

Fed: Another 75bp but the 'step down' to 50bp is coming

The Federal Reserve has delivered the fourth super-size 75bp hike in a row but signalled more modest moves are in store for December onwards. Nonetheless, more work is needed with a possibly higher 'terminal' interest rate. Recession risks are rising, but that is the price the Fed is prepared to pay to get inflation under control



Jerome Powell, chair of the Federal Reserve

375bp Cumulative interest rate increases in 2022

Fed goes for 75bp, but hints at slower hikes ahead

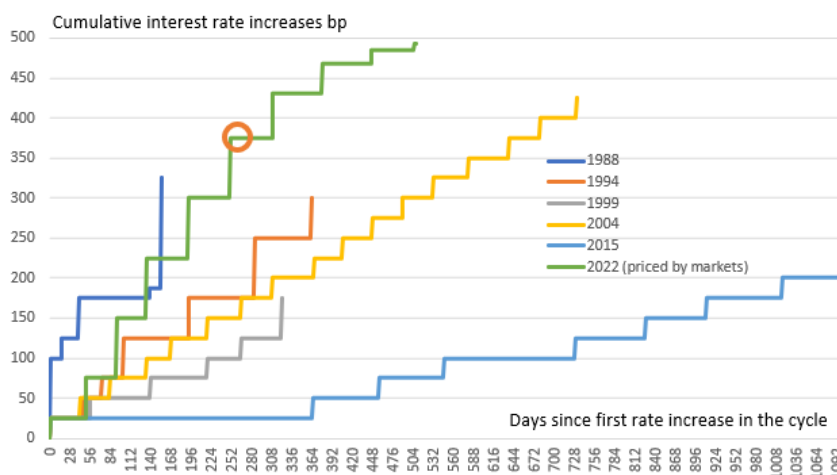
No surprise from the Federal Reserve in that we have a fourth 75bp interest rate increase in a row, bringing the cumulative policy tightening to 375bp since March and the Fed funds target range up to 3.75-4%, in what was a unanimous decision. However, there are some major changes to the statement and Fed chair Jerome Powell's press conference that suggests we will see a "step down"

in the size of rate hikes in the future, but a possibly "higher" endpoint for interest rates.

The Fed continues to “anticipate that ongoing increases in the target range will be appropriate”, adding that hikes will continue until they achieve a “stance of monetary policy that is sufficiently restrictive to return inflation to 2% over time”. But there is an important caveat in that “the Committee will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, and economic and financial developments.” This suggests that they’ve done a lot of work already and it may be time to take things a little slower.

This is a key shift that had been signalled by Fed governor Chris Waller and San Francisco Fed president Mary Daly in October, the latter who suggested back then that the Fed is "thinking about a step down [in the pace of hikes], but we’re not there yet". That said, it is important to emphasise this does not mean rate hikes are going to stop soon. Powell in the press conference highlighted an important distinction between the pace of rate hikes and what will be the ultimate, or terminal, rate level. Indeed, he commented that the Fed doesn't want to fail to tighten enough and loosen too soon.

The current rate hike cycle vs. previous cycles – the orange circle marks where we currently are



Source: Macrobond, ING

Market scales back hikes, but extends duration

Right now, financial markets seem to be thinking the Fed is indeed signalling the prospect of slower-paced hikes AND a slightly lower terminal rate. Futures markets are pricing in around 120bp of additional Federal Reserve interest rate increases from here, having been pricing 125bp immediately ahead of the decision. About 57bp is priced for mid-December, 38bp is priced for early February 2023 and 18bp is priced for the 22 March Federal Open Market Committee (FOMC) meeting with 8bp for May. We are currently favouring 50bp in December and 50bp in February and calling that the top.

As Powell has repeatedly admitted, monetary policy works with “long and varied lags” and after having hiked rates 375bp, it makes sense to hike a little less aggressively. Certainly, the speed with which Treasury yields, mortgage rates and other borrowing costs have been rising in the economy

is causing some economic stress, most notably in the housing market, and recession fears are undoubtedly spreading.

