Forecasting an interest rate hike in the U.S. in 2022

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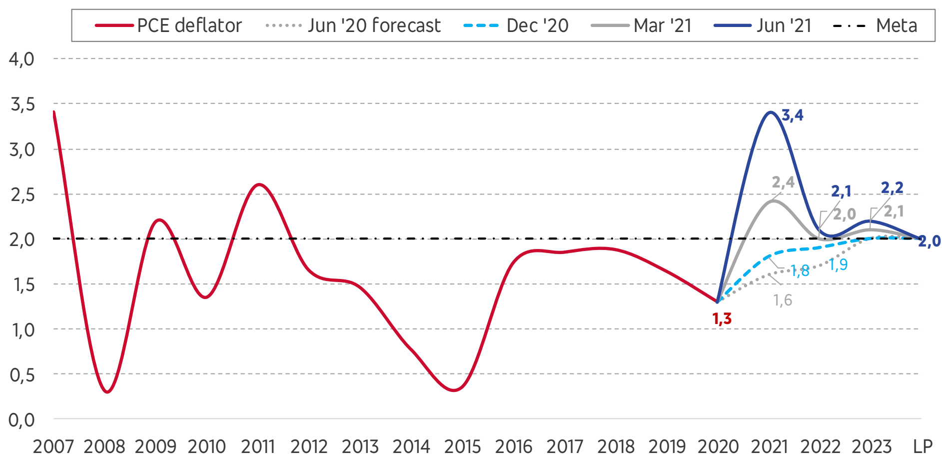
In the coming weeks, investors will pay close attention to the interviews and speeches of the directors of the Federal Reserve (U.S. central bank), which will serve as an input for investors to assess the implications of the change in the Fed's tone at last week's FOMC (monetary policy committee) meeting, while they wait three weeks until the minutes are published.

Falling Treasuries yields in the days leading up to the meeting suggested that some investors expected last week's meeting to be a non-event. They expected the Fed to maintain the dovish tone of recent meetings, repeating the arguments that recent inflation acceleration was mainly due to transitory factors and that, despite the bottlenecks caused by the reopening of the economy after the pandemic, the job market would still fall well short of the goal to reestablish full employment. This environment had also been contributing to reinforce the weakening trend of the U.S. dollar in the global market.

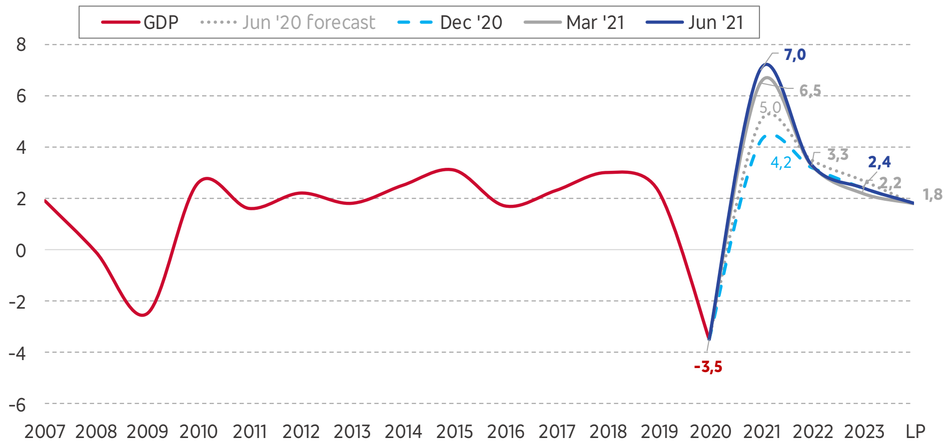
The FOMC statement did not introduce anything new, but the changes in individual FOMC members' projections published together with the statement were interpreted as a more hawkish sign. In addition to adjusting the median forecast for the personal consumption expenditures deflator from 2.4% to 3.4% in 2021, incorporating recent inflationary surprises, the FOMC also revised the median estimate for this year's GDP growth from 6.5% to 7.0%. In December 2020, these forecasts were 1.8% for inflation and 4.2% for growth.

