# Federal Reserve set for lift-off with 25bp hike

With the economy growing strongly, creating jobs in significant numbers and experiencing the fastest rate of price inflation in 40 years, not even the uncertainty and financial market volatility caused by Russia's invasion of Ukraine will deter the Fed from hiking on Wednesday. We continue to look for six 25bp hikes this year and two more in 2023

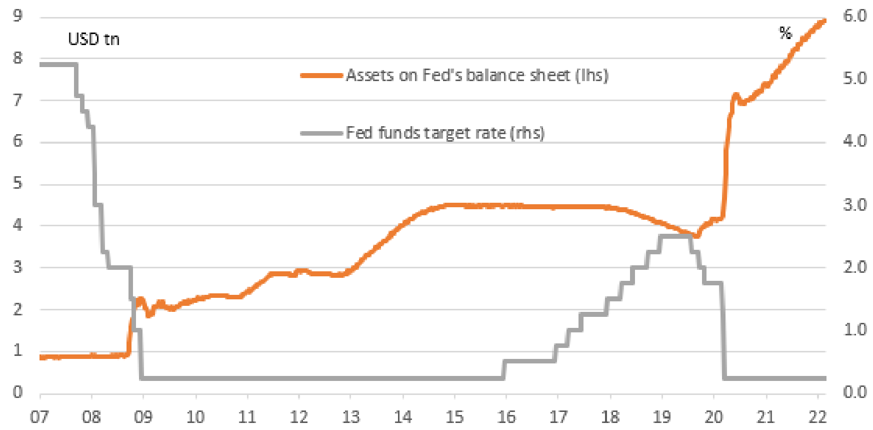
While the US economy weathered the Omicron wave well, there are certainly economic headwinds resulting from the Russia-Ukraine war

## March lift-off with 25bp hike

As recently as February 10th, financial markets were pricing a 90% chance that the Federal Reserve would hike the fed funds rate by 50bp at the March 16th FOMC. However, Russia's invasion of Ukraine has led to a rethink, although not by all that much given the huge geopolitical, economic and financial uncertainty it has generated. While we are back to pricing a 25bp for next week, markets are still positioned for 160bp – more than six rate hikes – in total for the year.

A 25bp move does indeed look odds on. In his prepared comments to Congress last week, Fed Chair Powell stated that "with inflation well above 2% and a strong labour market, we expect it will be appropriate to raise the target range for the federal funds rate at our meeting later this month." He is "inclined to propose and support a 25bp rate hike" with a "series" of rate hikes likely thereafter. Moreover, the Fed could "be prepared to move more aggressively by raising the federal funds rate by more than 25bp" at one or more meetings.

## Fed funds target rate and the Fed's balance sheet




Source: Macrobond, ING

## New Fed forecasts to highlight weaker growth, stronger inflation

Market pricing of future action will be influenced by the Fed's new forecasts and the tone Chair Powell takes at the press conference. While the economy weathered the Omicron wave well, there are certainly economic headwinds from the uncertainty, the hit to supply chains and the massive upward moves in commodity prices resulting from Russia's actions.

We suspect the Fed will be cautious and cut their 4Q YoY GDP projection back to around 3% for this year rather than 4%. Inflation projections will inevitably have to be raised given the surge in commodity and energy prices at a time when corporates appear to have a strong degree of pricing power and can pass higher costs onto customers.

This weaker growth, stronger inflation narrative is unlikely to result in major changes to the unemployment projections given the surprise strength seen in recent months, but the real challenge is what they have to say on interest rates. Powell suggested that the Fed will need to be "nimble" given the uncertain environment and outlook, but we suspect they will be wary of deviating too far from market pricing in case that leads to even more financial market volatility. They may have five rate hikes penciled in for the year rather than the six the market has, but there could be a wide spread of dots.

## ING expectations for the new Federal Reserve forecasts

Growth and inflation numbers are 4Q YoY averages. Unemployment is the 4Q average and the fed funds forecast is for December of the year in question

| | 2022 | 2023 | 2024 | Longer run |
|---|---|---|---|---|
| **Change in real GDP (ING Expectation)** | **3.0** | **2.0** | **2.0** | **1.8** |
| Previous Fed projection (Dec) | 4.0 | 2.2 | 2.0 | 1.8 |
| **Unemployment rate (ING Expectation)** | **3.5** | **3.5** | **3.5** | **4.0** |
| Previous Fed projection (Dec) | 3.5 | 3.5 | 3.5 | 4.0 |
| **Core PCE inflation (ING Expectation)** | **3.5** | **2.0** | **2.0** | - |
| Previous Fed projection (Dec) | 2.7 | 2.3 | 2.1 | - |
| **Federal funds rate (ING Expectation)** | **1.4** | **2.1** | **2.5** | **2.5** |
| Previous Fed projection (Dec) | 0.9 | 1.6 | 2.1 | 2.5 |

Source: Federal Reserve, ING

## 6 hikes remains our base case, but a wide range of outcomes are possible

While they will be reluctant to pre-commit to specific action at specific meetings the tone of the press release and the subsequent press conference is set to be similar to Chair Powell's recent testimony and lay out a desire to get interest rates higher and to start running down the Fed's $8.9tn balance sheet in coming months. How fast this happens will be determined by the data and the evolving geopolitical outlook, and our own forecasts are subject to a huge degree of risk.

