



**Kristina Hooper**  
Chief Global Market Strategist



## Federal Reserve

Following a hawkish pause, any better-than-expected US economic data could magnify the market's fears of a higher fed funds rate in 2024.

## Bank of England

Lower-than-expected UK inflation led to a somewhat surprising pause by the Bank of England last week, following 14 consecutive rate increases.

## Bank of Japan

Unsurprisingly, the Bank of Japan left its policy unchanged last week. It noted that wage growth was the most important factor to judge the path of inflation.

# Connecting the dots: Markets react to hawkish revisions in the Fed's interest rate projections

Weekly Market Compass | September 26, 2023

I was in Houston last Tuesday, presenting to a group of financial professionals. It was fun for me, although I'm not sure it was that much fun for them. That's because I spent so much time talking about central banks. I felt a little guilty about that, but I couldn't help myself. After all, monetary policy continues to have an outsized impact on markets, so I believe it's necessary to give adequate coverage to central banks.

## The Federal Reserve changes its "dot plot"

My mild obsession with central banks proved to be warranted last Wednesday, when markets had a substantial reaction to the Federal Reserve's (Fed) "hawkish pause." Specifically, markets repriced assets as they bought into the narrative that rates would be "higher for longer."

Markets came to this conclusion largely because of what was provided in the Summary of Economic Projections (SEP) — also known as the "dot plot" — which is released quarterly. The June 2023 dot plot forecasted the fed funds rate to be 4.6% by end of 2024, implying four rate cuts, but the September 2023 dot plot bumped up that forecast to 5.1%, implying only two rate cuts in 2024.<sup>1</sup> This is a significant change.

The September dot plot contained several other notable changes from the June dot plot<sup>1</sup>:

- The projection for core Personal Consumption Expenditures (PCE) came down materially. The end-of-year forecast for core PCE was 3.9% in the June dot plot; now it's 3.7%.
- Growth projections were revised upward significantly for 2023, from 1% in June to 2.1% in September. Growth was also revised upward for 2024, from 1.1% to 1.5%.
- Unemployment projections were lowered significantly. End of 2023 projections went from 4.1% in the June dot plot to 3.8%. A bigger change is projected for end of 2024, from 4.5% in June to 4.1% in the current dot plot.
- The Fed still expects core inflation to reach 2.6% by the end of 2024. In addition, it expects core inflation to return to its 2% target by 2026.
- The Fed did not change its expectations for one more rate hike this year (although many had hoped that alteration would appear in the September dot plot).

Markets had a rather visceral reaction to the change in the Fed's forecasted rate cuts for next year. Stocks fell globally, and the 2-year and 10-year US Treasury yields hit new highs for the cycle — levels not seen in more than 15 years.<sup>2</sup>

---

## Projections are not promises

I can't help but take the dot plot with a few grains of salt. I must caution that the dot plot is merely each individual Federal Open Market Committee member's policy prescription. It was only introduced in 2012 (several years after the last time the 2-year and 10-year US Treasury yields hit levels finally revisited last week) in an attempt to increase transparency and better guide market expectations. Recall that it was not that long ago when the most communication coming out of the Fed before a monetary policy decision was the size of Alan Greenspan's briefcase. However, as with many things created with the best of intentions, the dot plot has many flaws. It requires a significant amount of conjecture on the part of members (remember, to quote Powell, they are "navigating by the stars, under cloudy skies"<sup>3</sup>). And projections can be extremely unreliable, especially the farther out they go.

For example, the December 2021 dot plot showed expectations that the median fed funds rate would be 90 basis points by December 2022. By December 2022, the fed funds rate was actually 4.25% - 4.5%, nearly 350 basis points higher than the Fed's expectations just a year before. I keep a copy of the December 2021 fed funds rate dot plot hanging on my office wall to remind me to be skeptical of the SEP (let's just say I am "SEPTical" – and with good reason.)

The most important thing to recognize is that ultimately the path of the fed funds rate will be dictated by the data. The Fed doesn't know what the data will say, so when it cuts and by how much remains undetermined. In other words, the SEP is no crystal ball and therefore does not warrant the market reaction we have seen, in my view.

---

## The Bank of England enacts a surprise pause

We got other important central bank decisions last week. In a somewhat surprising turn of events, the Bank of England (BOE) chose to pause rate hikes after 14 consecutive increases.

It seems that lower-than-expected inflation data tipped the balance in favor of maintaining the current rate. The UK Consumer Price Index (CPI) for August rose 0.3% month-over-month, versus an expected 0.7%, and it rose 6.7% year-over-year, down from 6.8% in July. Core CPI was also down meaningfully, to 6.19% year-over-year, from 6.83% in July.<sup>4</sup>

The sharp decline in month-over-month headline inflation and continuing decline in core inflation (which seems to have peaked at 7.14% year-over-year in the April release<sup>4</sup>), suggest that the BOE is finally getting traction on its disinflation effort.

The minutes from the BOE meeting pointed to a loosening of the labor market and weakening activity as additional reasons for the pause. For example, the minutes stated that the BOE's Monetary Policy Committee (MPC) thinks "underlying growth in the second half of 2023 is ... likely to be weaker than expected." It's also important to note that the MPC hasn't paused quantitative tightening. It actually voted unanimously to increase the pace of quantitative tightening to 100 billion pounds of gilts over the next year from 80 billion pounds, representing about 10% of its assets.

