30 March 2022

Fed Update

Quickly back to neutral by front-loading rate hikes

Key takeaways

- Recent Fed speeches and interviews have been to the hawkish side suggesting the Fed is about to front-load rate hikes in order to ease high underlying inflation pressure by raising the target range quickly back to neutral.
- We change our Fed call accordingly, as we have argued for a long time that the Fed is behind the curve and it seems like the Fed has come to the same conclusion.
- We now expect the Fed to deliver 50bp rate hikes in May, June and July. We expect the Fed to hike by 25bp at each of the following meetings, implying a Fed funds rate of 2.50-2.75% by year-end.
- Risk is still skewed towards faster rate hikes and we cannot rule out a larger 75bp rate hike at some point or that the Fed continues hiking by 50bp for longer.
- Inflation is higher and the labour market tighter than when the Fed hiked by 50bp in 2000 and 75bp in 1994, respectively.

Recent Fed comments: No one is ruling out 50bp rate hikes

Despite the 25bp rate hike at the March meeting, we are still of the view that the Fed is behind the curve. **After the March meeting, the rhetoric has been more hawkish, focusing on hiking the Fed funds target range to neutral territory faster**. In Fed Chair Jerome Powell's speech on Monday, he opened the door for raising rates at a faster pace: "*if we conclude that it is appropriate to move more aggressively by raising the federal funds rate by more than 25 basis points at a meeting or meetings, we will do so*". Powell added that "*There is an obvious need to move expeditiously to return the stance of monetary policy to a more neutral level, and then to move to more restrictive levels if that is what is required to restore price stability"*.

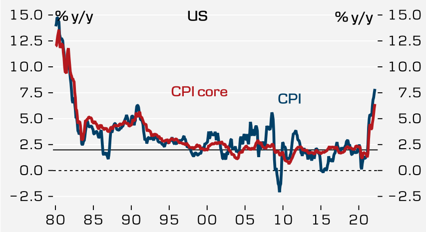
Several other FOMC members have expressed their views since the March meeting and so far none has ruled out 50bp rate hikes and most are arguing that monetary policy should get back to neutral. The Fed's longer-run dot is 2.25-2.50%. We have included an overview of the most important Fed quotes on page 6.

St Louis Fed President James Bullard remains the most hawkish member of the FOMC arguing that the Fed should raise the Fed funds rate to above 3% by year-end, which is the highest 'dot' among all the FOMC members. He argues that the Committee successfully adjusted policy rates in this manner in 1994. We discuss the large rate hikes in November 1994 (75bp) and in May 2000 (50bp) in further details in our case study on page 3.

Fed governor Christopher Waller said *"I really favor front-loading our rate hikes"*. He added that data ahead of the March meeting were screaming for a 50bp rate hike but the geopolitical situation led him to support 25bp. Cleveland Fed President Loretta Mester also argued for front-loading rate hikes. Richmond Fed President Tom Barkin says the Fed could move faster if needed to tame inflation. NY Fed President John Williams did not comment specifically on the May meeting but said the Fed would hike by 50bp if needed.

Content

Inflation is much higher than 2%



Sources: BLS, Macrobond Financial

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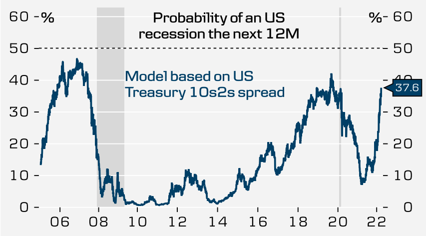
Atlanta Fed President Raphael Bostic is more cautious, as he still focuses on the uncertainty related to the war in Ukraine indicating six additional rate hikes this year (likely 25bp at each meeting).

Even the "usual dovish suspects" sound more hawkish an. Bank of Chicago Fed President Charles Evans also hinted that he may support a larger rate hike by saying *"We want to be careful, we want to be humble and nimble, and get to neutral before too long -- maybe 50 helps, I'm open to that"*. SF Fed President Mary Daly opened up for 50bp if necessary but does not seem fully convinced yet. Minneapolis Fed President Neel Kashkari signals six more rate hikes this year (25bp at each meeting) but also warned about the risks of overdoing tightening.

