

Another 75bp from the Fed, but a pivot is coming

The Federal Reserve has raised the Fed funds target range by 75bp, making it a cumulative 225bp of rate hikes this year so far. The Fed's work is not yet done and we look for a further 125bp of hikes before the end of the year. But with recession risks mounting and inflation set to fall sharply in 2023, rate cuts will be the key theme for next year



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Another 75bp

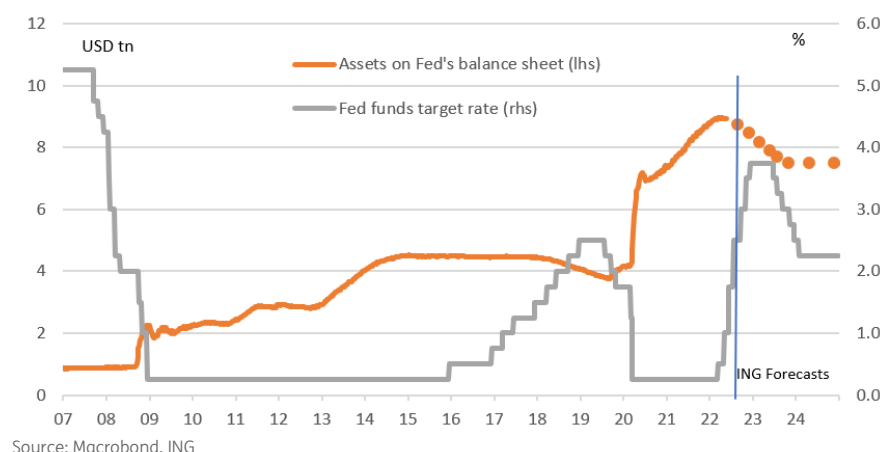
So it is indeed another 75bp hike from the Federal Reserve, taking the target range for the federal funds rate to 2.25-2.5%. In the statement they acknowledge that "recent indicators of spending and production have softened", but that "job gains have been robust". Moreover they remain "highly attentive to inflation risks" and anticipate that "ongoing increases in the target rate will be appropriate". They will continue to run down their balance sheet as they previously outlined with the committee remaining "strongly committed" to returning inflation to its 2% target. This time around it was a unanimous decision after Esther George voted in favour of a less aggressive 50bp hike in June.

Fed likely to switch to 50bp from September, Jackson Hole to provide clarity

We have the best part of two months until the September 21st FOMC meeting, a period that includes two jobs report, two inflation reports and the Fed's Jackson Hole symposium (August 25-27). A lot could happen in that time so it is unsurprising that the Fed is being somewhat vague in its forward guidance. Comments for Chair Powell that the size of future rate hikes will depend on the data and that smaller rate hikes will be appropriate at some point make obvious sense. Jackson Hole is when we will get a clearer indication from the Fed.

For now the Fed's base case remains a soft landing (even if tomorrow's GDP report shows a trade and inventory swing induced "technical" recession), but this looks hard to achieve in the current circumstances. The immediate priority is getting a grip on inflation, but we think the Fed will switch to 50bp hikes at the September and November FOMC meetings with a final 25bp hike in December.

ING's forecasts for the Fed funds target range and balance sheet size



2023 rate cuts are firmly on the cards

By delaying their response to high inflation and now having to move policy faster and deeper into restrictive territory, there is clearly the fear of a recession. Household finances are already being squeezed by inflation and confidence on the floor and if the housing market topples over after 40% price appreciation over the past two years then recessionary forces will undoubtedly intensify. At the same time dollar strength and widening credit spreads are additional headwinds for the economy.

In a recessionary environment inflation could fall quickly with falling house prices set to weigh on rents next year while improved supply chains could boost new car availability and lead to sharply lower used car prices. At the same time, weaker demand will reduce corporate pricing power while lower import and producer price inflation and a moderation in wages will also dampen inflationary pressures. If gasoline prices also gradually moderate we could see inflation drop to 2% by the end of next year.

Moreover, interest rates don't stay high for long in the US. Over the past 50 years, the average

period of time between the last Fed rate hike in a cycle and the first rate cut has only been six months. This suggests the potential for rate cuts as soon as early next summer.

The peak in market rates is consistent with where the Fed now is in the cycle

Minimal market reaction to the 75bp hike. If anything inflation breakevens were a tad higher, but not much in it. Nominal rates are seeing little change in terms of impact effect. But the lead up to this has seen market rates fall, calming inflation expectations, pushing towards delivering on what was expected and no more. Meanwhile the 5yr continues to richen to the curve, strengthening the turning point story for market rates having set that peak at 3.5% for the 10yr a little over a month ago.

We think market rates have peaked. Specifically, the 3.5% area reached by the 10yr Treasury yield in mid-June was most likely it. We argue that it's not about the level per se. It's about the cycle, and the fact that the influential 5yr area is now signalling a turn in the cycle. Specifically, the 5yr yield is no longer sitting above an interpolation between the 2yr and 10yr (and trading cheap), but is now trading rich.

This second 75bp hike from the Federal Reserve solidifies this, as it will further tame inflation expectations, which have really come down markedly in the past month or so. The recent 9.1% inflation print is noteworthy, but not pivotal. Inflation expectations matter more. The 2yr inflation breakeven (which incorporates latest inflation) is now down to the 3% area, having been at 4.5% in mid-June (and 5% in March).

In addition, post this FOMC the Fed has completed two-thirds of what we think they will deliver in total. Typically from there, the turning point is upon us. The US yield curve is under flattening pressure now as the Fed continues to hike. As the hikes begin to slow (which we see by the autumn), the next big move will be a steepening from the front end, as the curve begins to get ready for potential cuts at some point in 2023.

FX: Dollar negative reaction unlikely to last long

We're currently seeing a correction in the dollar after a well-telegraphed 75bp rate hike was announced. This "sell-the-fact" reaction is no surprise to us, and it was actually our base-case scenario for today given the dollar's rally into the meeting and the greenback's tendency to correct lower after recent FOMC announcements.

However, we do not expect the dollar to face a longer-lasting soft momentum. First, because the Fed's still hawkish stance itself should continue to put a floor below the dollar at least into September; second, because continued instability in risk assets and risks for the European region due to the Russian gas crunch all suggest the safe-haven dollar should retain some strength.

EUR/USD may re-test parity in the near term, in our view. It must be noted that European-specific factors (Russian gas, Italy's election campaign, expectations around the September ECB hike) appear to be increasingly important drivers of the pair, with US-specific factors playing a secondary role. In the rest of G10, we think the dollar could remain strong against high-beta currencies for a bit longer, with the possible exception of NOK and CAD should oil continue to recover.

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