

Federal Reserve preview: A final hike as US recession fears mount

Inflation remains 'unacceptably high', but banking stresses are leading to a tightening of lending conditions, which will do more to slow the economy than the likely 25bp hike on Wednesday. While the Fed will leave the door ajar for further hikes, the need for higher policy rates is highly questionable. We expect 100bp of rate cuts before year-end

Scenario analysis: The Federal Reserve's alternatives

	Inflation outlook	Growth outlook	Interest rates	Quantitative Tightening	10Y Treas (3.50%)	EUR/USD (1.10)
Current stance	Fed "highly attentive" to inflation risks and "strongly committed" to 2%	"A period of below-trend growth [is] needed"	Target rate range at 4.75-5.00%, ongoing interest rate increases "may be appropriate"	Monthly balance sheet reduction \$60bn of Treasuries, \$35bn MBS		
Very dovish	Banking stresses mean credit conditions are tightening	Increased uncertainty has the potential to restrain growth	No change with future moves being "data dependent"	Balance sheet reduction halted	3.20	1.12
Dovish	Inflation is unacceptably high, but upside risks are moderating	Jobs market is strong, but there is a higher chance of weaker growth	25bp hike, but future hikes "data dependent"	Unchanged	3.40	1.11
ING Base Case	Inflation is unacceptably high, but upside risks are moderating	A period of below trend growth is needed to bring inflation down	25bp hike and ongoing interest rate increases "may yet be appropriate"	Unchanged	3.50	1.09
Hawkish	Inflation is unacceptably high with risks weighted to the upside	Need a sustained period of below trend growth to bring inflation down	50bp hike and ongoing interest rate increases "appropriate"	Unchanged	3.70	1.08

Source: ING

Another 25bp hike from the Fed

The minutes of the March Federal Open Market Committee (FOMC) meeting showed the Federal Reserve continuing to believe inflation was "unacceptably high" and that a "period of below trend growth [was] needed" to get it back to the 2% target. The prospect of a "mild recession" didn't faze the central bank since unemployment at just 3.5% meant tightness of the labour market could keep wage pressures elevated and mean "slower-than-expected progress on disinflation" continued.

Were it not for the banking stresses experienced earlier in March, "many participants" felt "the appropriate path for the federal funds rate as somewhat higher than their assessment at the time of the December meeting" with "some" willing to consider the possibility of a 50bp hike in March. In the end, the Committee unanimously opted for 25bp with the "dot plot" signalling one further 25bp was likely this year with rates staying at 5-5.25% through year-end.

Since then, inflation has continued to run hot and the jobs market is tight while [first-quarter GDP](#)

was headlined by strong consumer spending. Moreover, Federal Reserve officials' comments have changed little over the past month, other than hints that the impact on credit conditions is being more readily acknowledged, with some officials, including the likes of Atlanta Fed President Raphael Bostic, openly talking about one more hike and then a pause.

The graphic above shows the different scenarios that are likely in play for the May FOMC meeting and what we expect to happen. A no-change decision would be seen as very dovish given the Fed commentary over recent weeks. It would suggest that the Fed has received news that the latest banking stresses are causing major issues and this would be the catalyst for a sharply weaker dollar and lower Treasury yields. We don't believe we are there yet. Nonetheless, the uncertainty and nervousness that banking stresses are causing rule out a very hawkish 50bp hike.

We are forecasting a 25bp hike on 3 May, which is the consensus view.

Subtle dovish signals, but no talk of eventual rate cuts

We do think this will mark the end of the Fed's tightening cycle, but the central bank will be reluctant to explicitly state that. Last month it switched its language from February's "ongoing increases in the target range will be appropriate" to "some additional policy firming *may* be appropriate" [our emphasis].

We doubt it will switch fully to the idea that future moves will be "data dependent" given inflation is still running well above target and it doesn't want to give the market further ammunition to anticipate a turn in policy. Instead, we expect it to adopt its 2006 pathway and with an incremental step, suggesting "additional policy firming may *yet* be appropriate".

