15 June 2022

Fed Research

Review: big rate hikes until inflation pressure eases

Key takeaways

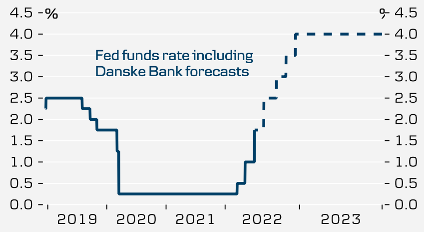
- As expected, the Fed hiked the target range by 75bp to 1.50-1.75% and left the QT programme unchanged.
- Fed Chair Jerome Powell mentioned that the Fed can hike by another 75bp in July but that we should not expect a series of 75bp rate hikes. This sounds very similar to the May meeting when Powell mentioned that the committee was not "actively considering" 75bp. As long as inflation remains high, the Fed is forced to deliver.
- We change our Fed call now expecting the Fed to hike by 75bp in July and 50bp in September, November and December. If we are right, the Fed funds target range would be 3.75-4.00% by year-end (vs. Fed dot of 3.375% and market pricing of 3.5%).
- We still see risks skewed towards faster and more tightening given the inflation outlook. Our base case is that the US falls into a recession in Q2 23 but the faster hiking pace increases the risk that it starts earlier.
- FX: We expect the Fed to underpin our forecast for seeing EUR/USD towards parity in 12M.
- FI: We see upside risks to our UST 10yr yield target of 3.50% in 3-6M..

Fed: Inflation pressure remains too high

In line with expectations, the Federal Reserve decided to hike the target range by 75bp to 1.50-1.75%. For long, consensus was 50bp but that view changed rapidly after the *Wall Street Journal article* on Monday. We have emphasised for a long time that the Fed could be forced to follow the "emerging market central bank playbook" by out-hiking expectations and today's announcement seems to be the first step in that direction. Underlying inflation pressure (as measured by monthly increases in CPI headline and CPI core) remains too high and long-term inflation expectations are at uncomfortable high levels according to the latest survey from the University of Michigan. We noticed that Fed Chair Jerome Powell specifically mentioned the latter during the press conference.

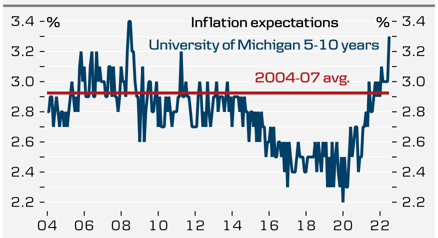
While the Federal Reserve now says it is *"strongly committed"* to get inflation back to 2%, Chair Jerome Powell's press conference was interpreted dovishly, as he indicated that the Fed is not going to make a string of 75bp rate hikes. EUR/USD moved higher and 2yr US Treasury yields declined after this comment. We think, however, that this sounds very similar to what we heard in May when Powell said policymakers did not discuss a 75bp rate hike, see *Fed Research – Review: 50bp rate hike but no appetite for 75bp (yet?)*, 4 May 2022. **As long as monthly price increases remain too high, the Fed is forced to deliver big rate hikes, in our view, and the environment is still very inflationary in nature.**

Our new Fed call



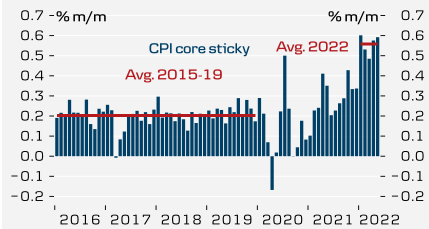
Note: Past performance is not a reliable indicator of current or future results.
Sources: Federal Reserve, Macrobond Financial, Danske Bank forecasts

