US Daily: June FOMC Recap: Pulling Forward Liftoff to 2023 on Hawkish News About Fed's Interpretation of Average Inflation

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- The June FOMC meeting delivered a hawkish surprise with a shift up in the median dot in 2023 to two hikes, from none in March and against our expectation of an unchanged flat path.
- The discussion of tapering was largely in line with our expectations. Chair Powell acknowledged committee discussion but made clear that "reaching the standard of substantial further progress is still a ways off." We continue to expect the first hint about tapering in August or September, followed by a formal announcement in December that would begin the tapering process at the start of next year, though the risks lean toward an earlier start.
- The rise in the median dot to show two hikes was particularly striking because the 2023 core PCE inflation forecast remained steady at 2.1%. Our preferred explanation is that the FOMC takes a more firmly backward-looking interpretation of average inflation targeting than we had assumed. With average inflation over the cycle already on track to exceed 2% by this year, this interpretation appears to lower the future inflation bar for liftoff. We had previously assumed that the Fed leadership would instead desire a larger sustained overshoot of 2% to hammer home its commitment to the new framework in the very first cycle where it is in place.
- In light of what we learned today, we have changed our forecast of the timing of the first hike to 2023Q3, from 2024Q1 previously. However, we see the odds of a hike by the end of 2023 as only modestly better than 50% because liftoff could easily be derailed by lower-than-expected inflation or a sharper deceleration in growth as fiscal support fades.

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June FOMC Recap: Pulling Forward Liftoff to 2023 on Hawkish News About Fed's Interpretation of Average Inflation Targeting

The FOMC delivered a hawkish surprise at its June meeting today. The meeting offered little new information about the tapering timeline, but did provide new insight into how Fed officials interpret average inflation targeting. Their interpretation appears to be more firmly focused on the backward-looking average level of inflation this cycle than we expected, which implies that the 2021 inflation spike has more hawkish implications than we anticipated. We have therefore pulled forward our forecast of liftoff to 2023.

The discussion of tapering was largely consistent with our expectations. Chair Powell acknowledged that the FOMC had been "talking about talking about" tapering at its June meeting, but made clear that "reaching the standard of substantial further progress is still a ways off." He added that the FOMC will continue to assess the economy's progress "in coming meetings."

We continue to expect the first hint about tapering to come in August or September, followed by details about issues such as the pace in November, and then a formal announcement at the December meeting that would begin the taper process in January. This appeared to be the consensus expectation prior to the meeting, and we see little reason for the FOMC to surprise markets in a hawkish direction on tapering. But the risks lean toward an earlier start, both because the first hint could come sooner and because the "advance notice" the FOMC plans to provide could consist of one meeting rather than two.

The main reason that we do not expect the first decisive hint to come in July is that there will only be one additional employment report between now and then, the June report, and we think that job gains in June are likely to be unspectacular because they should face a moderate seasonal headwind and are unlikely to benefit meaningfully from the expiration of unemployment benefits. Exhibit 1 shows our forecast for upcoming payroll gains based on these considerations. If the July report is as strong as we expect, a first hint in August or September would seem natural.