The emphasis on recession risks is limited so far. Powell pointed that soft, or at least soft-ish, landings have been relatively common in U.S. monetary history but it is probably also difficult to see the Fed talking about its actions causing a recession down the road. **We are more concerned about the prospects of a soft-landing and see a high recession risk 1-2 years down the road.** Inflation is too high at this stage and the Fed does not have the luxury to take several factors into account when adjusting monetary policy. The Fed needs to slow demand in order to ease underlying inflation pressure. **Recession risk 12 month ahead is close to 38% based on the current 10s2s US Treasury yield spread.**

Markets are pricing in a much higher recession risk

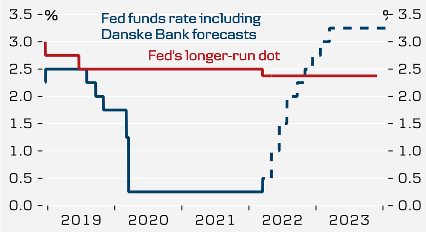


Source: Macrobond Financial, Danske Bank model

New Fed call: 50bp rate hikes in May, June and July

We have been arguing that the Fed was behind when looking at how negative real rates are, how accommodative financial conditions still are and what different Taylor-rules suggest. We definitely think that it is the right call for the Fed to front-load rate hikes. **We change our Fed call accordingly by now calling for 50bp rate hikes in both May, June and July and 25bp on each of the following meetings in 2022**. This implies a Fed funds target range of 2.50-2.75% by year-end. **We still believe balance of risk is that the Fed will be more aggressive, especially near-term and we cannot rule out the Fed hiking by 75bp at one of the forthcoming meetings.** The reason is that markets are already pricing in a lot of Fed rate hikes and still financial conditions are quite accommodative in a historical perspective. It may be necessary for the Fed to follow the "emerging markets central bank playbook" by out-hiking expectations.

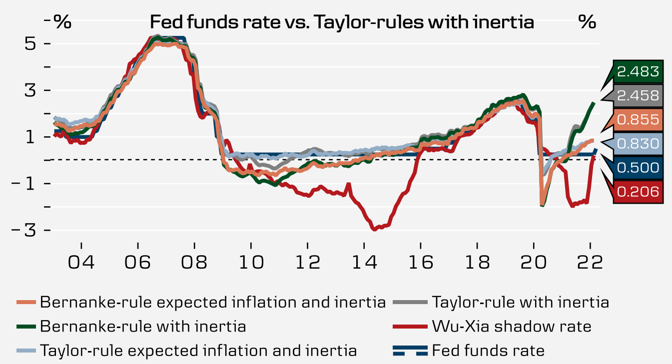
New Fed call - chart



Note: Past performance is not a reliable indicator of current or future results.
Sources: Federal Reserve, Macrobond Financial, Danske Bank forecasts

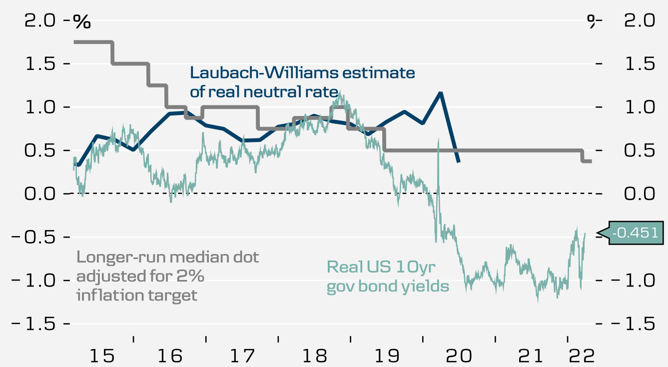
Markets are now pricing in more than 200bp rate hikes this year. Markets are pricing in 125bp by July.

Taylor rules: Fed is behind the curve



Note: Past performance is not a reliable indicator of current or future results.
Sources: Federal Reserve, BLS, University of Michigan, University of Chicago, NY Fed, Bernanke (2015), Taylor (1993), Macrobond Financial and Danske Bank estimations

Real interest rates are still too low



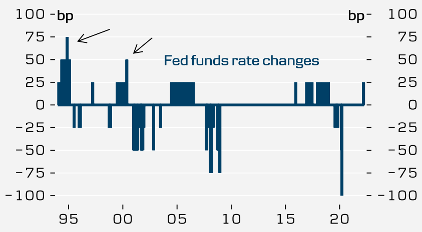
Note: Past performance is not a reliable indicator of current or future results.
Sources: Laubach-Williams, Federal Reserve, Bloomberg, Macrobond Financial

Case study: The large rate hikes in 1994 and in 2000

When looking at historical Fed funds changes we know that the Fed's hiking cycles are usually more gradually than the Fed's cutting cycles. The Fed prefers to hike by 25bp and large rate hikes are rare, especially the past 30 years. In the following section we compare the current economic situation to the 75bp rate hike in November 1994 and the 50bp rate hike in May 2000 (see charts on pages 3-5).

