

## Federal Reserve hikes another 75bp with much more still to come

The Federal Reserve met expectations and hiked rates 75bp. With inflation proving to be far stickier than imagined, the Fed repeated that activity needs to slow much more with the door left wide open for a fourth consecutive 75bp hike in November. With recession looking virtually impossible to avoid, we see a strong chance of policy reversal later in 2023



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### A very hawkish 75bp

The Federal Reserve has hiked the Fed funds target range to 75bp in what was a unanimous decision and upped its forecasts for rate hikes aggressively. Year-end 2022 Fed funds is now expected at 4.4%, above the 4.2% rate implied by futures contracts ahead of this update, signalling the strong likelihood of another 75bp in November with a further 50bp or possibly even a fifth consecutive 75bp on the cards at the December Federal Open Market Committee (FOMC) meeting. It is important to note that there is a strong clustering within the dot-plots, showing all FOMC members are on board with this more hawkish narrative.

More tightening is signalled for 2023 with the year-end rate at 4.6%, before it moves lower to 3.9% for 2024, 2.9% in 2025 with the longer run prediction remaining at 2.5%. To underscore the Fed's willingness to sacrifice growth to get inflation lower it has cut 4Q 2022 year-on-year GDP growth to 0.2% from 1.7% with 2023 cut to 1.2% from 1.7%. Core PCE is also revised up 0.2 percentage points to 5.4% for 2022 and 2023 is now 3.1% vs 2.7%. The Fed is effectively acknowledging that a recession is coming, but inflation will not fall quickly and there will be a lot of pain. Note the unemployment rate for next year is expected to reach 4.4% versus the current 3.7% and stay there through 2024 with only a very minor drop in 2025.

The accompanying statement barely has any changes in it versus the one published in July – just a minor tweak regarding near-term “modest growth”.

## Federal Reserve forecasts September versus previous June predictions

	2022	2023	2024	2025	Longer run
<b>Change in real GDP (Sep Fed forecast)</b>	<b>0.2</b>	<b>1.2</b>	<b>1.7</b>	<b>1.8</b>	<b>1.8</b>
Previous Fed projection (Jun)	1.7	1.7	1.9		1.8
<b>Unemployment rate (Sep Fed forecast)</b>	<b>3.8</b>	<b>4.4</b>	<b>4.4</b>	<b>4.3</b>	<b>4.0</b>
Previous Fed projection (Jun)	3.7	3.9	4.1		4.0
<b>Core PCE inflation (Sep Fed forecast)</b>	<b>4.5</b>	<b>3.1</b>	<b>2.3</b>	<b>2.1</b>	-
Previous Fed projection (Jun)	4.3	2.7	2.3		-
<b>Federal funds rate (Sep Fed forecast)</b>	<b>4.4</b>	<b>4.6</b>	<b>3.9</b>	<b>2.9</b>	<b>2.5</b>
Previous Fed projection (Jun)	3.4	3.8	3.4		2.5

Source: Federal Reserve, ING

## Another 75bp in November with 50bp minimum in December

Inflation has been stickier than the Federal Reserve expected and certainly more broad-based. To get it down the economy needs to run below potential, bringing demand into better balance with supply capacity. The only way the Fed can do that is to hike rates and keep policy restrictive until that is achieved.

Given the Fed's aggressive stance and the likelihood that inflation moves little over the next month while job creation remains firm, we expect the Fed to hike 75bp for a fourth consecutive time at the November 2nd FOMC meeting. Come the December FOMC meeting we are more hopeful that we will see clearer signs of moderating price pressure on the lead indicators, but we are also fearing weaker activity data that may be enough to convince the Fed to move more cautiously. 50bp is our call, which would leave the target range at 4.25-4.5%, but we certainly can't dismiss the possibility of a fifth 75bp hike.

## We still favour rate cuts as a theme for 2023

The Fed clearly disagrees, with the dot plot chart implying at least 11 FOMC members project higher rates in 2023, but we think December will mark the peak. On the inflation front there are encouraging signs on both market and household inflation expectations, and also corporate price plans which suggest inflation may not be as embedded as some in the market fear. Long-term price expectations have returned to what we might term “normal”, suggesting fears of a 1970s wage-price spiral are misplaced and there is confidence the Fed will indeed get inflation down.

Meanwhile, the National Federation of Independent Businesses reported that the proportion of companies looking to raise prices over the next three months fell from 51% in May to 32% in August. This is a sizeable turn which, given the strong relationship with CPI over the past 40+ years, offers a signal that inflation rates could soon start to slow.

