As FOMC grows more cautious about inflation, markets have only priced in smaller interest rate hikes

SAI YABUKI
ECONOMIC RESEARCH OFFICE

MUFG Bank, Ltd.
A member of MUFG, a global financial group

3 FEBRUARY 2022
(ORIGINAL JAPANESE VERSION RELEASED ON 27 DECEMBER 2021)

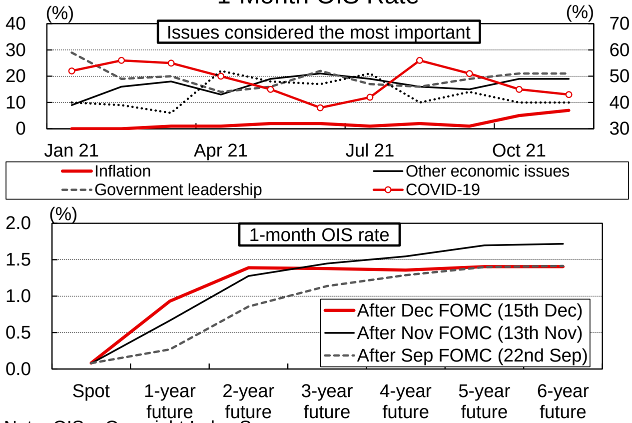
At the Federal Open Market Committee (FOMC) meeting held on 14th and 15th December, the Committee decided to further reduce the pace of its asset purchases. The median of participants' projected path of appropriate monetary policy increased from the FOMC meeting in September and three rate hikes are forecast for both 2022 and 2023.

The reason behind this sharp change in attitude by the Federal Reserve Board is that high levels of inflation are becoming an issue for society. In various opinion polls, there is a marked rise in concerns about inflation (Chart 1, upper). Moreover, during the press conference after the FOMC, Chairman Powell said: "we understand that high inflation imposes significant hardship, especially on those least able to meet the higher cost of essentials". Financial markets have factored in an accelerated pace of rate hikes in the short term on the back of the Federal Reserve Board's cautious attitude about inflation and forward interest rates show interest rates up to and including 2-year forwards are increasing from the level they were at directly after the FOMC in November. However, 3-year forwards and beyond have decreased, albeit by a small amount, and are far below 2.5%, which is FOMC participants' projection (median) for the federal funds rate in the mid-to-long term (Chart 1, lower). In other words, markets do not think that the federal funds target rate will be raised to such a high level and they are probably "doubtful about the persistence of high levels of inflation", "cautious about COVID-19" and think that "rate hikes themselves cool the economy".

That being said, even if inflation peaks in the future as the year-on-year effect of energy prices wears off, it is unlikely that interest rate hikes will remain at low levels given that the current US economy is relatively strong based on factors such as its labour market. As the supply-demand gap continues to tighten, there is a large gap between 2% (the sum of the natural rate of interest and the FOMC target inflation rate) and the federal funds rate, and monetary policy may overly simulate the economy while this gap remains (Chart 2). There is also a risk that this will lead to further acceleration of the rise in asset prices, such as property.

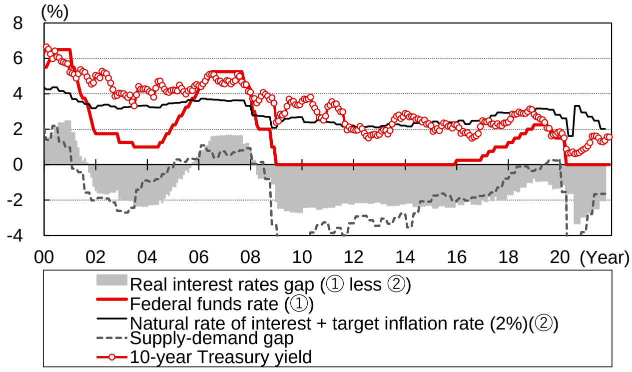
If uncertainty about variants decreases, supply constraints are eased and a sustained economic recovery becomes very likely, financial markets' will increase their interest rate forecasts – which currently stand at a smaller rise – and it is likely that the trend of long-term interest rates, which generally moved within a certain range throughout 2021, may rise.

Chart 1: Issues Considered Most Important and the 1-Month OIS Rate



Note: OIS = Overnight Index Swap
Source: Gallup, Bloomberg, MUFG Bank Economic Research Office

Chart 2: The Supply-Demand Gap & Various Indicators



Note: Federal funds rate uses month-end values of the lower limit of the target range. Ten-year Treasury yield is the monthly average
Source: US Department of Commerce, Congressional Budget Office, Federal Reserve Bank of Richmond, Bloomberg, MUFG Bank Economic Research Office

Translation by Elizabeth Foster

For further details, please contact the Economic Research Office, MUFG Bank

Managing Director, Rei Tsuruta <rei_tsuruta@mufg.jp>

Written by Sai Yabuki <sai_yabuki@mufg.jp>

This report is intended for information purposes only and shall not be construed as solicitation to take any action such as purchasing/selling/investing financial market products. In taking any action, each reader is requested to act on the basis of his or her own judgment. This report is based on information believed to be reliable, but we do not guarantee its accuracy. The contents of the report may be revised without advance notice. Also, this report is a literary work protected by the copyright act. No part of this report may be reproduced in any form without express statement of its source. This report is also available for viewing online.