Federal Reserve: Back to 25bp hikes as slowdown fears mount

Last year saw the most aggressive policy tightening path in four decades, but Fed officials have laid the groundwork for more modest 25bp hikes in February and March. Recessionary forces are building though and inflation looks set to slow sharply from here, implying rates cuts will be on the agenda later in the year

US Federal Reserve Chair Jerome Powell

25bp with more still to come

Having raised the Fed funds target range by 425bp in 2022, including 75bp and 50bp moves, expectations are firmly centred on the Federal Reserve opting for a more modest 25bp interest rate increase on Wednesday – taking the target range to 4.5-4.75%. While inflation is still well above target and unemployment is at a cycle low, there are signs that the economy is responding to tighter monetary policy and the Fed will be cognisant of fears that hiking rates too hard and fast risks toppling the economy into recession.

Officials certainly appear to be backing "standard" 25bp increases from now on after enacting their most aggressive hiking cycle for 40 years, but most are warning that there is still more work to be done. Consequently, we expect to hear that ongoing interest rate hikes are "appropriate" with the balance sheet shrinking strategy remaining in place.

Scenarios for the Federal Reserve meeting

Scenario analysis: The Federal Reserve's alternatives

	Inflation outlook	Growth outlook	Interest rates	Quantitative Tightening	24 hour reaction: 10Y Treas (3.50%)	24 hour reaction: EUR/USD (1.09)
Current stance	Fed "highly attentive" to inflation risks" and "strongly committed" to 2%	Require a "sustained period of below-trend growth"	Target rate range at 4.25-4.50%, ongoing interest rate increases "appropriate"	Monthly balance sheet reduction $60bn of Treasuries, $35bn MBS		
Dovish	Over tightening could lead to a sharper, deeper fall in inflation	Recessionary forces are building, early signs of cooling jobs market	**25bp** with future hikes being "data dependent"	Discussion of potential slower reduction in balance sheet	3.35	1.10
ING Base Case	Inflation is too high, but monetary policy works with long & varied lags	Growth is slowing, but the jobs market is strong and the focus is on inflation	**25bp hike,** ongoing interest rate increases "appropriate"	Unchanged	3.50	1.08
Hawkish	Inflation is proving to be stubborn with risks still weighted to the upside	Need a prolonged period of below trend growth to bring inflation down	**50bp hike** with ongoing interest rate increases "appropriate"	Unchanged	3.65	1.07
Very hawkish	Inflation is embedded and upside risks justify ongoing rate hikes	Recession required to have a material impact on inflation outlook	**50bp** Fed signals clear intent to crush inflation	Announcement of swifter balance sheet reduction	3.80	1.05

Source: ING

Officials are unlikely to switch to a "data dependency" narrative just yet, fearing that adopting too dovish a line could fuel market expectations for eventual rate cuts. In turn, this could lead to an unwanted loosening of financial conditions that contribute to inflation staying higher for longer.

Conversely, signalling 25bp but then hiking by a more aggressive 50bp would generate a large risk-off reaction with sharply higher borrowing costs. The majority of the committee would likely consider this too risky an option given the potential to intensify recessionary forces that could end up excessively dampening inflation.

With no new Federal Reserve forecasts at this meeting, the accompanying press conference is likely to re-affirm that it is appropriate to move in smaller 25bp steps from now on and we are not at the endpoint yet.

The Fed could over and/or under-hike other rates for technical reasons, but likely won't

Apart from the headline funds rate range of 4.25% to 4.50%, the Fed will also adjust higher the rate on the reverse repo facility and on excess reserves. These are currently at 4.3% and 4.4% respectively, and are often seen as the tighter corridor within which the effective fed funds rate sits (currently 4.33%).

There is constant speculation on the likelihood of the Fed deciding to under-hike the rate on the reverse repo facility, to bring it to flat to the fed funds floor (it's currently 5bp over). The logic would be to encourage less use of this facility, which routinely takes in US$2tr in excess liquidity on a rolling daily basis. However, in all probability, repo would simply trade down to the same area, without a material effect on volumes.

There is a similar argument to instead over-hike the rate on excess reserves, say by 30bp (instead of 25bp). The idea here would be to encourage a downsize in the use of the reverse repo facility in place of an upside in bank reserves (higher relative remuneration). This would allow the Fed to better manage bank reserves, ensuring that it doesn't fall too fast, as it gradually ratchets its balance sheet lower through the ongoing soft quantitative tightening programme (as it allows

$95bn of bonds per month to roll off the front end).

