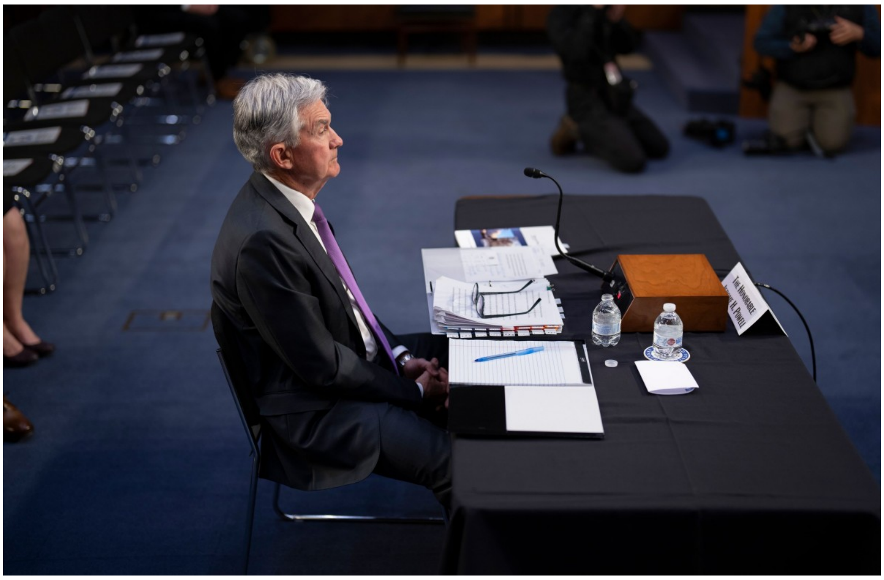
Fed nerves open the door to more hikes

The February FOMC meeting saw the Fed dial back to a 25bp incremental hike. Jerome Powell's testimony shows that opinion has shifted again with the strength in data suggesting the need for a higher ultimate policy rate and potentially faster rate hikes. Given long and varied lags the odds of a hard landing and an eventual policy reversal are rising



Federal Reserve Chair Powell at his Congressional testimony on 7 March 2023

Hawkishness back in fashion

Federal Reserve Chair Jerome Powell's semi-annual testimony has certainly taken a more hawkish tone relative to his last major comments in February. Back then he talked of disinflation but now acknowledges that "inflationary pressures are running higher than expected at the time of our previous Federal Open Market Committee". Moreover, with the latest economic data having "come in stronger than expected", it "suggests that the ultimate level of interest rates is likely to be higher than previously anticipated". In December the median projection from Fed officials was for the Fed funds target rate to be at 5.1%, but Powell's higher for longer message on rates now means markets are pricing the Fed funds rate at 5.4% for year-end. This is getting on for 100bp of hikes from here.

Powell went on to warn that "if the totality of the data were to indicate that faster tightening is warranted, we would be prepared to increase the pace of rate hikes". Before the publication of the testimony markets were pricing around 30bp of tightening at the March FOMC, but now we are up at 35bp. 25bp is therefore still the slightly favoured outcome, but between now and 22 March we have this Friday's jobs report and then next week we have inflation, retail sales and housing numbers.

But the risks of a hard landing are rising

Generous seasonal adjustment factors and unseasonally warm weather – January was the sixth warmest on record across the United States – certainly helped the near-term activity and inflation story and this should unwind in coming months. The data isn't going to be as 'hot' as it was in January, but we are not confident that it will show extreme weakness either. Consequently, we do have to acknowledge the possibility that if the market moves in the direction of fully discounting 50bp the Fed are unlikely to hold back.

Nonetheless, we continue to make the point that monetary policy operates with long and varied lags and so we are yet to fully feel the effects of the most aggressive period for monetary policy tightening for over forty years. It isn't just the increase in borrowing costs that is the issue, but also the availability of credit with the Federal Reserve's own Senior Loan Officer Survey highlighting how rapidly banks are pulling back from lending. So we have an intensifying issue regarding both the cost and access to borrowing, which runs the risk of a harder landing for the economy than markets are currently discounting.

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