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Fed holds rates steady now but unsure about the future

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Today's no-surprise FOMC decision to keep rates unchanged comes with a side of caution as the dot plot continued to show another hike this year isn't off the table and that the Fed expects to hold rates higher for longer. The projections significantly revised the outlook for the economy beyond this year, with the output gap materially less negative in 2024 and 2025 than they expected in June. For end-2024 and end-2025, the unemployment rate was revised down to 4.1% from 4.5%. Consistent with that stronger outlook and to keep inflation around its target by 2025, the projection for the median fed funds rate was revised up by end-2024 and 2025 to 5.1% and 3.9% respectively. The FOMC now expects to hold the policy rate about 50bps higher by end-2025 than it expected in June.

Still, judging by their actions of not hiking today and Chair Powell's press conference, we see the Fed remaining patient and are skeptical that they will raise rates further this year. The FOMC is looking for more progress, particularly in light of the strength of consumer spending in recent months, and is reasonably biased to upside inflation surprises given we still have above-target inflation. However, we view this more as treading caution than as a firm position. If we continue to see inflation readings close to target, continued labor market rebalancing, and some cooling in consumer spending through the fall -- would the same two-thirds of the FOMC in favor of a hike today continue to think that real rates need to be higher in December? We're not so sure they will. In part, because of the number of forces that could affect the economy that Powell noted -- student loan repayments, the auto strike, a looming government shutdown, and an oil price shock. In the end, there is an obvious tactical advantage to keeping an additional rate hike in the projection to guard against upside risks.

However, the big change in this projection round was the large downward revisions to the unemployment rate in 2024 and 2025. Using a standard rule of thumb, this implies that the Fed believes the output gap is going to be slightly negative in 2024 and 2025 as compared to about -1% implied from the June estimate. This is a large change in view that Powell left mostly unexplained. While the median view for the fed funds rate was revised higher as a result, we're not so sure that the median is the right metric to look at. The committee's range for 2024 remains wide and got even wider for 2025. It seems as if the FOMC is not very sure where rates should be in the future and Powell struck that impression in the press conference. A stronger outlook, should all else equal, implies higher rates but real rates are now pushing close to 3% in the FOMC's outlook for an implicit increase in inflation that is predicted. We believe the lags of monetary policy are still working their way through the economy and should continue to exert downward pressure on activity and inflation.

Overall, this was a surprising FOMC meeting. The projections portray a US economy that is on an upswing and vulnerable to another burst of demand-driven inflation, requiring even further monetary restraint. But we place more weight on the nuanced and patient position Powell struck in the press conference.

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