

FED WATCH: DOWNSHIFTING TO FIFTY

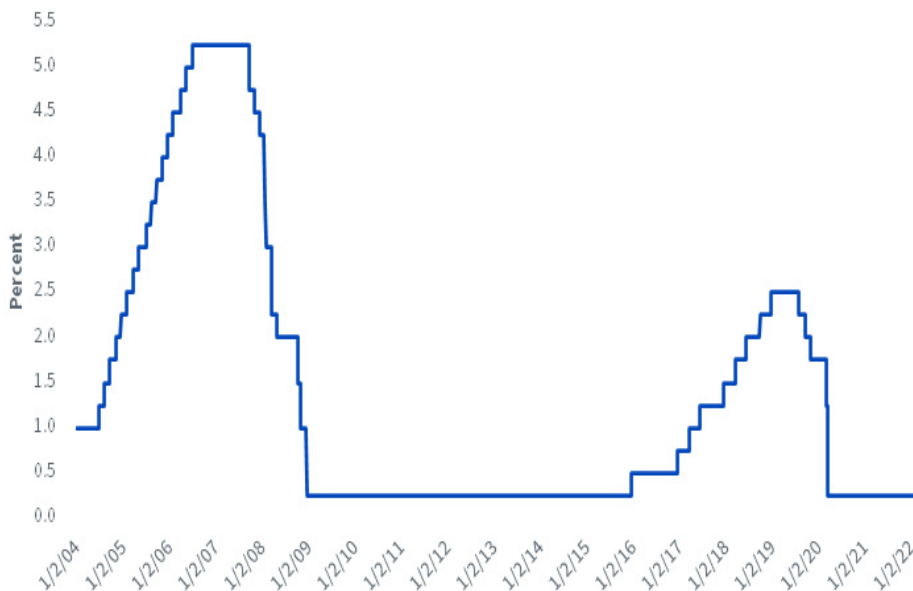
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The [Fed](#) delivered another outsized rate increase at today's [FOMC](#) meeting, but this time it was 'only' worth 50 [basis points \(bps\)](#), a quarter-point downshift from the historical hikes the voting members had been engineering during their prior four FOMC meetings. As a result, the [Fed Funds trading range](#) will end 2022 and begin the new year at 4.25%–4.50%.

The downshifting in the magnitude of [rate hikes](#) was well telegraphed by Powell & Co. and appeared to be widely expected by the [money](#) and [bond markets](#). Indeed, at the November Fed meeting and subsequent public appearances, Fed officials were highlighting how monetary policy acts with a lag and the time was approaching to begin moving away from 75-bps increases and take stock of what has transpired up to this point.

As I've blogged before, the '[Volcker](#)-esque' increase in Fed Funds this year has resulted in the target range going from a [zero interest rate policy \(ZIRP\)](#) as recently as March to an upper bound of 4.50% now, an incredible total of 425 bps in rate hikes. Although the increases of the Greenspan/Bernanke era (2004–2006) amounted to an identical 425 bps, the moves were more methodical, coming in at 25-bps intervals at consecutive FOMC meetings (see below).

Fed Funds Target Rate – Upper Bound



Source: Bloomberg, as of 12/14/22.

So, where does Chairman Powell take monetary policy from here? Well, one aspect of this tightening cycle, quantitative tightening (QT), continues to fly under the radar, just as the policy makers hoped, and appears to be on auto-pilot for now. Now comes the tricky part...additional rate hikes. Based on the December [dot-plot](#), the Fed seems poised to continue increasing the Fed Funds Rate into 2023, with a [terminal rate](#) coalescing

somewhere around the 5% level.

Against this backdrop, the key questions now are centered on how fast will the policy makers get to that terminal rate and how long will they stay there? Let's take the first part of the question. There are generally two schools of thought on this: 1) much like the Fed front-loaded rate hikes up to this point, they should get to the terminal rate sooner rather than later, or 2) given the historical amount of tightening still waiting to work its way through the system, the Fed should become more deliberate in its approach.

Conclusion

Whichever choice the Fed makes, one thing we know for sure is that another rate hike, at a minimum, is on the table for early in the new year. That brings us to the much ballyhooed 'Powell Pivot.' Right now, I would presume once the Fed gets to their terminal rate, the policy makers will then go into a holding pattern, and then possibly entertain rate cuts during the latter portion of 2023. Based on recent Fed guidance on this issue, there seems to be a consensus not to reverse course too soon, but as we've seen, things can change quickly

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DEFINITIONS

Federal Reserve: The Federal Reserve System is the central banking system of the United States.

Federal Open Market Committee (FOMC): The branch of the Federal Reserve Board that determines the direction of monetary policy.

Basis point: 1/100th of 1 percent.

Federal Funds Rate: The rate that banks that are members of the Federal Reserve system charge on overnight loans to one another. The Federal Open Market Committee sets this rate. Also referred to as the “policy rate” of the U.S. Federal Reserve.

Rate Hike: refers to an increase in the policy rate set by a central bank. In the U.S., this generally refers to the Federal Funds Target Rate.

Money Market: a market for highly-liquid assets generally maturing in one year or less.

Bond market: The bond market—often called the debt market, fixed-income market, or credit market—is the collective name given to all trades and issues of debt securities. Governments typically issue bonds in order to raise capital to pay down debts or fund infrastructural improvements.

Paul Volcker: Paul Volcker was an American economist who served as the 12th chairman of the Federal Reserve from 1979 to 1987. During his tenure as chairman, Volcker was widely credited with having ended the high levels of inflation seen in the United States throughout the 1970s and early 1980s.

Zero Interest Rate Policy (ZIRP): A monetary policy where by interest rates, such as Fed Funds, are kept close to, or at zero.

Dot Plot: a chart based on the economic projections of the Federal Reserve board members that illustrates their views on the appropriate pace of policy firming and provides a target range or target level for the federal funds rate.

Terminal rate: The peak spot where the benchmark interest rate – the federal funds rate – will come to rest before the central bank begins trimming it back.