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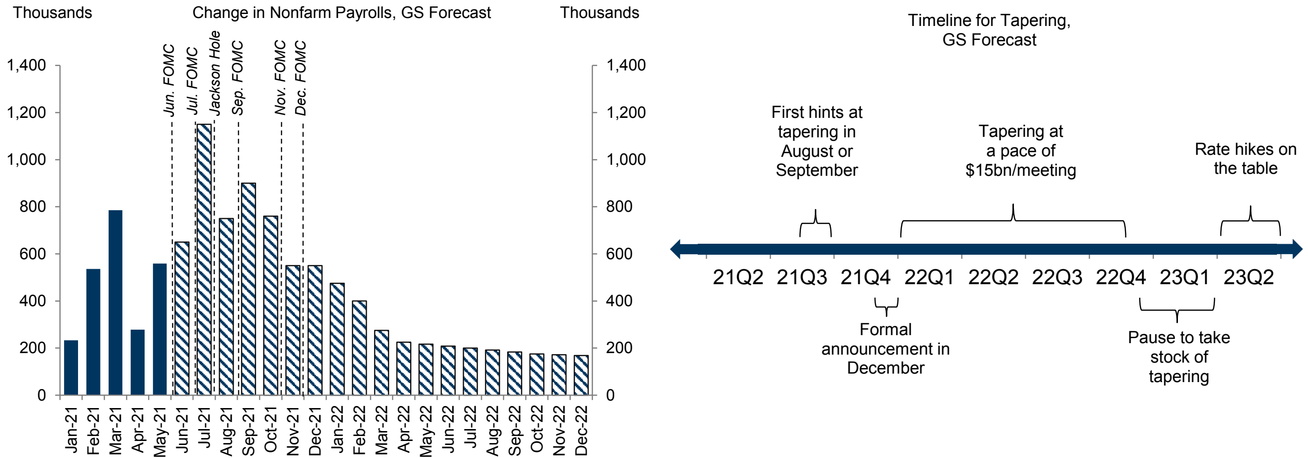
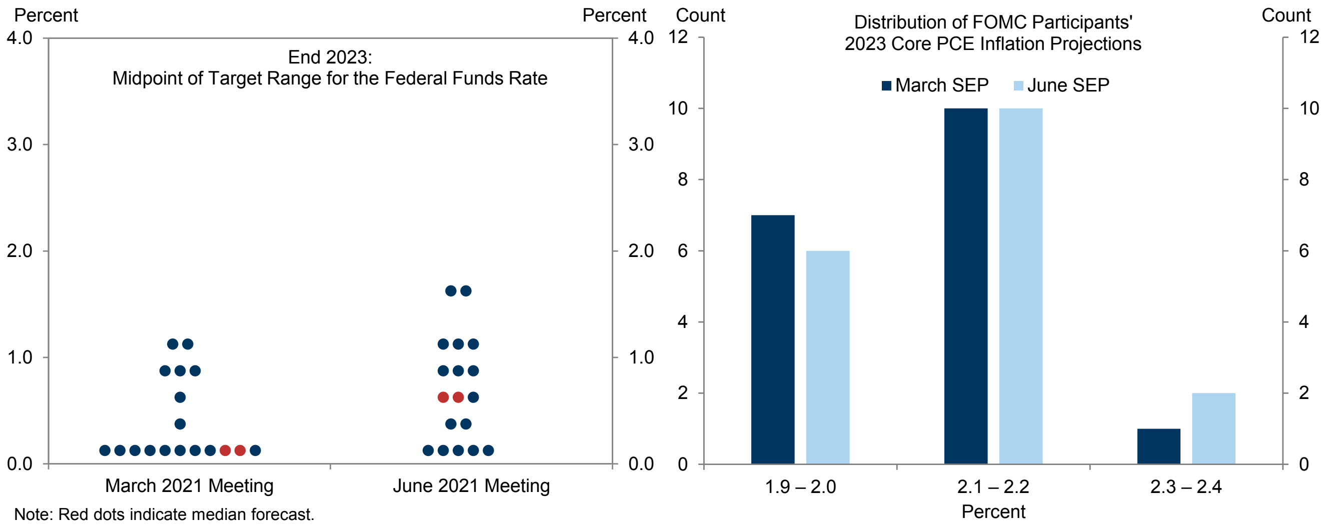
Exhibit 1: The Strong Job Gains We Expect in July Would Set the Stage for a First Hint at Tapering in August or September



Source: Goldman Sachs Global Investment Research

The key surprise at the June meeting was that the median dot now shows two hikes in 2023, up from none in March and against our expectation of an unchanged flat path. This is particularly striking in light of the extremely minimal changes to the 2023 core PCE inflation forecasts, as shown in Exhibit 2.

Exhibit 2: The Median Dot Added Two Hikes in 2023, Despite Almost No Change in the Inflation Forecasts



Source: Federal Reserve Board, Goldman Sachs Global Investment Research

Our best explanation is that the FOMC takes a more firmly backward-looking interpretation of its new average inflation targeting (AIT) framework than we had assumed. We highlighted in our preview of the meeting that core PCE inflation is on track to end 2021 having already averaged more than 2% since the recession began, as the FOMC's forecast also implies (Exhibit 3). We noted that Fed officials would have to decide whether this means that the AIT objective would therefore be effectively accomplished, reducing the need to further exceed 2% and lowering the inflation bar for liftoff. Both the FOMC statement and the Fed's Statement on Longer-Run Goals and Monetary Policy Strategy use backward-looking language to describe AIT, and we did expect more hawkish participants to hold this view.

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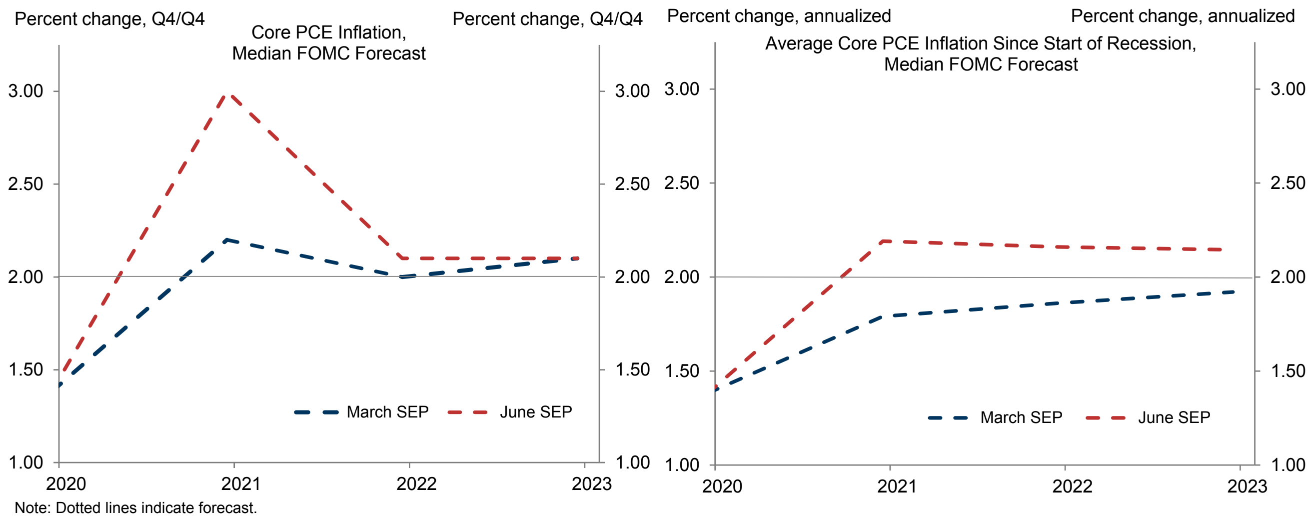
But we are surprised that most FOMC participants, seemingly including at least part of the leadership, also appear to interpret AIT in this way. We would have thought that the leadership would instead have wanted to err on the side of overdoing it in the first cycle with the new framework in place, hammering home its commitment to its new framework and its comfort with running above 2% by achieving a larger sustained overshoot of 2% at liftoff and thereafter. We see today's outcome as a hawkish revelation about how most of the FOMC is interpreting AIT.