---

### **Bank of Japan stays steady, as expected**

The Bank of Japan (BOJ) kept its policy unchanged at its Monetary Policy Meeting last week, as had been widely expected. The BOJ's statement indicated that it has not changed its view on the economy and inflation. In the press conference, Governor Kazuo Ueda sounded dovish as he indicated that BOJ had not yet reached the point where sustained 2% inflation could be expected, as there was a high level of uncertainty over the economy and financial markets, as well as companies' price-setting behaviors.

Ueda did not provide any clues about the timing and sequence of monetary tightening, as it will depend on future developments with regard to both growth and inflation. He said that the BOJ would closely examine the output gap, inflation expectations and the wage growth situation to formulate its inflation outlook, although he suggested that wage increases are the most important factor to judge in determining whether or not Japan is on the path to sustained 2% inflation. The BOJ remains extremely accommodative.

---

### **People's Bank of China likely to continue to loosen policy**

And then there is the People's Bank of China (PBOC), which is likely to continue to loosen, although that is likely to be overshadowed by targeted fiscal policy. The renminbi has been under pressure mostly due to interest rate differentials: the PBOC has been loosening monetary policy while the Fed and other central banks have been tightening. Markets have also become overly negative about China's growth outlook, convinced that a weaker currency could be needed.

---

### **Policy uncertainty remains an issue**

Looking ahead, I would anticipate more volatility in the near term. Volatility is very often the result of policy uncertainty, and policy is even more uncertain today than it was last week.

That's because, looking back to June, we saw that the market expectation of the end-2024 federal funds rate was far below the June FOMC dot plot. However, market expectations moved over the past several months, reaching the June dot plot level before the September dot plot was released. Given this experience, I expect the market is likely to stay rather volatile in the short run as any better-than-expected economic data could magnify the market's fears of a higher fed funds rate — and an even higher for longer scenario — in 2024. This fear is amplified because of concerns that the 10-year US Treasury yield could rise as high as the fed funds rate, as it has done in some past tightening cycles. I suspect that this fear will only be mitigated by actual moderation of inflation and slower US economic growth.

And it's not just monetary policy uncertainty. The looming US government shutdown, United Auto Workers strike and resumption of student loan payments all add to the uncertainty and could increase volatility in the very near term — although I don't think it will have a material impact on markets. I also anticipate more market jitters because if US interest rates indeed become "higher for longer," that would increase the risk of overkill by the Fed, which could send the US economy into recession. And higher rates have typically exerted downward pressure on stocks, especially sectors such as technology. We have gotten a taste of that in recent weeks.

---

While the Fed's latest dot plot is a reaction to better economic data, the irony is that it could cause unnecessary damage because of the lagged effects of monetary policy. Now more than ever, we will want avoid overreacting to the dot plot but also follow every data point closely. And while we are waiting and watching, investors can at least enjoy the higher yields in fixed income in many places around the globe that we haven't seen in years ...

*With contributions from Paul Jackson, Arnab Das, Tomo Kinoshita and Adam Burton*

---

#### Notes

<sup>1</sup>Source: US Federal Reserve as of Sept. 20, 2023

<sup>2</sup>Source: Bloomberg, L.P., as of Sept. 20, 2023

<sup>3</sup>Source: Jay Powell speech at Jackson Hole, Aug. 25, 2023

<sup>4</sup>Source: UK Office for National Statistics, as of Sept. 20, 2023

---

#### Important information

Past performance is not a guarantee of future results.

This does not constitute a recommendation of any investment strategy or product for a particular investor. Investors should consult a financial professional before making any investment decisions.

All investing involves risk, including the risk of loss.

In general, stock values fluctuate, sometimes widely, in response to activities specific to the company as well as general market, economic and political conditions.

Fixed-income investments are subject to credit risk of the issuer and the effects of changing interest rates.

Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa. An issuer may be unable to meet interest and/or principal payments, thereby causing its instruments to decrease in value and lowering the issuer's credit rating.

The Federal Reserve's "dot plot" is a chart that the central bank uses to illustrate its outlook for the path of interest rates.

The federal funds rate, or fed funds rate, is the rate at which banks lend balances to each other overnight.

The Consumer Price Index (CPI) measures change in consumer prices.

Personal consumption expenditures (PCE), or the PCE Index, measures price changes in consumer goods and services.

Core inflation is the change in the costs of goods and services, but it does not include those from the food and energy sectors. This measure of inflation excludes these items because their prices are much more volatile.

Disinflation, a slowing in the rate of price inflation, describes instances when the inflation rate has reduced marginally over the short term.

Dovish refers to an outlook that generally supports low interest rates as a means of encouraging growth within the economy. Hawkish refers to an outlook that generally supports higher interest rates as way to combat inflation.

Hawkish pause is when a central bank keeps interest rates unchanged, while sticking to its hawkish tone due to strong and/or elevated market conditions (inflation, job market).

Inflation is the rate at which the general price level for goods and services is increasing.

Tightening monetary policy includes actions by a central bank to curb inflation.

The Federal Open Market Committee (FOMC) is a 12-member committee of the Federal Reserve Board that meets regularly to set monetary policy, including the interest rates that are charged to banks.

A basis point is one hundredth of a percentage point.

The opinions referenced above are those of the author as of September 25, 2023. These comments should not be construed as recommendations, but as an illustration of broader themes. Forward-looking statements are not guarantees of future results. They involve risks, uncertainties and assumptions; there can be no assurance that actual results will not differ materially from expectations.