US Fed pushes back against the market with a hawkish 50bp rate hike

A 50bp hike takes the policy rate to 4.25-4.5%. There is clearly some discomfort at the Federal Reserve that recent declines in Treasury yields and the dollar are undermining its efforts to bring inflation under control. Consequently, it will keep the hikes coming and acknowledge this will mean a 'sustained period' of below-trend growth and job losses

Federal Reserve Chair Jerome Powell speaks during a news conference on 14 December 2022

4.25-4.5% Target range for the Fed Funds Rate

50bp with a hawkish twist

The Federal Reserve voted unanimously to raise the Fed Funds target rate range by 50bp to 4.25-4.5%, in line with market expectations. The text repeats that officials anticipate that “ongoing increases” in the Fed Funds rate will be “appropriate”, while its forecast update has the central projection being for the Fed funds rate to end 2023 at 5.1% and 4.1% for 2024. They were 4.6% and 3.9% previously.

Two consecutive undershoots of inflation have led the market to believe we are getting very close to the peak for interest rates, and rate cuts will soon be on the agenda. The Fed clearly isn't willing to make that call.

There are some big upward revisions to the central bank's inflation forecasts. Remember the Fed focuses on the core personal consumer expenditure deflator and not the core CPI which was published yesterday. Core CPI is more impacted by used cars and has a different definition of medical care costs, both of with contributed significantly to the downside CPI miss. The core PCE deflator is likely to be stickier than core CPI with the Fed revising up its core PCE estimate to 3.5% for the end of 2023 versus 3.1% previously, with 2024 revised up to 2.5% from 2.3%.

The Fed is seemingly predicting only a modest downturn in activity next year with the unemployment rate rising to 4.6% from the current level of 3.7% with the economy continuing to expand, albeit at just 0.5% year-on-year between the fourth quarter of 2022 and the fourth quarter of 2023.

Federal Reserve projections

	2022	2023	2024	2025	Longer run
Change in real GDP (Dec Fed forecast)	**0.5**	**0.5**	**1.6**	**1.8**	**1.8**
Previous Fed projection (Sep)	0.2	1.2	1.7	1.8	1.8
Unemployment rate (Dec Fed forecast)	**3.7**	**4.6**	**4.6**	**4.5**	**4.0**
Previous Fed projection (Sep)	3.8	4.4	4.4	4.3	4.0
Core PCE inflation (Dec Fed forecast)	**4.8**	**3.5**	**2.5**	**2.1**	**-**
Previous Fed projection (Sep)	4.5	3.1	2.3	2.1	-
Federal funds rate (Dec Fed forecast)	**4.4**	**5.1**	**4.1**	**3.1**	**2.5**
Previous Fed projection (Sep)	4.4	4.6	3.9	2.9	2.5

Source: Federal Reserve, ING

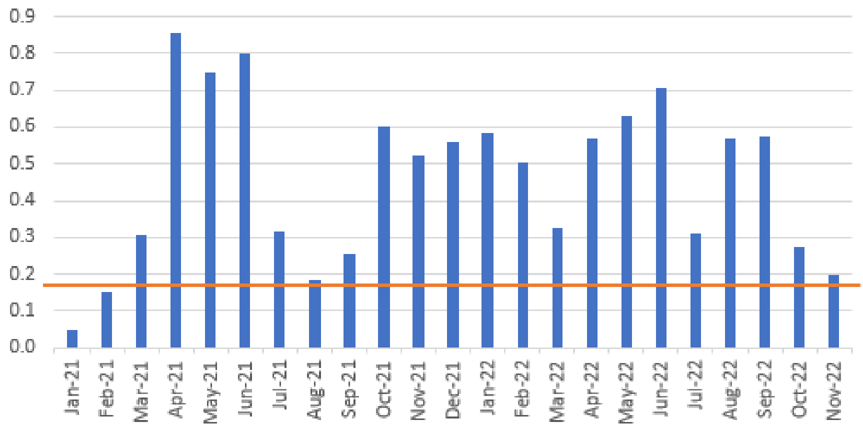
Another 50bp hike in February – the Fed wants more evidence that inflation is slowing

This relative hawkishness likely stems from concern that the recent steep falls in Treasury yields and the dollar are undermining the Fed's interest rate hikes by loosening financial conditions – the exact opposite of what the Fed wants to see as it battles to get inflation lower. Indeed, comments from Fed Chair Jerome Powell emphasise that the bank wants financial conditions to "reflect the policy restraint that we're putting in place". After all, inflation is indeed still running well above target, the jobs market and wage pressure remain hot, and activity data is pointing to a decent fourth-quarter GDP report after a healthy 2.9% growth rate in the third quarter.