Long-term inflation expectations are too high



Sources: University of Michigan, Macrobond financial

Price increases are too high



Sources: Atlanta Fed, Macrobond Financial

Chief Analyst
Mikael Olai Milhøj
+45 45 12 76 07
milh@danskebank.dk

Senior Analyst
Lars Sparresø Lykke Merklin
+45 45 12 85 18
lsm@danskebank.dk

Chief Analyst
Arne Lohmann Rasmussen
+45 21 46 29 51
arr@danskebank.dk

New Fed call: Another 75bp rate hike in July, 50bp afterwards

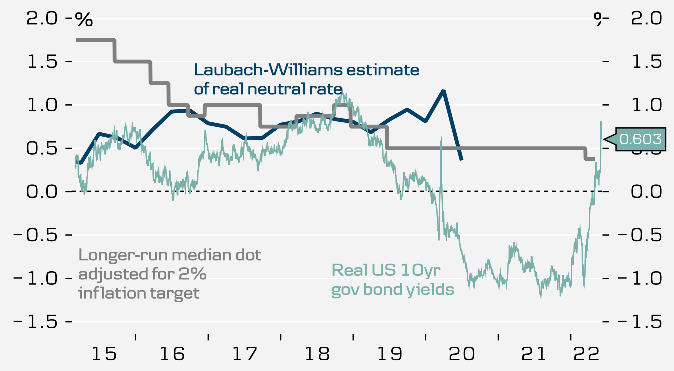
Based on recent evets, we are changing our Fed call. We do not expect monthly changes in CPI headline and CPI core to ease materially, hence supporting the case for the Fed to continue front-loading rate hikes. **We now expect the Fed to hike by another 75bp in July, which would bring the target range to neutral (2.50% according to the dots). We then expect the Fed to slow down the hiking pace to 50bp in September, November and December**.

If we are right, the Fed funds rate will be 3.75-4.00% by year-end. We then expect the Fed hiking cycle to end because of rising fears of a forthcoming recession. We continue to believe that risks are skewed towards faster and more tightening and cannot rule out further 75bp rate hikes and/or a 100bp rate hike at some point. If the US falls into a recession, the Fed is likely to cut but it is not as easy as in previous recessions because it may take time for inflation pressure to ease substantially when demand slows.

In comparison, the Fed is signalling a Fed funds rate of 3.375% by year-end and markets are pricing in a Fed funds rate of 3.5% by year-end, at the time of writing.

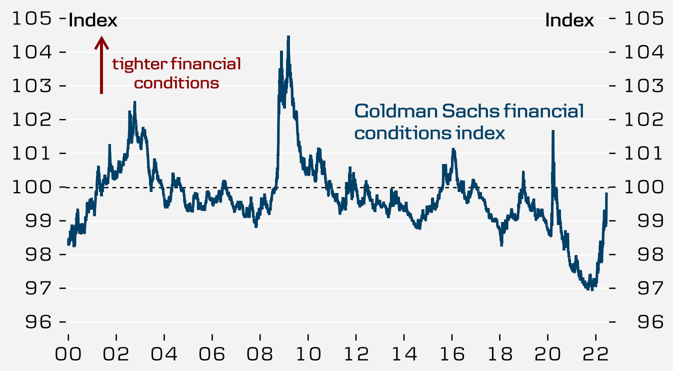
We notice, however, that expected monetary policy, as based on current market pricing, has moved into restrictive territory. Real 10yr US Treasury yields are now above neutral and financial conditions are no longer easy in a historical perspective. **Whether it is enough to cool down inflation is difficult to say, but nonetheless it suggests that there probably is a limit to how many further rate hikes investors can price in at this point**.

Real rates are finally above neutral



Note: Past performance is not a reliable indicator of current or future results.
Source: Federal Reserve, Bloomberg, NY Fed, BEA, Macrobond Financial, Danske Bank

Fed no longer very easy in a historical perspective



Note: Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index.
Sources: Goldman Sachs, Bloomberg, Macrobond Financial