Inflation remains key and the Fed has two bites of the cherry

Nonetheless, the Fed would clearly like to see some evidence that price pressures are starting to moderate. The core (ex-food and energy) CPI and core PCE deflator continue to show prices rising 0.5% or 0.6% month-on-month, whereas we need to see numbers closer to 0.1/0.2% to get annual inflation down to 2% over time. That said, we have got two bites of the cherry with two inflation prints scheduled ahead of the December FOMC meeting – October CPI next Thursday and the November CPI report on 13 December. If we can get a 0.3% or a 0.4% month-on-month for the core CPI in one of those, coupled with further signs of a broadening slowdown and easing pipeline price pressures, that would give the Fed the green light to go for a 50bp move.

We anticipate a final 50bp for February, but by the time of the March FOMC meeting we are predicting the US to have entered a recession with slowing rents, falling used car prices and rapidly receding corporate pricing power contributing to far more convincing signs that inflation is moderating.

Market rates still deliberating whether to fall from here. Essentially they shouldn't

The Fed has caved to the "pivot" camp. A very smart use of phraseology. But the messaging is clear – something different is probably coming from the December meeting. The danger the Fed runs here is a significant fall in market rates. So far the terminal rate at 5% is holding in. But there is open season now for that to be pulled down. This telegraphing from the Fed could reflect worries beyond recessionary ones. We've noted before that USD commercial paper prints have become far more concessional of late, with European banks printing in excess of 50bp in the 3-month. While there is no imminent threat of a system break, even the build in risk could be enough to sway the Fed.

It may also be less complex than that. It could also be a preparatory glide path that ultimately guides us to a terminal rate of 5%. If that's the case, then 10yr still has no business making a structural break below 4% this early. But the risk is as stated, that the door is open now for a lower terminal rate, and if so, a material easing in financial conditions in anticipation of that. The model for the 10yr at this stage of the cycle remains; we still see the 10yr peaking at 25-50bp through the fed funds terminal rate, and we need to see that terminal rate level before the 10yr actually knows with conviction that it is a peak. That's the argument for market rates not getting too carried away with this, and understanding that we are still in a rate hiking process, with the terminal rate still much higher than where we are now.

The main outcome has been a rise in inflation expectations following this aggregate FOMC outcome, and the only rationale for this is from the verbal commentary. Based on this, the market views this, at the margin, as presenting upside risks to inflation. Real rates are lower, which gels with risk assets outperforming as a reaction. Overall this represents a loosening in financial conditions coming from market moves alone. It's not been dramatic so far, and whether these moves become material enough to wipe out the value of the 75bp hike delivered today will depend on the degree of follow-through in the coming days and weeks.

FX markets: down and up

The FX markets initially reacted to the FOMC statement by selling the dollar. The insertion into the statement of the need to take cumulative tightening into account recalled events in Europe last week. Last Thursday, the market took 30bp off the ECB cycle and sold the euro on news that the ECB had seen 'substantial progress had been made in withdrawing monetary accommodation'. Today's FOMC statement briefly took 8bp off the Fed cycle and saw the dollar sell-off 0.5-1.0%.

But markets read the press conference more hawkishly. Particularly comments from Powell that he expected the Fed terminal rate to be higher than the Fed expected back in September. Those September Dot Plots saw the policy rate ending 2023 in the 4.50-4.75% area. News that the terminal rate could be higher tended to trump the discussion of the pace of hikes – and Powell certainly wanted to shift the narrative to the terminal rate from the pace. As we conclude writing this short update, the pricing of the Fed cycle is now higher than it was shortly before the FOMC statement. Equally the dollar has retraced its intra-day losses.

Where does that leave us? Expectations of the policy rate being taken to 5% into early next year, inverting the yield curve still further, is a dollar positive. As always, markets will be highly sensitive to incoming US data and based on today's press conference it does seem that the bar is set very high for the market to start pricing a substantially lower terminal rate. We think the balance of risks still favours a stronger dollar, particularly against European currencies where our macro team see growth substantially below consensus over coming quarters.

In practice, this means EUR/USD can still make a run towards 0.95 over the coming months and USD/JPY can still retest 150. Where interest in the carry trade could emerge is in Latin America. Here the risk-adjusted implied yields of the Mexican peso are 50% above those for the Brazilian real and USD/MXN could retest the lows of the year at 19.42 should any key US data disappoint.

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