The overall conclusion is that inflation is substantially higher today compared to 1994 and 2000. This is also true when looking at core inflation. Short-term inflation expectations are higher while long-term inflation expectations are around the same level. The unemployment rate is significantly lower than in 1994 and around the same level as in 2000. Both initial and continuing jobless claims are significant lower compared to 1994 and 2000 despite a much bigger population. Wage growth is also stronger. **In other words, if large rate hikes were justified in 1994 and 2000, large rate hikes today are as well when looking at inflation and labour market data.**

Large Fed rate hikes are rare



Note: Past performance is not a reliable indicator of current or future results.
Sources: Federal Reserve, Macrobond Financial

75bp rate hike on November 15, 1994

75bp rate hike on 15. November 1994*: "These measures were taken against the background of evidence of persistent strength in economic activity and high and rising levels of resource utilization. In these circumstances, the Federal Reserve views these actions as necessary to keep inflation contained, and thereby foster sustainable economic growth".*

Previous meeting August 1994 (50bp): *"These measures were taken against the background of evidence of continuing strength in the economic expansion and high levels of resource utilization. The actions are intended to keep inflationary pressures contained, and thereby foster sustainable economic growth".*

Source: Federal Reserve

50bp rate hike on May 16, 2000

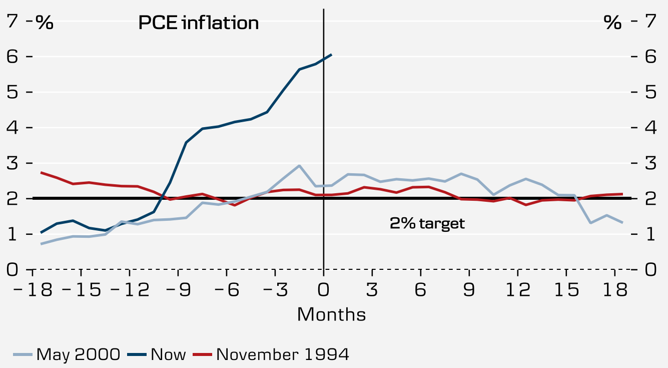
50bp rate hike on May 16 2000: *"Increases in demand have remained in excess of even the rapid pace of productivity-driven gains in potential supply, exerting continued pressure on resources. The Committee is concerned that this disparity in the growth of demand and potential supply will continue, which could foster inflationary imbalances that would undermine the economy's outstanding performance"*

Previous meeting March 2000 (25bp rate hike): *"The Committee remains concerned that increases in demand will continue to exceed the growth in potential supply, which could foster inflationary imbalances that would undermine the economy's record economic expansion."*

Source: Federal Reserve

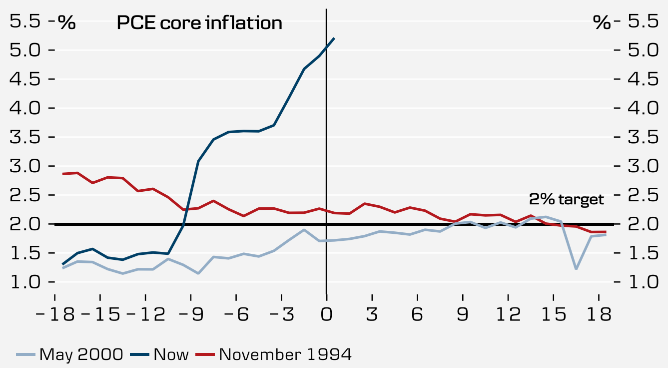
Inflation charts

Very high PCE inflation today compared to 1994 and 2000



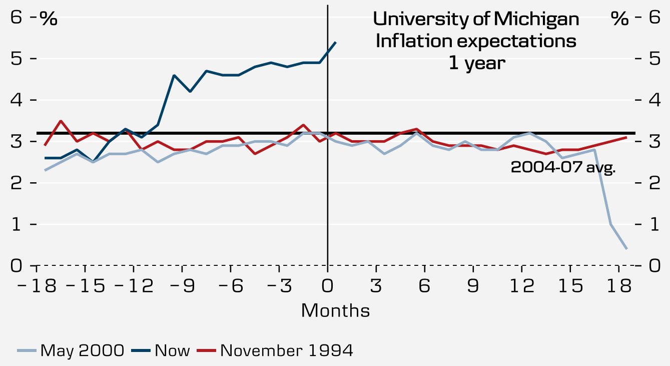
Note: Now refers the most recent observation
Source: BEA Macrobond Financial