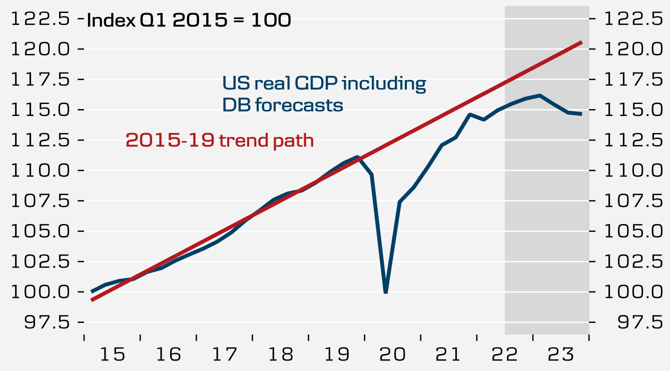
Macro outlook: Rising recession risks

As we outlined in *Big Picture: A (mild) recession in western economies seems unavoidable*, 3 June 2022, we expect the US economy to fall into a recession in Q2 23. We argued that risks were skewed towards an earlier start of the recession if the Fed hiked at a faster pace and this is exactly what is happening right now. **We continue to expect that the Fed will hike interest rates until the US economy falls into a recession and inflation starts to ease because of slower demand** and in that sense we are expecting a more "traditional" recession after two more extraordinary economic crisis (the financial crisis and the COVID-19 crisis). It is, unfortunately, difficult to predict the exact timing, depth and length of a forthcoming recession. Fed Chair Powell still believes a soft landing is achievable but it is difficult for him to say otherwise given the Fed's dual-mandate. **The inconvenient truth is that the Federal Reserve does not have luxury to take several**

factors into consideration when adjusting monetary policy, as very high inflation is the biggest problem facing the Fed and the US economy right now. Markets are also pricing in a higher recession risk after the inversion of the UST 2s10s yield spread.

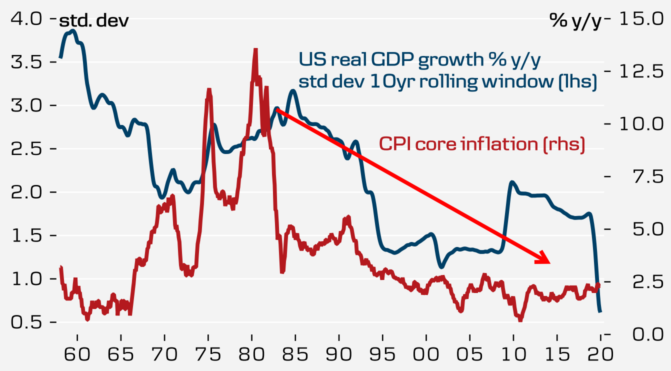
A recession is definitely not positive but the way to look at it is probably "short-term pain, long-term gain". We know that macro volatility declined rapidly when inflation came under control in the late 80's/early 90's with fewer recessions. Macro stability caused by low, stable and predictable inflation gives better macro outcomes in the long-run.

We expect the US to fall into a recession in Q2 23



Sources: BEA, Danske Bank forecasts

Short-term pain, long-term gain. Low, stable and predictable inflation reduces macro volatility



Note: We have excluded the COVID-19 crisis

Sources: BEA, BLS, Macrobond Financial

FX: We still expect EUR/USD to move to parity in 12M

At the FOMC press conference, Powell had a lot of focus on 'dangers', 'data dependency', 'clouded outlook' and so forth. To us, this is playing a bit of both sides and a more clear (hawkish) message could have been delivered, if he so wanted. At present, high-frequency indicators point towards one more 1% m/m print on the headline CPI and there is mostly tentative evidence that CPI has peaked. That said, **markets sold (broad) USD and bought risk on the back of this somewhat ambiguous message**. However, looking ahead, we see inflation prints as remaining high amid a cyclical slowdown. If data confirms this, then **we also expect Fed to underpin our forecast for seeing EUR/USD towards parity in 12M**. Our view is that Fed on the margin could have *chosen* to do more to underline hawkishness - and that we might see a brief pause in the USD rally before we see the next data print/evidence of high CPI and cyclical slowdown but that Fed did not push markets to add to such defensive pricing during the press conference.

Fixed Income: Still upside for 10y UST yields on a 3 to 6 months horizon

The Fed managed to convince the market today that despite the high current inflation it would be able to shift to 50bp hikes going forward. Hence, we saw a major rally in 2Y UST that dropped close to 20bp when Powell underlined that the next rate hike could be 50bp and not necessarily 75bp. The message also supported the long end with 10Y UST yields down some 8bp after the comment. Hence, despite the big 75bp rate hike and a substantial dot-revision the US 2s10s yield curve made a bullish steepening on the announcement.