Chart 1: Median Inflation Forecast (PCE Deflator) from FOMC Members



Source: Federal Reserve

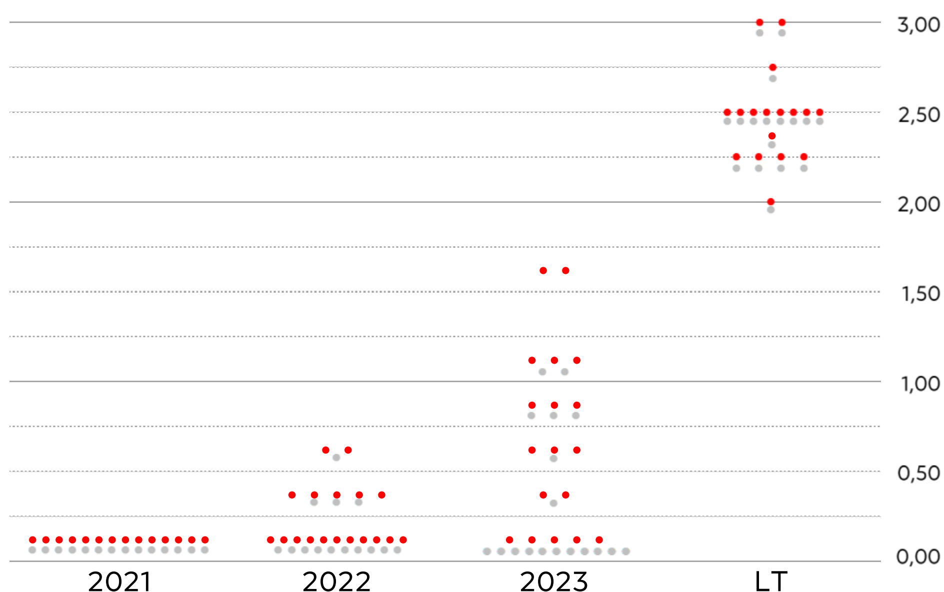
Chart 2: Median Real GDP Growth Forecast from FOMC Members



Source: Federal Reserve

The change in interest rate forecasts by the FOMC members (dot plot), however, was the adjustment that most significantly impacted the market. The chart reveals the individual expectations of the FOMC members regarding the policy rate. Until then, the majority of members did not project interest rate hikes before 2024, which was perceived as evidence of the Fed's commitment to the new monetary policy framework announced last year, in which interest rates would remain low until the targets of full employment and inflation above 2% materialized. In June, however, 7 members of the FOMC forecasted a rate increase in 2022, and a majority of 13 (out of 18) now forecast an increase at least in 2023. These figures were 4 and 7 at the March meeting, respectively.

Chart 3: Projections for the Fed Funds Rate by Members of the FOMC



Source: BCB, Bradesco

At the post-meeting press conference, Fed Chair Jerome Powell cautiously hinted that the Fed is changing the tone of its speech. The assessment of the job market conditions, for example, has become more constructive. And while he said there are still steps to be taken before the Fed meets its objectives to reduce asset purchases, he also said that estimates indicate that those targets will be met sooner than expected, a welcome occurrence.

Under the new monetary policy framework, the Fed pursues an average inflation target of 2%. Periods of below-target inflation should be followed by periods of slightly above-target inflation to ensure that inflation expectations are always anchored at the center of the target. And since the major monetary policy challenge in recent years has been to avoid deflation, the Fed is now seeking to promote a period of inflation slightly above 2%.

As such, it has emphasized the need to differentiate shocks that may temporarily raise inflation above 2% from an inflation trend of more than 2%. Considering the result of the May consumer price index[1], almost 1/3 of the monthly change in core CPI resulted from the contribution of the upswing in used car prices[2], pressured by issues in the manufacture of new cars due to the global shortage of semiconductors. This is a typical example of what the Federal Reserve would call the transitional effect associated with the reopening of the economy.

On the other hand, some inflation components suggest a more difficult outlook. Owner's equivalent rent of residences[3] accelerated by more than 0.1 p.p. to 0.31% – the highest monthly increase since April 2019. Since this inflation item has high persistence and significant weight, it will likely contribute with 8 bps to monthly inflation in the coming months. Considering that the 2% inflation target implies an average monthly inflation of 0.21%, this is a relevant inflationary pressure.