In all probability, it won't do this either. It is already a 10bp spread between the reverse repo window and the excess reserves one, and widening that to 15bp might not make a material difference. That said, a spread of 20bp just might, and is something the Fed could consider down the line i.e. under-hiking the reverse repo rate and over-hiking the rate on excess reserves. On this occasion, there would be quite a surprise if it did anything along these lines, at least not at this juncture.

The Fed could also upsize the quantitative tightening agenda, but likely won't either

The Fed has also been quite quiet on the balance sheet roll-off programme. It seems that's the way it likes it – churning away quietly in the background, and not causing too many market ripples. The big question in this space is whether the Fed could consider outright selling some bonds off its books, and thereby engage in a harder version of quantitative tightening. It would be huge if it did. There is certainly an appetite for bonds in the market if the recent Treasury auctions are anything to go by.

However, such selling of bonds outright would likely be a step too far at this juncture, as it would likely generate a tantrum. But it's always there should the Fed start to feel that the fall in longer-dated market rates is acting contrary to its hiking efforts on the front end. Even a mention that it is looking at this down the line would have a material effect. Not expected, but these are potential market movers that we need to cross off as the meeting outcome unfolds.

Importantly, any mention of potentially upsizing the bond roll-off in the future or considering any bond selling (e.g. of the longer-dated mortgage portfolio) would signal it was uncomfortable with where longer-dated market rates are at.

But the outlook is darkening and the peak is close

We think that the Fed will probably hike once more on 22 March, but that will mark the top for the policy rate. We are concerned that signs of a slowdown will spread and intensify with a recession our baseline forecasts.

Residential construction has fallen in each of the past six months, industrial production has been down for the past three months and retail sales have dropped by 1% or more in both November and December. Unfortunately, business surveys offer no hint of a turn with both the manufacturing and service sector ISM indices in contraction territory and the Conference Board's measure of CEO confidence at the most depressed level since the Global Financial Crisis – a clear signal that businesses will be focusing more on cost-cutting rather than revenue expansion this year.

At the same time, the heavy weighting of shelter and vehicles within CPI and clear signs of softening corporate pricing power mean that inflation will be close to 2% by the end of this year. Rents have topped out in most major cities while vehicle prices are now falling, with the National Federation of Independent Businesses survey on price intentions pointing to a sharp slowdown in core inflation through the second quarter into the third quarter of this year.

As for the jobs market, while headline payrolls growth remains impressive there are flashing warning lights with the temporary help component reporting falling employment numbers in each of the past five months. This is concerning because this grouping of workers is typically easier to hire and fire by the nature of the position so they tend to lead broader shifts in payrolls.

Worryingly, the declines are getting bigger each month, suggesting the momentum in the jobs market is souring. In an environment of weak activity, falling inflation, and mounting job losses, we doubt the Fed will raise rates beyond March with rate cuts the order of the day from the third onwards.

FX: Things are getting interesting

It has been pretty much one-way traffic for the dollar bear trend since early November. Clear signs of easing US price pressures and a slowing economy have upended the prior narrative of a Fed forced to tighten into a recession. Risk assets have rallied strongly.

Data shows that the EUR/USD six-hour reaction to last year's Federal Open Market Committee (FOMC) decisions triggered moves of anywhere between +/- 0.7%. And the FX options market has a 90 pip range priced for EUR/USD over the period which covers both the Fed and the ECB meetings next Wednesday/Thursday.

We were about to say that an expected 25bp rate hike from the Fed and a relatively unchanged statement would have little impact on FX markets. Yet we have just seen FX markets move on the Bank of Canada's decision to halt its tightening cycle at 4.50%. The dollar was marked lower on this decision, presumably on the minority view that the Fed could also be ready to call time on its tightening cycle.

This suggests that the FOMC meeting could prove more interesting than the market has priced. Our base case would assume that EUR/USD continues to trade near 1.08/1.09 after the FOMC meeting. Any suggestion that the Fed was virtually done tightening could send EUR/USD through 1.10. While aggressive Fed push-back against the 50bp of 2023 easing already priced by the market could briefly send EUR/USD to 1.07.

In the bigger picture, we expect EUR/USD to head higher this year – perhaps to the 1.15 area in the second quarter – this will be the time when US inflation is falling more sharply and China re-opening is providing a tailwind to the pro-cyclical currencies, including the euro.

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