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Economics Group

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Amid Rising Inflation, The Fed Remains on Course

The FOMC left interest rates unchanged and acknowledged inflation's progress of reaching the 2 percent target. The policy statement reaffirmed that the Fed intends to continue to "gradually" tighten monetary policy.

Inflation Mandate Progress Recognized

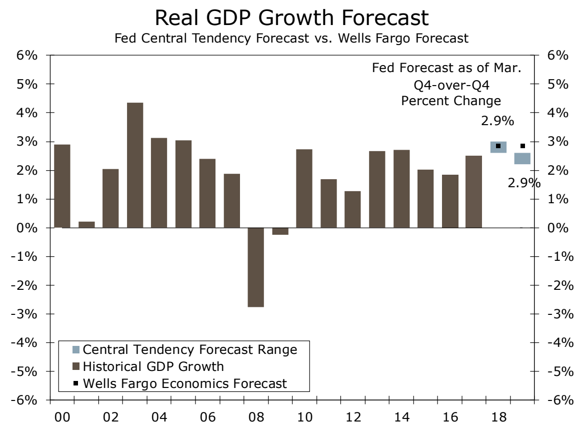
Widely anticipated, the Federal Open Market Committee (FOMC) left the federal funds target rate range [1.50 percent-1.75 percent] unchanged at the conclusion of this two-day meeting. With no rate hike in the cards, focus was squarely on the policy statement and officials' updated assessment of the U.S. economy and whether any signals were being sent as to a change in the anticipated pace of interest rate tightening. Today's statement provided no such evidence.

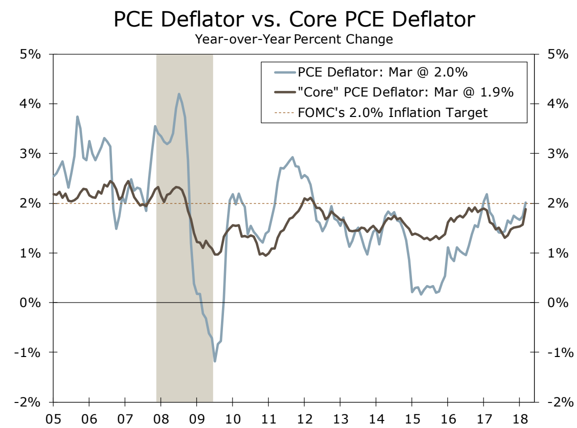
As expected, officials continued to characterize the labor market as "strengthening" and overall economic activity as rising at a "moderate" rate. Despite the relatively soft Q1 performance from a variety of indicators, the Fed continues to express confidence in the U.S. economy's underlying momentum, which in turn fuels its determination to normalize interest rates. That sentiment is reaffirmed by the FOMC's unanimous decision.

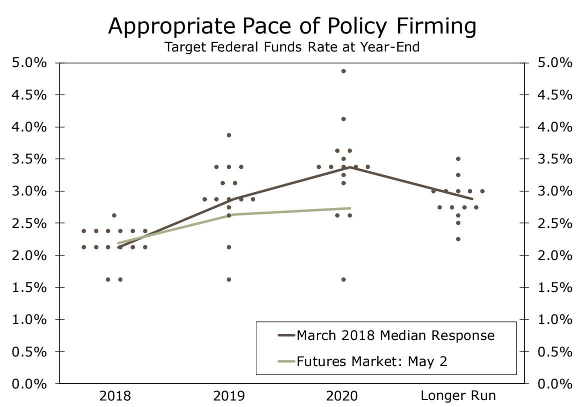
The only material change to the statement came around the language on inflation. In recent months, we have seen a pickup in the pace of consumer inflation as well as wages and salaries. Acknowledging the gap to its target has narrowed considerably, the FOMC upgraded the current assessment, noting that headline and core inflation have "moved closer to 2 percent." Moreover, officials expect inflation to "run near the Committee's symmetric 2 percent objective over the medium term"–a signal of the Fed's willingness to allow inflation to modestly overshoot the 2 percent target for a period of time.

Focus Turns to June and a Likely Boost to the Number of Hikes

Collectively, the pace of the economic expansion, inflationary pressures continuing to build and officials' strengthened confidence in the outlook has led to the financial markets placing a high probability on the next Fed rate hike occurring at the June 12-13 FOMC meeting. While the March dot plot chart maintained the median number of projected rate hikes for 2018 at three, we suspect the incoming economic data leading up to the June meeting will result in a change to four rate hikes, when officials provide their updated outlook. Seven of the fifteen dots have the Fed raising interest rates four or more times this year (bottom chart). However, with the annual rates of the headline and core PCE deflators already at/near the 2 percent target, and assuming economic growth is as strong as the FOMC's current projections, we would expect the majority of officials' projections to collectively raise the median number of 2018 rate hikes by more than it has currently outlined. In our opinion, inflation is the key metric to monitor and will guide the pending pace of monetary policy tightening for the foreseeable future. We look for the Fed-favorite core PCE deflator to rise and trend at/slightly above the 2 percent target through 2019, supporting our call for four rate hikes this year. We look for the Fed to join that perspective next month.







Source: Federal Reserve Board, U.S. Dept. of Commerce, U.S. Dept. of Labor, Bloomberg LP and Wells Fargo Securities

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