Powell also adjusted his speech regarding the job market at the last FOMC meeting. The previous emphasis was on the fact that there were still 7.6 million jobs needed for the U.S. to return to pre-pandemic levels. And the mantra was that the great lesson from recent years had been that it was possible to sustain lower unemployment rates than previously believed, allowing income growth, without this turning into inflationary pressure.

At the press conference, Powell commented on evidence of restricted labor supply stemming from the possibility that an increase in the pace of retirements has led to a more persistent drop in the participation rate. Powell cannot be said to have joined the Federal Reserve's more hawkish group of directors, but his speech suggests that arguments that the job market is perhaps tighter than previously thought may have gained some traction among committee members.

[1] Change of 0.64% m/m and 4.9% in 12 months, with core by exclusion of 0.74% m/m and 3.5% in 12 months.
[2] +7.3% m/m, compared to +10% in April.
[3] An item with a weight of 24% on the index as a whole.

A breakdown of the data suggests that conditions in the labor market may indeed be tighter than imagined. Table 1 compares the sectoral breakdown of jobs that still need to be created[4] with the survey of job openings by sector. Both series are released by the Bureau of Labor Statistics (BLS). Assuming that everyone who was employed before the pandemic wants to return to work, the NFP survey data serves as an estimate of the potential labor supply by sector. The data from the survey of open positions represents the demand for labor. The fourth column of the table shows the annualized change in the average hourly earnings for non-supervisory workers.

This exercise suggests that there are more job openings than there is labor supply in the economy as a whole[5]. In some sectors of the economy, companies seem to demand much more labor than the potential supply, such as in financial services (at a ratio of almost 6:1), the transport and warehousing (almost 4:1), retail, health services and professional services (more than 2:1)[6]. As might be expected, this excess demand for labor appears to be putting significant pressure on wages in these sectors.

Table 1: Estimated Labor Supply and Demand (by sector) – thousands

	Net change in employment since the pandemic (May)	Job openings (April)	Job openings/ remaining unemployed	Change in hourly earnings (non-supervisory) - Feb-May (annualized)
Total	(7.629)	9.286	**122%**	
Private	(6.462)	8.374	**130%**	**6,3%**
Construction	(225)	357	**159%**	**8,3%**
Industry	(509)	851	**167%**	**4,0%**
Retail	(411)	965	**235%**	**11,6%**
Transp. & Warehousing	(100)	386	**387%**	**12,0%**
Professional Services	(708)	1.517	**214%**	**7,3%**
Financial Services	(73)	430	**589%**	**9,9%**
Education Services	(293)	121	**41%**	**4,50%**
Health & Social Serv.	(508)	1.319	**260%**	**4,50%**
Hospitality & Leisure	(3.781)	1.586	**42%**	**23,6%**
Other	146	842		
Government	(1.379)	913	**66%**	

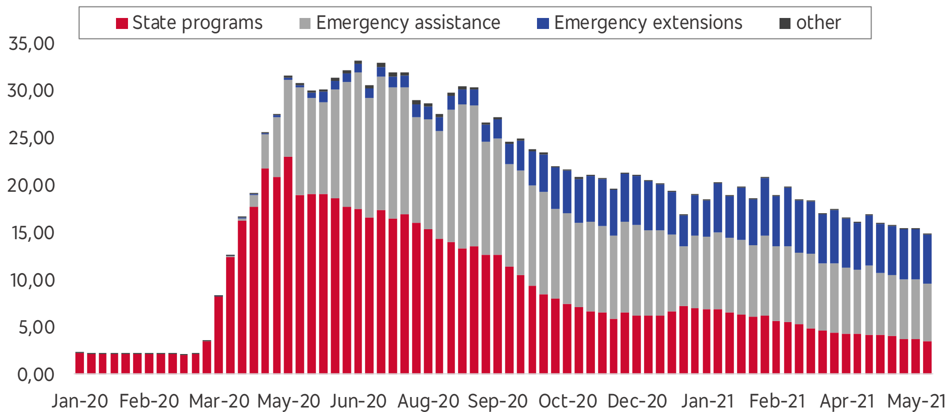
Source: BLS and Bradesco

In the hospitality and leisure sector, which accounts for almost half of the net job loss since the beginning of the pandemic, there seems to be much more potential labor supply than open positions. However, this is the sector where wages are rising at the fastest pace. The best explanation for this apparent contradiction seems to be the effect of the unemployment benefits created by the fiscal stimulus packages. Since the average wage level in the sector is among the lowest in the economy, part of the sector's unemployed population receives more in unemployment benefits than if they were working. The average U.S. unemployment benefit (varies from state to state)[7] is slightly over $300 per week and the duration of the benefit depends on a number of factors. With the $300 federal emergency aid benefit in effect through September, an unemployed person can receive, on average, just over $600 a week in benefits. The average weekly income in the economy (excluding managerial positions) was $878, but in the hospitality industry it was $398.