However, with our new Fed funds forecast (peak in Fed funds at 4% December 2022) and the drop in Fed funds pricing today we are now ahead of the market pricing for 2022. The market is currently pricing an additional 193bp rate hikes this year. We look for

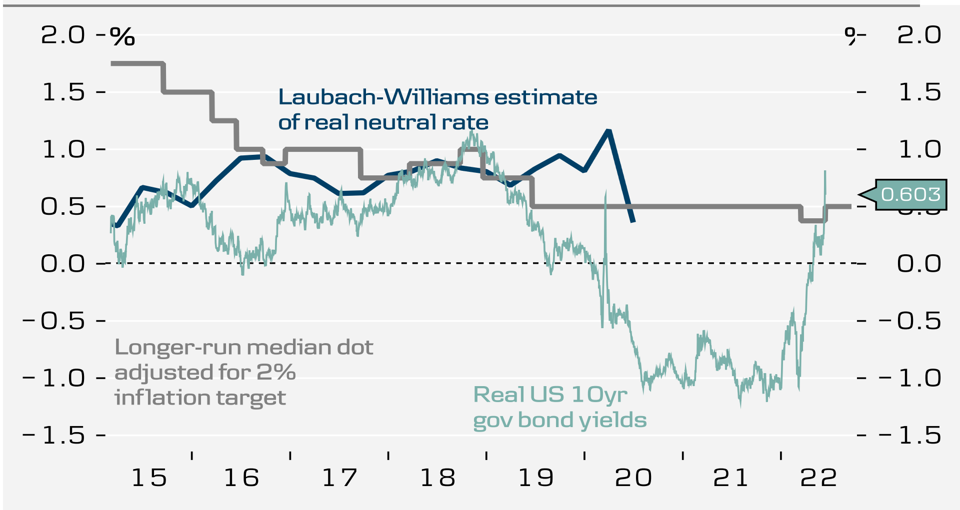
225bp. **Hence, we still believe we have the peak in 10Y UST yields ahead of us.** We have a so far an unrevised 3.50% 10Y UST yield-target and with our new Fed funds forecast the risk is now skewed to the upside over the next three to six months. **We do expect today's 2s10s curve steepening to reverse later this year as the rate hikes roll in.**

Peak in yields when the market price "end of tightening"

However, as 2023 approaches we should expect a new downward pressure on UST yields, as the market starts to price in 'end of tightening' and as the risk of a forthcoming 2023 recession becomes evident. That could move 10Y UST yields back to the 3.0% - 3.25% area.

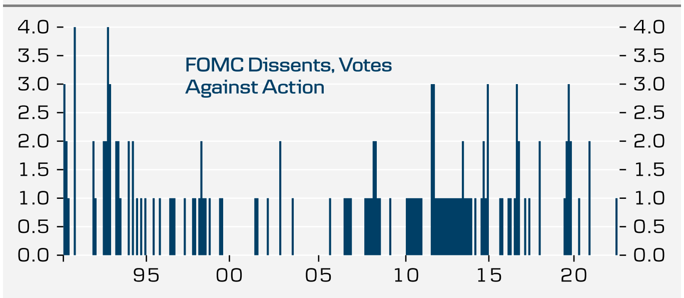
Fed charts

Real rates finally above neutral



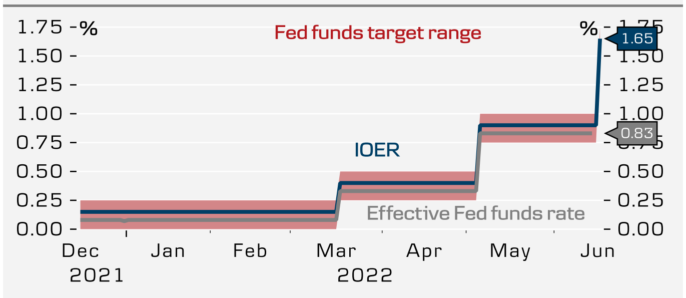
Note: Past performance is not a reliable indicator of current or future results.
Source: Federal Reserve, Bloomberg, NY Fed, BEA, Macrobond Financial, Danske Bank

