If the Fed Doesn’t Know, How Could Banks?

Monetary policymakers were extraordinarily slow in recognizing the need to raise rates. Moreover, the Fed’s forward rate guidance, which showed only a modest upward path in interest rates, likely exacerbated what has become a record sell-off in the bond market. Arguably this is most evident from massive mark-to-market losses with commercial banks’ securities holdings, as shown in the chart below.

Commercial bank risk managers were caught completely offside by much higher-than-expected interest rate increases. However, the Fed was not signaling its intention to raise rates anywhere near the extent that official rate has gone. And “forward guidance” was a powerful tool collapsing risk premia and allowing the Fed to ease policy through unconventional means.

There was no tightening in the Fed’s forecast for 2022 as late as their September 2021 meeting despite rising inflation. Three months later when the new forecasts were provided, the Fed anticipated hiking rates by just 75 basis points, bringing the funds rate to a range of 0.75% to 1.0%.

By March 2022 with inflation accelerating further, the Fed lifted rates 25 bps and signaled its intention to lift the funds rates another 150 bps to a range of 1.75% to 2.0% by yearend. Instead, the Fed wound up raising interest rates nearly threefold. And this was in just nine months! The Fed lifted official interest rates another 400 bps to finish the year at a range of 4.25 to 4.5%.

Since then, official interest rates have risen to a range 5.25 to 5.50%. Many policymakers have signaled their desire to stand pat, to better ascertain the lagged impacts on growth and inflation from actions taken to date.

Current rate projections show 50 bps of total rate cuts next year, but that assumes the Fed raises rates one more time this year. If the Fed is done tightening, then conceivably, next year’s forecast could show just one 25 bp cut when the Fed publishes updated economic and financial forecasts at the December 13th FOMC meeting.

What should we take away from the current rate hiking cycle? At economic inflection points, the Fed does not know how much policy will change. Clearly, this was the case on the upside. And we highly doubt it will be any different on the downside. Investors need to be careful in giving too much credence to Fed forecasts. Stay tuned.
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