policy.

However, the main takeaway for us was the sanguine explanation for the recent strength in the economy, mostly implying it had a limited implications for future inflation. He repeatedly emphasized the improvement in the supply-side of the economy and the unwinding of the pandemic effects as being a potential explanation of the recent strength in the labour market and GDP. On GDP, he went as far as to suggest that the recent improvement in labour supply, partly driven by immigration, could imply a higher level of potential GDP. On inflation, he did not discuss the flattening out of underlying inflation measures produced by regional Feds or the upturn in "super core" measures watched by the Fed. Here he noted substantial progress in recent months although not sufficient and that wage inflation also has moderated in line with the Fed's expectations. He did note that the supply-side improvements on inflation would likely subside and the emergence of excess demand conditions could build inflationary pressures, but it was far from his emphasis.

Another very important signal from the Fed was the change in the risk bias from "not doing enough" to "doing too much" and the risks becoming more balanced. This change in bias is likely the start of a slightly different data-dependence regime in which the Fed takes longer pauses to assess data and determine the course of policy as Powell seemed to imply. This came out in a question when asked about monetary policy lags and Powell expressed his uncertainty around making precise assumptions about monetary policy lags and wanting to "slow down" to assess the data.

In part, the dovish tone was needed to justify the action of today's pause and certainly the bar for the Fed to move again seems to have nudged up a bit. But we remain a bit skeptical. Powell laid out very clearly what he is looking at for December: two more labour reports, two more CPI prints, some activity data and now, the durability of financial conditions tightening. We'll be watching those too, and keeping a keen eye on the evidence that the supply-side improvement in the economy has enough legs to explain the upsurge in consumption. We are least sure about that last part and the argument that the level of potential output is materially stronger now. Relying on "star variables" is a common central banker crutch but seems a bit unusual in this context. We agree the labour market that is rebalancing and supply is healing, but it remains mostly insulated from restrictive monetary policy given the declining share of interest-sensitive portion of the economy and the muted mortgage channel of monetary policy from 30 year mortgages being so widespread. The recent updrift in measures of inflation also makes us nervous that policy is not restrictive enough. We'll wait and see. Just like Powell.

CIBC Capital Markets – PO Box 500, 161 Bay Street, Brookfield Place, Toronto, Canada M5J 2S8 – Bloomberg @ CIBC