As for the activity side, the geopolitical backdrop, the China slowdown story, the potential for energy rationing in Europe, the strong dollar, and fragile-looking domestic equity and housing markets point to clear recession risks. A more aggressive Federal Reserve rate hike profile and tighter monetary conditions will only intensify the threat. Remember too that shelter is the largest component of CPI and tends to lag behind swings in house prices by around 12-16 months. A housing downturn could have a dramatic impact on inflation in the second half of next year.

Despite the hawkishness of the Fed today, the market is tentatively pricing in nearly 50bp of rate cuts in 2023. We think the Fed could swing aggressively to policy easing in 2H 2023. The average period of time between the last rate hike in a cycle and the first Federal Reserve rate cut has averaged just six months over the past 50 years. Given the risks to growth and the potential for lower inflation, we are forecasting rate cuts throughout the second half of 2023 with our best guess for where the Fed funds rate ends the year being 3-3.25% – more than 100bp below where the Fed is indicating.

## Market rates under pressure higher, chasing a higher terminal rate

The big impact move was in the 2yr, which shot up to 4.1% post the hike, a full 10bp move. The elevated median dots for 2022 and 2023 were the dominant driver here, and especially the 2023 median dot which is now closer to 5% than to 4%. There is also a messaging there for the market that the Fed intends to maintain a tightening trajectory beyond the end of 2022 and into 2023, at least as telegraphed from the dots themselves.

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*The 10yr yield now needs to consider a path towards 4%*

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The 10yr yield now needs to consider a path towards 4% in the coming couple of months. History shows that the 10yr rarely trades more than 50bp through the funds rate before the Fed has peaked. And note that 50bp through is the exception. A more normal discount would be to see the 10yr 25bp through the funds rate ahead of a confirmed peak from the Fed.

Real rates have come under rising pressure as inflation expectations managed to ease lower post the hike. This is good from the Fed's perspective. Higher real rates are required in order to tighten financial conditions, while an easing in inflation expectations tells us that the market ultimately expects the Fed to see inflation fall. The thing is, the case for big falls in inflation has yet to be proven.

The dot profile points to rising official rates in 2023, and muddies the waters for the prognosis of falling market rates into the turn of the year. But if we are right and the Fed does in fact peak by year-end, then that fall in market rates anticipated through December/January is very much back on.

## FX Markets: Bracing for the descent

The FOMC's projections are very telling for global FX markets in that while the Fed has cut growth and raised unemployment forecasts the Fed wants to convey the message that inflation will still be higher than previous forecasts and that the policy rate could be as high as 4.60% by the end of 2023. Understandably this undermines Fed 'pivot' ideas still further and sees the FX market biased towards slow-down and recession. This playbook really favours the dollar over pro-cyclical currencies.

Investors will therefore be in no hurry to quit the most liquid FX reserve currency – and one that pays 3.3% on one-month deposits – at a time of escalating war in Ukraine. In addition, comparisons to the early 1980s Paul Volcker period remain, when the Fed needed to take the US economy into recession to get inflation under control. The dollar soared during this period.

Further strength in the dollar will see trading partners respond as much as they can. The ECB is 'attentive' to EUR/USD weakness but is never going to be able to match the 4%+ Fed policy rates coming our way. Unlike the US economy, the eurozone went into this crisis with a negative output gap. EUR/USD has today traded to a new low for the year. After some profit-taking on EUR/USD short positions and given events in Ukraine, it is hard to rule out a further grind towards 0.95 over coming months.

More pressing is USD/JPY which is again closing in on 145. Japanese authorities remain close to pulling the trigger on FX intervention. And we have a BoJ meeting early tomorrow. No change is expected from the dovish BoJ – but a tweak to the BoJ's 10-year JGB target (0-0.25%) and intervention would certainly catch the market unawares. We think USD/JPY traded volatility is too cheap.

Elsewhere, we think the [Swiss franc can out-perform in Europe](#). And further inversion of the US yield curve can continue to weigh on commodity currencies and EM in particular over the coming months. Unsupportive for EMFX is the continued decline in the Chinese renminbi. On a trade-weighted basis this has fallen 3% since the summer and with USD/CNH now well through 7.00, the 2019/2020 highs of 7.20 come firmly into view. One final remark, tighter liquidity worldwide means higher FX volatility. So, forget FX carry trade strategies this autumn.

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