The FOMC members usually work by consensus



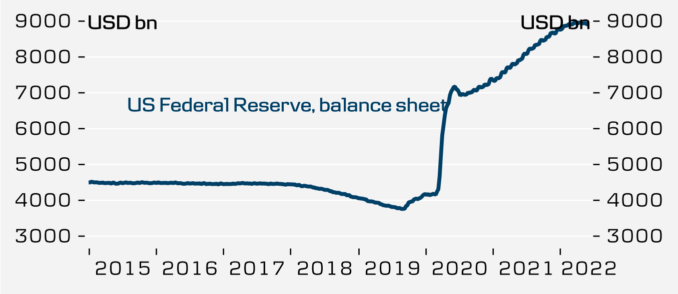
Source: St Louis Fed, Macrobond Financial, Danske Bank

Effective Fed funds stable in the middle of the range



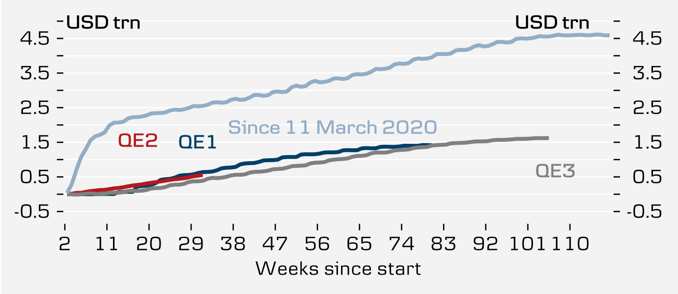
Note: Past performance is not a reliable indicator of current or future results.
Source: Federal Reserve, Macrobond Financial, Danske Bank

The Fed has initiated QT



Source: Federal Reserve, Macrobond Financial, Danske Bank

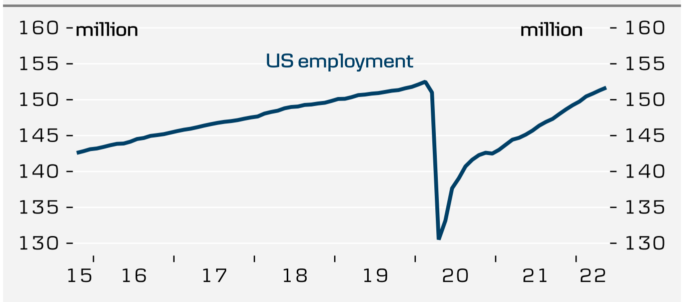
Fed bought a lot of bonds during QE



Sources: Federal Reserve, Macrobond Financial

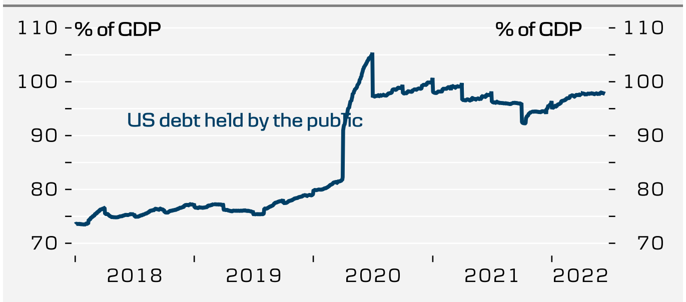
Macro charts

Maximum employment despite lower level than pre-covid (lower labour force)



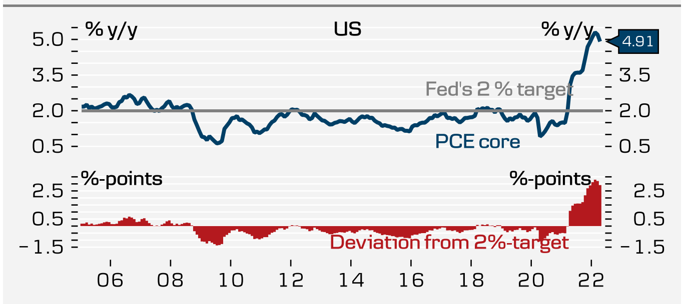
Source: BLS, Macrobond Financial, Danske Bank

US debt has been quite stable since the increase in the early days of the pandemic