2006 Fed language shift

December 2005: **25bp hike to 4.25%** – "some further measured policy firming is **likely** to be needed"

January 2006: **25bp hike to 4.5%** – "some further policy firming **may** be needed"

March 2006: **25bp hike to 4.75%** – "some further policy firming **may** be needed"

May 2006: **25bp hike to 5%** – "some further policy tightening **may yet** be needed"

June 2006: **25bp hike to 5.25%** – "the extent and timing of any additional firming ... **will depend on the evolution of the outlook...** as implied by incoming information"

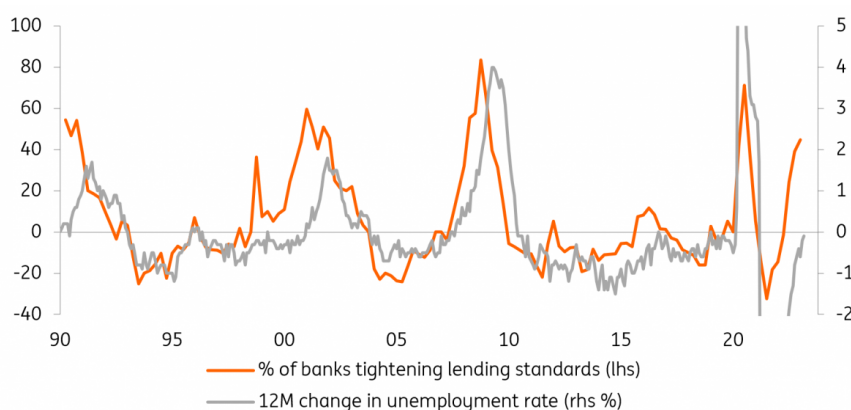
August 2006: **No change** – "the extent and timing of any additional firming ... **will depend on the evolution of the outlook...** as implied by incoming information"

It is possible that Fed Chair Jerome Powell's press conference may see him admitting a degree of data dependency and a pause at the next meeting can't be ruled out. However, he will not suggest rate cuts are on the agenda for later in the year as this would be viewed very dovishly by markets and undermine the bank's efforts to tame inflation. It would give the all-clear for the dollar to sell off and Treasury yields to plunge.

A hard stop in June

We strongly suspect that at the 14 June FOMC meeting, the Fed will adopt a hard stop as it did in January 2019 when it paused and talked of “patience” after just the previous month’s warning to markets to “expect some further gradual increases”. This is because we think recessionary forces are building rapidly, which will lead to rising unemployment and inflation falling quickly through late 2023 into 2024.

After banks tighten lending standards, unemployment always rises



Source: Macrobond, ING

The chart above shows that when banks tighten their lending standards, unemployment always rises. Most companies can handle a small increase in borrowing costs even after the significant hikes already experienced. What sends struggling businesses to failure is when credit is choked off. We will get an update on the Federal Reserve’s Senior Loan Officers survey in the next two weeks and in the wake of banking failures, deposit flight and the prospect of greater regulatory oversight kicking in, we strongly suspect that lending conditions will have tightened further quite substantially.

A two-to-three percentage point increase in the US unemployment rate over coming quarters, as currently implied by the chart, equates to around three-to-four million Americans losing their jobs. Given the Federal Reserve has a dual mandate of maximising employment as well as achieving 2% inflation over time, it is not as constrained as the European Central Bank or the Bank of England which only target 2% inflation. Policy optimisation for the Fed’s framework implies it doesn’t need to see inflation hitting 2% before cutting rates if unemployment is starting to rise.

100bp of cuts is possible before year-end

Historically, the Fed doesn’t leave it long before cutting rates – over the past 50 years the average period of time between the last rate hike cycle and the first rate cut has only been six months. This implies that if May is indeed the last rate hike in a typical cycle, we should expect a cut by around November.