Exhibit 3: The FOMC's Forecasts Now Imply That Inflation Will Have Already Averaged More Than 2% by 2021, Which We See As the Best Explanation for the Hawkish Shift in the Dots



Source: Federal Reserve Board, Goldman Sachs Global Investment Research

We see two implications for future interest rate policy decisions. First, the liftoff threshold appears to be modestly lower than we previously thought, though the FOMC did maintain the liftoff requirement that inflation must be "on track to moderately exceed 2 percent for some time," which presumably implies that some buffer above 2% is still needed. Second, the median projection of two hikes with core PCE at just 2.1% suggests to us that most of the FOMC would support proceeding steadily with normalization after the liftoff goals are met even if inflation is only running a bit above 2%.

In light of our takeaways from the June meeting, especially the lower inflation bar for liftoff, we have changed our forecast of the timing of the first hike to 2023Q3, from 2024Q1 previously. We continue to forecast two additional rates hikes in 2024.

However, we see the odds of a hike by the end of 2023 as only modestly better than 50%. We can imagine three plausible scenarios in which the Fed would not hike in 2023: inflation simply does not clear the bar for liftoff, the pullback in fiscal support causes the economy to decelerate enough naturally to make a hike seem excessive, or financial conditions tighten enough on their own to make a hike unnecessary. We see the odds of at least one of these scenarios playing out as close to 50%.

The market also took the June meeting as hawkish. Market pricing of total tightening by the end of 2023 (including at the December meeting) rose by 18bp, or about ¾ of a hike, from just before the FOMC meeting to the end of the day. Breakeven CPI inflation

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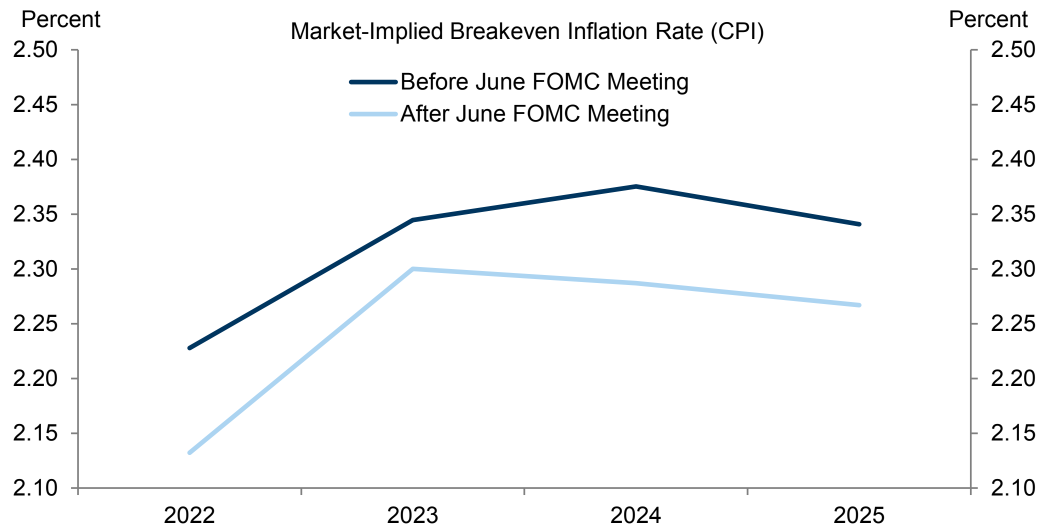
expectations for the next several years also fell by 5-10bps, as shown in Exhibit 4, to a level that now implies PCE inflation of roughly 2%.

Exhibit 4: Market-Implied Inflation Expectations Shifted Lower to a Level Consistent with 2% PCE Inflation



Source: Bloomberg, Goldman Sachs Global Investment Research

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