US Daily: September FOMC Recap: New Forward Guidance but No Change to Treasury Purchases (Mericle)

- The FOMC incorporated its new flexible average inflation targeting strategy into its post-meeting statement today and introduced new forward guidance, but made no major changes to its asset purchase program. We recap three highlights from the September meeting.
- First, the new forward guidance, which came sooner than we expected, delays liftoff until the economy has reached maximum employment and inflation has risen to 2% and "is on track to moderately exceed 2 percent for some time." This was close to but a touch more dovish than our expectation.
- Second, the FOMC chose not to provide a timeline for asset purchases and did not change the composition of its Treasury purchases. We interpret this to mean that the FOMC does not currently plan to extend the average duration of its purchases, against our previous expectation. At this point, a change would likely require a deterioration in market conditions or the economy.
- Third, while the dot plot showed that a strong majority expect no rate hikes through the end of the forecast horizon in 2023, as we expected, the economic projections implied that participants expect conditions close to those required for liftoff by the end of 2023. We see a fairly wide, two-sided confidence interval around our early 2025 baseline for liftoff.

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September FOMC Recap: New Forward Guidance but No Change to Treasury Purchases

The FOMC incorporated its new flexible average inflation targeting strategy into its post-meeting statement today and introduced new forward guidance but made no major changes to its asset purchase program. We recap three highlights from the September meeting.

First, the FOMC introduced new forward guidance that was close to but a touch more dovish than our expectation. The new guidance delays liftoff until the economy has reached maximum employment and inflation has risen to 2% and "is on track to moderately exceed 2 percent for some time." We had expected the first two criteria but not the third. After liftoff, Powell said, the FOMC "will keep policy accommodative until we actually have a moderate overshoot of inflation for some time."

We had expected the change to the forward guidance to come later because several regional Fed presidents recently said that they preferred to wait. One, Dallas Fed President Robert Kaplan, dissented against today's decision for this reason. Another, Minneapolis Fed President Neel Kashkari, dissented because he preferred a liftoff criterion of core inflation reaching 2 percent on a sustained basis.

Second, the FOMC chose not to provide further guidance on the timeline for asset purchases and did not change the composition of its Treasury purchases. On the timeline, our expectation remains that asset purchases will continue at the current pace until roughly a year before liftoff, leaving time for both a gradual tapering and a pause between the end of tapering and the first rate hike. Specifying an economic criterion that one can be confident will be met roughly a year before the liftoff criteria are met is difficult, and the FOMC might have chosen to maintain the current language for this reason. If the Committee wants to provide guidance about the timeline for asset purchases in the future, one option would be to plan to begin tapering when liftoff comes into view. Asked why the FOMC did not provide guidance about asset purchases, Powell said, "we think our policy stance is appropriate today."

We interpret the lack of changes to the composition of Treasury purchases to mean that the FOMC does not currently plan to extend the average duration of its purchases, against our previous expectation that it would. Powell said that the current purchases are already easing financial conditions, implying that changes are not necessary, and we think that today was the most natural time for a change, alongside the change to the forward guidance. As a result, we now think that some additional trigger—such as a disorderly rise in yields at longer maturities or a deterioration of the economy—would likely be required. With yields already low across the curve, the Committee might have preferred to save duration extension as an option for providing more accommodation if the need arises, say if further fiscal support fails to materialize and the recovery takes a step backward.

Third, while a strong majority of the FOMC—13 out of 17 participants—showed a baseline of no rate hikes through the end of the forecast horizon in 2023, the economic projections hinted at a risk of an earlier liftoff than our early 2025 baseline. Specifically, the 2023 economic projections showed an unemployment rate of 4%, below the 4.1% longer-run estimate, and inflation of 2%, satisfying two of the three criteria for liftoff. This hints at an economy already on the cusp of liftoff by the end of 2023 and suggests a possible first hike in 2024 if the economy evolves as FOMC participants expect.

We see a fairly wide and certainly two-sided confidence interval around our early 2025 baseline for liftoff. As we have often noted, inflation does not always track the unemployment rate in textbook fashion, and inflation dynamics might evolve differently in this cycle than in the last cycle. Moreover, while Powell noted that FOMC participants expect some further fiscal action, we see risks to the fiscal outlook in both directions. A Democratic sweep would likely mean substantial further stimulus and would raise the risk of an earlier liftoff, while a failure of the Phase 4 negotiations this month and divided government after the election would raise the risk of a slower recovery and a later liftoff.

David Mericle

Disclosure Appendix

Reg AC

We, Jan Hatzius, Alec Phillips, David Mericle, Spencer Hill, CFA, Daan Struyven, David Choi, Joseph Briggs, Blake Taylor, Ronnie Walker and Laura Nicolae, hereby certify that all of the views expressed in this report accurately reflect our personal views, which have not been influenced by considerations of the firm's business or client relationships.

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