[4] 7.6 million jobs still need to be created, according to NFP data, to return to the pre-pandemic level
[5] Open positions correspond to just over 120% of the potential labor supply
[6] This excess demand is likely due to the strong growth in property sales, the growth of online delivery and purchase services and the reopening of the economy as a whole.
[7] A second federal benefit extended the validity of the aid to people who have already stopped receiving aid through the state's regular program and remain unemployed.

In order to attract labor, employers in the hospitality sector must offer higher wages than usual, which explains the upward trend, despite the elevated number of unemployed compared to job openings. It is worth remembering that because of the flexibility of the job market, companies will likely be able to adjust wages downwards after the emergency aid expires in September.

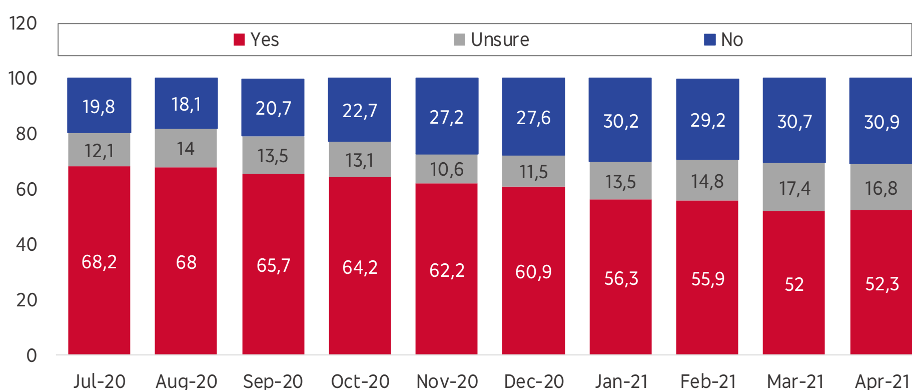
Chart 4: Unemployment Allowance (thousands of benefits)



Source: U.S. Department of Labor

The exercise does not take into account population growth or falling participation rates during the pandemic. While people who have left the job market may return as the reopening of the economy progresses, the cumulative effect of these factors most likely means that employment conditions will remain tight. In a recent survey, the Federal Reserve in Dallas found that the unemployed population is less willing to return to work under conditions that prevailed before the pandemic.

Chart 5: Portion of Unemployed willing to return to the job they had before the Pandemic under the same salary and hours worked conditions



Source: Real-time Population Survey / Federal Reserve Bank of Dallas

Overall, the data suggests that conditions in the job market are tighter than previously thought, despite the 7.6 million job gap. In particular, service sectors that require more training and pay higher wages appear to be facing increasing pressures.

In addition to the tight job market, the Beige Book, a collection of information published before every FOMC meeting, reports an increasingly complex inflation scenario. In summary, Fed contacts report that "input costs have continued to increase", in part "intensified by continuing supply chain disruptions", "sharp increases in construction and manufacturing prices", "increases in freight, packaging and petrochemicals prices" and that "strengthening demand allowed some businesses, particularly manufacturers, builders, and transportation companies, to pass through much of the cost increases to their customers." This last observation, in particular, seems to be a textbook definition of economic conditions that allow the emergence of secondary effects associated with a primary shock to the economy – a situation that should normally be addressed by central banks.

Given the evidence of increasingly tight conditions in the job market, persistently high inflation and the change in the Fed's communication, we revised our scenario for monetary policy in the United States. We believe the Fed will begin discussions on adjustments to the asset purchase program as early as the August FOMC meeting, with tapering starting between late 2021 and early 2022. This discussion can even be further explored in the traditional annual Jackson Hole symposium, which will be held in the second half of August. If this scenario is confirmed, we believe that additional adjustments to the purchase program will be announced over the next year and the first benchmark interest rate hike could take place in 2022.

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