For what it is worth our base case is six rate hikes this year and two more next year with the Fed announcing it will cease fully reinvesting all the proceeds from maturing assets on its balance sheet in late 2Q.

## US economy set to be more resilient than most

This may seem aggressive given the backdrop, but it is important to remember that the US is in a strong position to weather the situation the world is currently in. It has limited financial and trade linkages with Russia and is not dependent on Russian energy supplies, but the spike in gasoline prices will hurt consumer spending.

Assuming drivers use the same 139bn gallons of gasoline as they did in 2021 and prices average $4/gallon rather than the $2.25/gallon experienced last year, this means an extra $250bn of spending on gasoline that could instead have been spent on goods and services (equivalent to around 1% of GDP).

However, we have to remember that the US is a major energy producer and 12 million barrels per day production of oil at $120/barrel versus the $40 average last year means a windfall of $350bn with potentially an extra $100bn of revenues resulting from the surge in natural gas prices. This will be taxed while also generating employment, higher wages and stimulating investment.

Moreover, US employment and wages are rising strong and this boost to income, plus the $30tn increase in household wealth since the start of the pandemic, is a significant amount of financial ammunition that can keep the economy growing.

Consequently, with the US economy set to be more resilient to the crisis than virtually any other major economy (perhaps bar Canada), we believe the Fed can continue on a path of policy normalisation through 2022.

## The Fed could choose to under hike on the reverse repo rate, but could also choose to finesse this later

While the key focus is on the range for the fed funds rate, and where the effective funds rate sits withing that range, there are two other rates that need monitoring.

The first one is the rate paid at the Fed's reverse repo facility, which is currently set at 5bp; the rate the Fed pays to players that park liquidity at the Fed in exchange for collateral. The second one is the rate paid on excess reserves, which is currently at 15bp. Both of these rates were in fact hiked in June 2021, by 5bp apiece. The higher reverse repo rate helped coax the general collateral repo market away from printing in negative territory. The higher rate on excess reserves helped to prevent the effective funds rate from dipping too close to the fed funds floor at zero.

Where the Fed pitches both rates will be important.

The Fed could choose to hike the reverse repo rate by just 20bp, rather than the full 25bp as applied to the fed funds range. In other words, the delivery of a 25bp hike would push the fed funds range up to 25bp to 50bp. And then a 20bp hike in the reverse repo rate would then pitch it at 25bp, flat to the fed funds floor. If so, this could allow the repo market itself to absorb some of the excess liquidity. But at the same time, at 25bp there is more room below that rate for market repo to trade at (between zero and 25bp), which it could well do given the excess of liquidity over collateral in the system.

Alternatively the Fed could simply choose to raise all rates by the same 25bp, and leave finessing to another time. There is no urgent necessity to vary the degree of hikes for the different rates at this key meeting that kicks off the rate hiking process. A more simple scenario would see the Fed hiking the fed funds rate, the reverse repo rate and the rate on excess reserves by 25bp apiece, to the 25-50bp range, 30bp and 40bp respectively.

In that sense, the 30-40bp range would be where the effective fed funds rate would be expected to settle at, likely at slightly under 35bp.

## FX markets: Most roads lead to a firmer dollar

Trade-weighted measures of the dollar continue to trade near their highest levels since the summer of 2020. Driving this move is the domestic pull factor from a strong US economy and a Fed ready to tighten, as well as the push factor from what has become a deteriorating external investment environment.

The push from the external environment in Europe is so strong that we suspect that the dollar can hold gains even if the Fed marginally disappoints a market looking for slightly more than six hikes this year. That is because the stagflationary impulse from the Russian commodity supply shock is a negative one for global growth and especially for those economies in Europe and Asia where trade and manufacturing are more important.

The same applies to emerging markets in general. Close to US$30bn has flowed out of emerging debt and equity markets over the last three weeks. And we are far from the benign global conditions (very briefly seen in late 2020) that could create an environment for dollar outflows.

The combination of a hawkish Fed and an uncertain European backdrop suggests EUR/USD is more likely to trade a 1.05-1.10 range over coming weeks and months. North American currencies should remain favoured, while the energy importing currencies of Europe and Asia should continue to underperform.

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