Add in significant credit stresses and inflation falling quickly, it is likely to either happen sooner or end up being a more aggressive easing cycle – note the March FOMC minutes warned that

“historical recessions related to financial market problems tend to be more severe and persistent than average recessions”. We suspect the Fed, with its current mindset, will end up in the latter camp, hence our forecast of 50bp rate cuts at both the November and December FOMC meetings rather than starting to cut rates in the third quarter as implied by Fed funds futures contracts.

The deeply inverted curve continues to discount trouble ahead

For rates markets, the delivery of an inevitable 25bp hike is not the issue. Signals for what is to follow are more important. And as noted above, the Fed will not guide at this juncture for June. That leaves the market interpreting the language used in the press conference as best it can.

That said, the market discount for subsequent cuts is not coming from Fed guidance. Rather it's a market discount partly built on what's happened in previous cycles, but one that has also been bullied there by banking sector angst. While still mostly idiosyncratic, the market discounts potential systemic implications. The renewed focus on First Republic's woes keeps this theme at the forefront and is reflected in the 2yr yield trading back below 4% – more than 1% through the funds rate.

One mission for the Fed at this meeting will be to avoid giving the market an excuse to discount even deeper cuts, as that would effectively negate the effect of the 25bp hike delivered. The 10yr at sub-3.5% is even further through the funds rate and remains on a path towards the 3% area in the coming months. The Fed would prefer not to prompt a nudge lower, as it would see that as counterproductive at this juncture.

And the Fed will likely be quizzed on banking sector angst

Powell will likely be quizzed about the banking sector at the press conference. On questioning, he will likely acknowledge the fall in bank deposits seen in the past year, but we would expect him to view this as a natural course of events, where policy has switched from quantitative easing to one of quantitative tightening. It will be interesting to see whether he draws this parallel, and also how he views the stresses being felt by First Republic.

Access to the Fed's emergency facilities is applicable only to viable institutions, and the past few days have confirmed that remains the intention of Fed policy. At the same time, the Fed has been supporting First Republic effectively on a promise of resolution for the bank. In that sense, it will be interesting to hear commentary on the nuance here, and where the line is drawn; an area that Powell will not volunteer to enter unless prompted to do so through questioning.

There should also be interest in commentary from Powell on the recent spurt of inflows into money funds, and the parallel inflows to the Fed's reverse repo facility, and any impact on bank reserves. Again, he likely won't go there, unless the question is asked.

FX markets: positioning may stand against a further EUR/USD advance

FX markets go into Wednesday's FOMC meeting wary of: i) the simmering US bank crisis, ii) US debt ceiling negotiations, iii) concerns about global demand trends and iv) a conviction view that Europe will still be hiking after the Fed turns dovish. That favours the defensive currencies of the Japanese yen and Swiss franc, although the euro has been performing strongly, too.

Our base case assumes that a 25bp Fed hike and remarks that further hikes ‘may yet be required’ will not be enough to feed the EUR/USD bull story. This comes at a time when long euro positioning amongst the asset management community is relatively high. On balance, we see EUR/USD correcting back to the 1.10 area on the FOMC event risk – but probably not much lower given the ECB meeting the next day. That again could prove mildly bearish for EUR/USD given we favour just a 25bp hike.

The above view is roughly consistent with our quarterly profile for EUR/USD this year, where we see it ending June near 1.10, but really starting to push ahead to 1.12 and 1.15 into September and December – this is when evidence of the US slowdown and disinflation start to drive the short end of the yield curve even lower. Incidentally, it does look as though EUR/USD has become more sensitive to interest rate differentials – which should clearly be bullish for EUR/USD this year.

Beyond the EUR/USD story, we continue to expect the Japanese yen to perform well. Positioning is a lot lighter in the yen, lower energy prices are welcome to Japan and the Bank of Japan may well start to normalise monetary policy in June. 128 remains our initial target for USD/JPY. And defensive FX positions should perform well if it looks as though the Fed will not be rushed into easing.

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