While the market may view inflation as being in its death throws, the Fed certainly does not. For the Fed to relax it will want to see substantial evidence that inflation is slowing, not just one or two months where core inflation has come in less than the market was expecting. We must remember that to get inflation to 2% YoY over time we need to see month-on-month readings averaging 0.17% MoM. We are not there yet as the chart below shows – and remember it is the core PCE deflator that the Fed pays the most attention to.

Given this situation, we remain happy with our call for a further 50bp rate hike at the 1 February Federal Open Market Committee meeting.

US core CPI MoM still tracking above the required 0.17%MoM level



Source: Macrobond, ING

A pause in the second quarter before cuts in the third

Nonetheless, the Fed is raising interest rates at the most rapid pace since the early 1980s and stress is showing up in two key areas. The Conference Board's measure of US CEO confidence is at its lowest since the depths of the Global Financial Crisis. If CEOs are truly this pessimistic it bodes poorly for corporate profits, job hiring and business Capex. Secondly, the housing market is under real stress with demand falling sharply in response to higher mortgage rates with prices and the number of transactions reversing sharply.

We think the downturn will be more painful than the Fed is currently anticipating and that recessionary forces will dampen price pressures while the composition of the US inflation basket, which is heavily weighted to shelter and vehicles, will facilitate a far faster drop in annual inflation readings than in any other major economy.

Historically the Fed has on average only waited six months between the last rate hike in a cycle and the first rate cut. In this regard, the Fed has a dual mandate which includes an employment dynamic on top of price stability. This offers the Fed even greater flexibility versus other central banks which only have an inflation target, to respond with stimulus, and we believe it will from the third quarter of 2023 onwards.

Market rates: Under pressure to back off now and test higher in the months ahead

Markets need to re-think the sustainability of the bond rally seen in the past month. Nominal and real rates are up, but not by very much. With no sense as of yet that the Fed is done, we continue to call for market rates to move higher. We likely have seen the highs at 4.25%, although our models in fact call for a peak with a 5% handle, and the anomaly here is how big the discount is between the 10yr yield and the likely peak in the funds rate.

The 50bp fall in the US 2yr yield between this FOMC and the previous one correlated with a steady ratchet lower in the market discount for the terminal Fed funds rate. This also ratcheted lower the upward pressure on the 10yr yield, which tends to be influenced by where the funds rate peaks. It still leaves us with a conundrum, where the current 10yr yield looks quite low relative to the likely terminal funds rate. If the 10yr stays here, the discount would be in excess of 100bp, which is quite large relative to the past few decades. We think the 10yr can narrow that discount in the coming month or so.

Powell had little to say of any materiality on the bond-buying unwind. There had been a small probability attached to the possibility that the Fed could have considered consideration of outright bond selling (as opposed to the less impactful ongoing bond roll-off). The rationale could have been to mute, or even reverse, the significant fall in long-end yields seen in the past month, done with a view to re-tightening financial conditions. In the event, the Committee is not looking into this just yet. It remains an option, however, especially should the Fed require an overall tightening in liquidity circumstances to push in the same direction as the higher rates policy does.

The Fed also remains relaxed with the ongoing volumes going back to them on their reverse repo facility. Recently this has ticked back up again towards the $2.2tr area, partly as the US Treasury curbs bills issuance in an effort to smooth the rise into potentially hitting the debt ceiling by mid-2023. But that aside, the bond roll-off programme has done so more than cause the volume of cash going back to the Fed to plateau. The repo market would like to see it fall. But from the Fed's perspective this is a facility that's doing its job; mopping up liquidity at 5bp above the funds rate floor. So, no change in the Fed's tune on this. But 2023 should see these volumes ultimately wind lower, albeit slowly over the course of the year.

FX: Fed reality-check can slow the dollar's descent

Today's hawkish hike from the Fed can deliver some support to the free-falling dollar. Heavy losses from early November were built on the Fed declaring the all-clear on inflation and being in a position to cut rates in the second half of 2023. That may be the case, but the Fed is not ready to declare that today.

The short-term market reaction of some modest bearish inversion of the US curve should act as a brake on the most recent down leg of the dollar. We had been concerned this week that the short end of the curve was beginning to crumble – which could have seen the dollar sell off a further 2-3%. Instead, the Fed holding onto rate hikes in 1Q23 and to some degree pushing back against the scale of expected easing – 200bp of cuts had been priced in by the end of 2024 – can help the dollar stabilise.

It is probably a little dangerous to call EUR/USD back to 1.05 immediately since there is still a small chance the ECB surprises with a 75bp hike tomorrow and the dollar seasonally struggles in December. Yet today's communications have not fed the dollar bears and we suspect investors will not want to chase the dollar too much lower into year-end. EUR/USD closing back below 1.06 for a couple of days would be the first sign that the rally had lost momentum.

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