Federal Reserve set to pause again as the market does the heavy lifting

The sharp move higher in longer-dated Treasury yields has created a meaningful tightening of financial conditions. This affords the Fed time to wait and assess whether its policy is restrictive enough to bring inflation back to target. We think it already is

Fed Chair, Jerome Powell

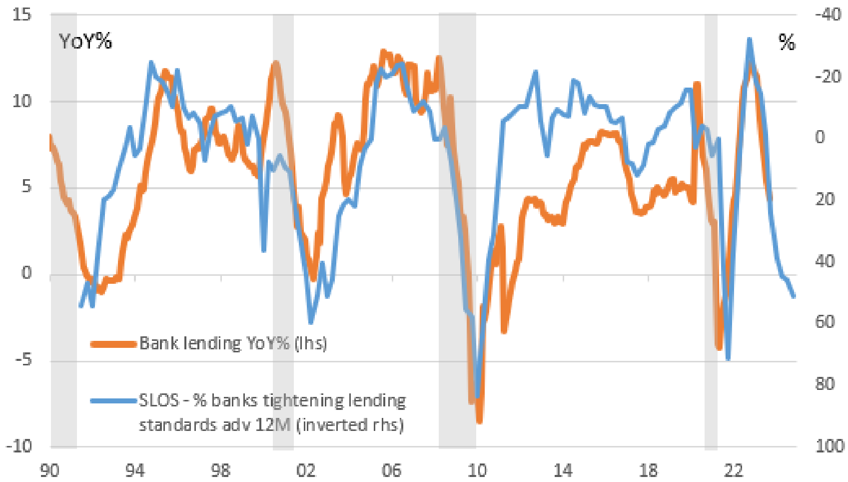
Market moves mean the Fed can afford to wait

The widely held view amongst economists surveyed by Bloomberg is that the US Federal Reserve will leave the Fed funds target range unchanged at 5.25-5.50% for the second consecutive meeting despite 3Q GDP growth coming in hot, the jobs market remaining tight and inflation remaining well above the 2% target. Markets are similarly seeing little prospect of any change to monetary policy next week in the wake of the recent surge in longer-dated Treasury yields and the tightening of financial conditions it's prompted. This is creating even more headwinds for activity in an environment where mortgage and car loan rates are already above 8% and credit card interest rates are at all-time highs. Consequently, if Treasury yields stay at these elevated levels, the need for further policy rate hikes is dramatically reduced.

Fed Chair Powell also continues to emphasise the "long and variable lags" between implementing a change to policy interest rates and its effect on the real economy. At his speech to the Economic

Club of New York earlier this month, he acknowledged that "*given the fast pace of the tightening, there may still be meaningful tightening in the pipeline.*" Throw in the fact banks have also tightened lending standards significantly, notably becoming increasingly selective in regards to who to lend to, how much to lend and on what terms, and this points to bank lending turning negative before the end of the year. Historically, in an economy where credit is such a critical driver of activity, this has always corresponded with a recession.

Tighter bank lending conditions points to credit growth turning negative



Source: Macrobond, ING

Peak rates with a cut the likely eventual next move

With conflicting signals in some of the business surveys becoming more apparent and geopolitical concerns intensifying and potentially dampening economic activity, some better news on inflation buys policymakers time. They can afford to wait and assess the impact of recent developments and decide whether monetary policy is indeed restrictive enough to bring inflation back to 2% over time. We think it is and that Federal Reserve interest rates have peaked.

Officials will not want to give the market the excuse to backtrack on the recent repricing of "higher for longer" policy interest rates. They will continue to leave the door open for additional policy rate rises should data justify it, fearing that a signal that policy has peaked could tempt traders to drive market rates lower in anticipation that the next move would be rate cuts. Such action could potentially reignite inflation pressures, but we doubt it.

Consumer spending remains the most important growth engine in the economy, and with real household disposable income flat-lining, savings being exhausted and consumer credit being repaid - and this is before the recent tightening of lending and financial conditions is fully felt - means we see the primary risk being recession. If right, this will depress inflation pressures even more rapidly than the Fed is anticipating, giving it the scope to cut policy rates in the first half of next year.

Bank reserves hold up as reverse repo balances take the strain

Importantly, the rise in the 10yr Treasury yield from sub-4% to 5% was underpinned by a rise in the real 10yr yield from around 1.5% to 2.5%. The rise in the real yield occurred as an independent factor, as the Fed has just hiked by 25bp over the same period. Higher real rates result in a meaningful tightening.

Also, the Fed will be pleased that the rise in nominal yields has not been driven by a material rise in inflation expectations. That helps to give the Fed a pass, as the market has been doing the latest tightening for them in the real rates space.

Even though the 10yr Treasury yield has come off the highs at 5%, the path is there for a resumed rise to the 5% area. The funds rate is at 5.33%, and the 10yr yield has not managed to hit the funds rate level during this rate hiking cycle. Typically, this would have happened ahead of the funds rate peak. This time, it's happening belatedly, partly as the market is now increasingly fretting about the wall of supply to come from the elevation in the fiscal deficit, and with little likely to change on that front this side of the presidential election over a year from now.

The other big mover that the Fed might comment on is the dramatic fall in cash going back to the Fed on the overnight repo facility. This has fallen from US$1.5trn to US$1.2trn since the last FOMC meeting and is down a full US$1trn in the past six months. Bank (excess) reserves have been less impacted by ongoing quantitative tightening and remain comfortable in the US$3.3trn area. The fact that the bulk of the reduction in liquidity is coming through lower overnight reverse repo balances will be regarded as a positive thing from the Fed's perspective – a facility that is doing its job.

Long dollar positions seem entrenched

The tighter US financial conditions described above have included persistent dollar strength. At a time of high US yields, overnight rates at 5.30%, geopolitical threats and stagnant growth elsewhere in the world, investors have had little reason to abandon long dollar positions.

Unless the Fed borrows some language out of the ECB's book that rates are at restrictive enough levels to get the job done – i.e. the Fed drops its tightening bias – we would say the dollar largely holds onto its recent gains. This in spite of November and December seasonally being weak months for the dollar.

Over the coming months, we think developments in the US yield curve will once again be key for the dollar trend. For example, do we see continued bearish steeping of the yield curve as investors demand a higher term premium to cover for US fiscal risk? Here, financial conditions would tighten further and a risk-averse environment would probably keep the dollar bid. Or do we finally see some bullish steepening in the curve as the short-end finally comes lower – were US activity data to finally roll over? That would signal a more benign environment and be broadly negative for the dollar.

For the time being, there is not enough evidence to call the dollar lower – especially with the ECB delivering a more convincing dovish pause – and we see no current reason to change our year-end EUR/USD forecast of 1.06.

Authors

James Knightley
Chief International Economist
james.knightley@ing.com

Padhraic Garvey, CFA
Regional Head of Research, Americas
padhraic.garvey@ing.com

Chris Turner
Global Head of Markets and Regional Head of Research for UK & CEE
chris.turner@ing.com

Disclaimer