PCE core shows the same picture



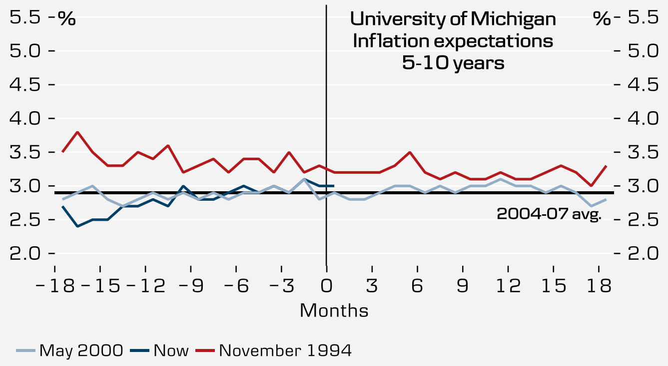
Note: Now refers the most recent observation
Source: BEA, Macrobond Financial

Short-term inflation expectations are much higher than in 1994 and 2000



Note: Now refers the most recent observation
Source: University of Michigan, Macrobond Financial

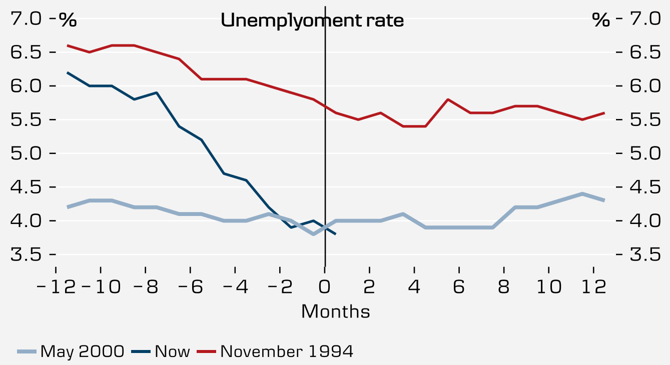
Long-term inflation remains well-anchored



Note: Now refers the most recent observation
Source: University of Michigan, Macrobond Financial

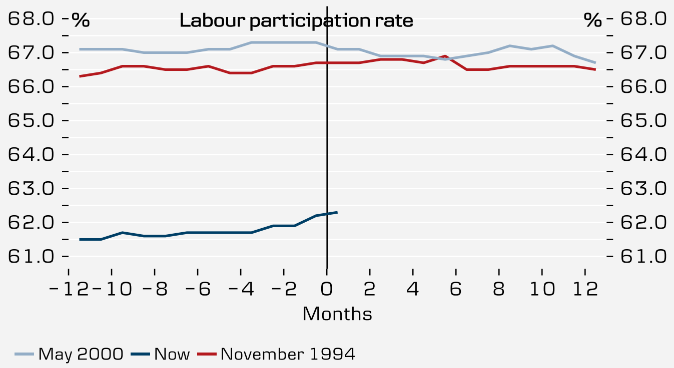
Labour market charts

The unemployment rate is lower than in 1994 but around the same level as in 2000



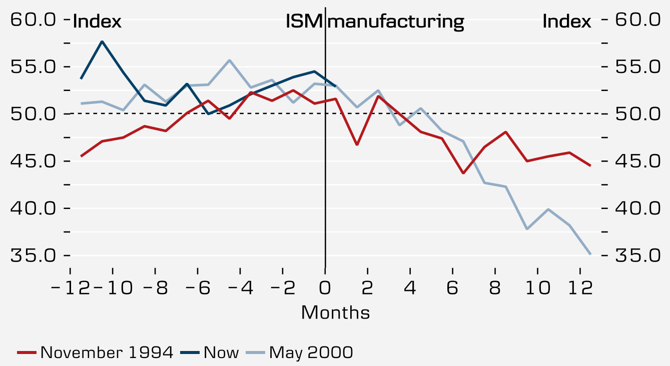
Note: Now refers the most recent observation
Source: BLS, Macrobond Financial

Labour participation rate is much lower



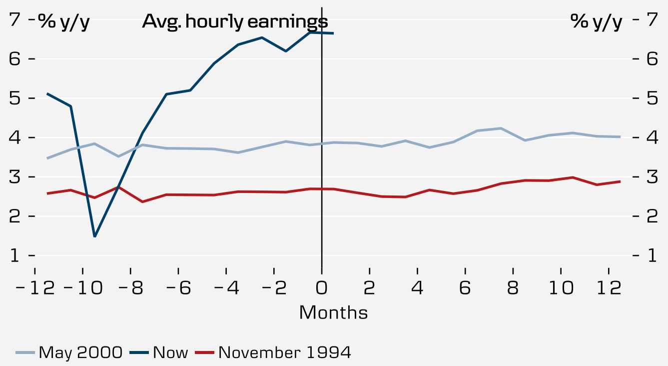
Note: Now refers the most recent observation
Source: BLS, Macrobond Financial

