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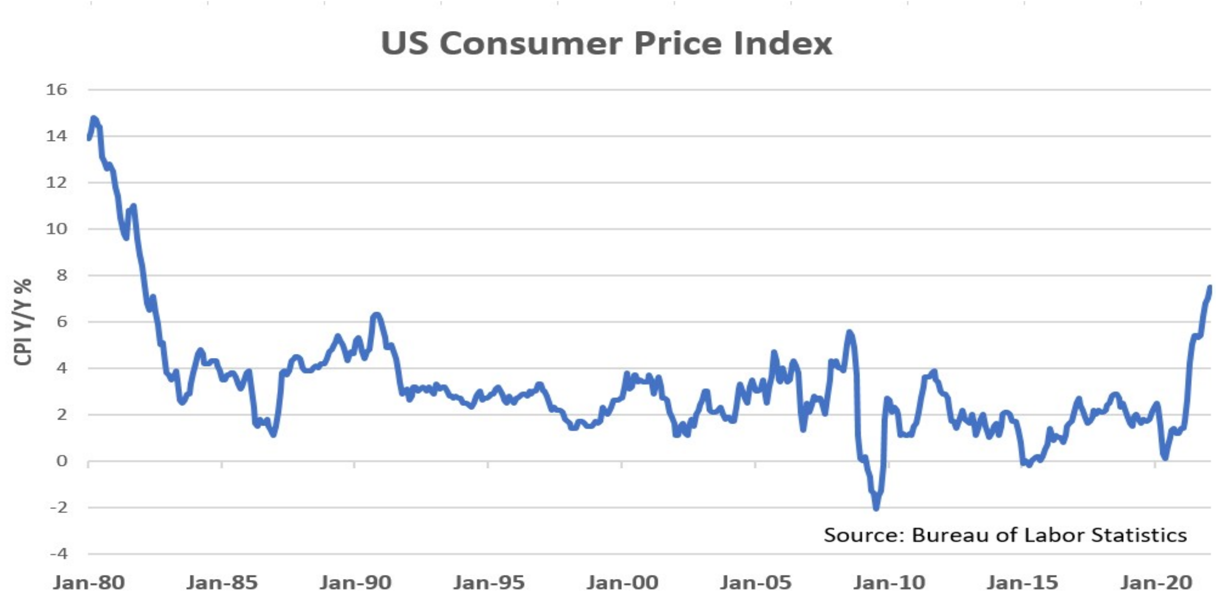
Will the Federal Reserve raise rates by 50 basis points in March?

On February 10, 2022, the US Bureau of Labor Statistics released inflation data which showed consumer prices in January 2022 rising at the fastest pace in 40 years. Following the report, futures markets reflected an increased belief by investors that the Federal Reserve will act aggressively to slow inflation. Markets now imply a total of six quarter-point hikes in 2022 and a higher probability of a 50-basis point rate hike in March 2022. While most investors believe it's a near certainty that the Federal Reserve will raise rates in March, the more difficult question is whether the rate increase will be 25 basis points or 50 basis points. The Federal Reserve last increased the federal funds rate by a full 50 basis points in May 2000; and in recent history, all but one 50-basis point move (i.e., the May 2000 hike) have been during periods of rate decreases, not increases.

Following the Federal Reserve's meeting in January 2022, Chairman Powell stated that the Federal Open market Committee (FOMC) was not committed to any particular pace of rate hikes, saying, "We know that the economy is in a very different place than it was when we began raising rates in 2015. Specifically, the economy is now much stronger. The labor market is far stronger. Inflation is running well above our 2 percent target, much higher than it was at that time. And these differences are likely to have important implications for the appropriate pace of policy adjustments." For comparison, the 2015 hiking cycle began with a 25-basis point hike and proceeded at a gradual pace of 25-basis points nearly every quarter until the end of 2018.

Since the Federal Reserve adopted a hawkish pivot in its January 2022 meeting, additional economic data suggest that prices continue to rise and that the central bank may be falling even further behind the curve in the fight against inflation. The January Consumer Price Index increased at a faster-than-expected pace of 0.6%, bringing the annual increase to 7.5%, the highest level since 1982. The price increases are persistent and broad based as the economy struggles with supply chain bottlenecks, pent-up demand on the COVID reopening, and the aftermath of aggressive fiscal and monetary stimulus to address the pandemic's economic effect.



Labor market data released after the Federal Reserve's meetings in January 2022 also suggest that the central bank may need to apply a more forceful approach to cool the economy. The US Bureau of Labor Statistics reported that employers added a much higher than expected 467,000 jobs in January 2022 and it revised the preceding two months of data higher by 729,000. While the January 2022 unemployment rate increased slightly to 4.0%, the labor force participation rate moved higher to 62.2%. In a more troubling development for the Federal Reserve, wage pressures continued to accelerate as average hourly earnings increased at a 5.7% annual rate in January 2022, versus 4.9% in December 2021. Even with the influx of workers back into the labor force and recent wage gains, labor demand remains red hot. According to The Bureau of Labor Statistics' Job Openings and Labor Turnover Report, the economy ended the year with nearly eleven million unfilled jobs, four million above the year ago level.

Not surprisingly, recent comments from Federal Reserve officials don't clarify the potential for a 50-basis point rate increase in March 2022. Atlanta Federal Reserve President Bostic recently stated that the Federal Reserve would rely heavily on economic data to decide the magnitude of any March 2022 rate increase, but he nevertheless maintained that his base case assumes only three one-quarter point hikes in 2022. San Francisco Federal Reserve President Daly, a dovish member of the FOMC, recently advocated for a more "measured" pace to avoid destabilizing economic growth and price stability. Last week, St. Louis Federal Reserve President Bullard said the highest inflation readings in four decades warrant a 50-basis point hike in March and that he would "like to see 100 basis points in the bag by July 1st."

Calling the magnitude of the Federal Reserve's March 2022 rate hike isn't an easy task. The Federal Reserve will have the benefit of another CPI report before the meeting, but we don't expect any near-term relief on the inflation front. The Federal Reserve may favor raising rates by only 25-basis points in March in part due to 1) recent history (i.e., the Federal Reserve rarely hikes by 50 basis points), 2) a preference for a more gradual approach to avoid disrupting economic growth and unsettling financial markets, and 3) the possibility that some inflation pressures could be transitory due to continuation of supply chain disruptions initiated by the COVID pandemic. Given the strength of the economic data and the risk of falling even further behind the curve on inflation, we suspect it is too late for a cautious approach and believe that the Federal Reserve should respond aggressively with a 50-basis point hike at the March meeting.