ISM manufacturing employment around the samme level as in 1990



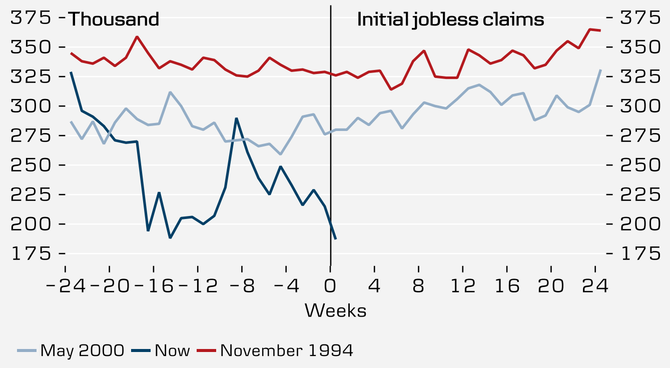
Note: Now refers the most recent observation
Source: BLS, Macrobond Financial

Wage growth is also significantly higher



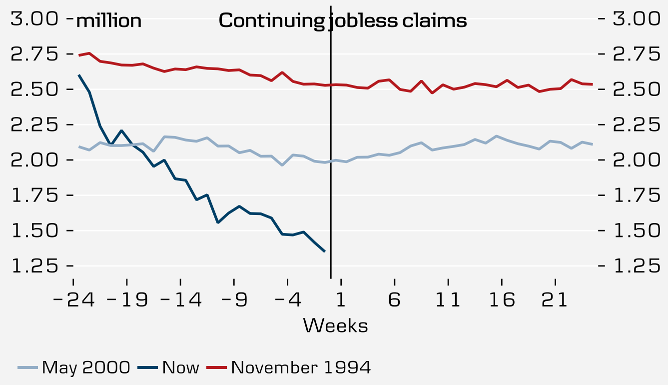
Note: Now refers the most recent observation
Source: BLS, Macrobond Financial

Initial jobless claims are lower than in 1994 and 2000



Note: Now refers the most recent observation
Source: US Department of Labor, Macrobond Financial

Continuing jobless claims are also lower



Note: Now refers the most recent observation
Source: US Department of Labour, Macrobond Financial

Recent Fed comments - overview

	50bp?	Number of hikes in 2022	Russia-Ukrain War	QT	Reccision risk
Kashkari	There's a danger to overdoing it	Federal funds rate to 1.75-2.00% by year-end 2022			
Evans	We need to move rates up close to neutral, maybe a 50bp hike, I'm open minded	Evans 'in line with' median of 7 quarter bp hikes for 2022			
Daly	Data will tell us whether 50bp or 25bp and the balance sheet is the right recipe		It's too early to call if we're going to have a global recession due to the war		She sees a "very limited probability that the U.S. will fall into reccession
Williams	If the Fed needs to raise rates by 50bp, we should do that			On track to start QT this year	
Brainard					
Powell	Open for 50 basis points at a meeting or meetings, if we conclude that it is appropriate.		Oil shocks tend to weigh on output in the U.S. economy, but by far less than in the 1970s.	Could start reducing the size of the holdings on its balance sheet as soon as May	Soft, or at least soft-ish, landings have been relatively common in U.S. monetary history
Bowman					
Barkin	50bp if it is necessary to prevent inflation expectations from unanchoring.			It is appropriate to start to normalize the balance sheet as well	We are still far from the level of rates that constrains the economy
Harker					
Waller	Favor front loading - implies 50bp hike at one or mutiple meetings	Wants Fed Funds Rate Over 2% by End of Year	Data was screaming at 50bp in March but the geopolitical situation led me to support 25bp	The Fed needs to start reducing its bond holdings soon (next meeting or two)	
Mester	Supoort “front-loading” interest rate hikes	Appropriate to raise rates by 2.5% this year		Support starting to shrink the balance sheet	
George					
Bostic	So I’m not wedded to moving only 25bp, but basecase is 25bp	Favors 6 rate hikes this year			
Bullard	Supports 50bp hike. Thinks faster is better	Recommends Fed funds above 3% this year			

Sources: Various media and Federal Reserve

Disclosures

This research report has been prepared by Danske Bank A/S ('Danske Bank'). The author of this research report is Mikael Olai Milhøj, Chief Analyst, and Jakob Sellebjerg Nielsen, Assistant Analyst.

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