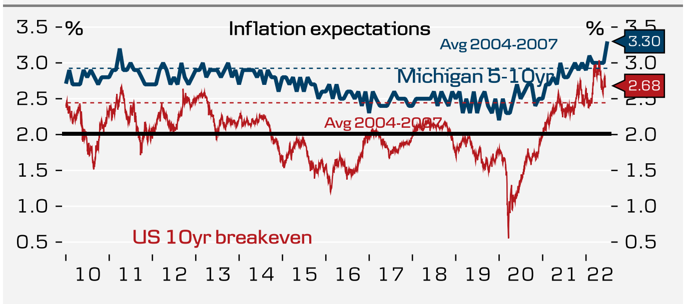
Sources: US Treasury, Federal Reserve, Macrobond Financial

Very high PCE inflation



Source: BEA, Macrobond Financial, Danske Bank

Long-term inflation above the 2004-07 average



Note: Past performance is not a reliable indicator of current or future results.
Source: Michigan, Bloomberg, Macrobond Financial, Danske Bank

Disclosures

This research report has been prepared by Danske Bank A/S ('Danske Bank'). The authors of this research report is Mikael Olai Milhøj, Chief Analyst, Arne Lohmann Rasmussen, Chief Analyst, and Lars Sparresø Lykke Merklin, Senior Analyst.

Analyst certification

Each research analyst responsible for the content of this research report certifies that the views expressed in the research report accurately reflect the research analyst's personal view about the financial instruments and issuers covered by the research report. Each responsible research analyst further certifies that no part of the compensation of the research analyst was, is or will be, directly or indirectly, related to the specific recommendations expressed in the research report.

Regulation

Danske Bank is authorised and subject to regulation by the Danish Financial Supervisory Authority and is subject to the rules and regulation of the relevant regulators in all other jurisdictions where it conducts business. Danske Bank is subject to limited regulation by the Financial Conduct Authority and the Prudential Regulation Authority (UK). Details on the extent of the regulation by the Financial Conduct Authority and the Prudential Regulation Authority are available from Danske Bank on request.

Danske Bank's research reports are prepared in accordance with the recommendations of the Danish Securities Dealers Association.

Conflicts of interest

Danske Bank has established procedures to prevent conflicts of interest and to ensure the provision of high-quality research based on research objectivity and independence. These procedures are documented in Danske Bank's research policies. Employees within Danske Bank's Research Departments have been instructed that any request that might impair the objectivity and independence of research shall be referred to Research Management and the Compliance Department. Danske Bank's Research Departments are organised independently from, and do not report to, other business areas within Danske Bank.

Research analysts are remunerated in part based on the overall profitability of Danske Bank, which includes investment banking revenues, but do not receive bonuses or other remuneration linked to specific corporate finance or debt capital transactions.

Financial models and/or methodology used in this research report

Calculations and presentations in this research report are based on standard econometric tools and methodology as well as publicly available statistics for each individual security, issuer and/or country. Documentation can be obtained from the authors on request.

Risk warning

Major risks connected with recommendations or opinions in this research report, including as sensitivity analysis of relevant assumptions, are stated throughout the text.

Expected updates

Ad hoc.

Date of first publication

See the front page of this research report for the date of first publication.

General disclaimer

This research has been prepared by Danske Bank A/S. It is provided for informational purposes only and should not be considered investment, legal or tax advice. It does not constitute or form part of, and shall under no circumstances be considered as, an offer to sell or a solicitation of an offer to purchase or sell any relevant financial instruments (i.e. financial instruments mentioned herein or other financial instruments of any issuer mentioned herein and/or options, warrants, rights or other interests with respect to any such financial instruments) [('Relevant Financial Instruments').]

This research report has been prepared independently and solely on the basis of publicly available information that Danske Bank A/S considers to be reliable but Danske Bank A/S has not independently verified the contents hereof. While reasonable care has been taken to ensure that its contents are not untrue or misleading, no representation or warranty, express or implied, is made as to, and no reliance should be placed on, the fairness, accuracy, completeness or reasonableness of the information, opinions and projections contained in this research report and Danske Bank A/S, its affiliates and subsidiaries accept no liability whatsoever for any direct or consequential loss, including without limitation any loss of profits, arising from reliance on this research report.

The opinions expressed herein are the opinions of the research analysts and reflect their opinion as of the date hereof. These opinions are subject to change and Danske Bank A/S does not undertake to notify any recipient of this research report of any such change nor of any other changes related to the information provided in this research report.

This research report is not intended for, and may not be redistributed to, retail customers in the United Kingdom (see separate disclaimer below) and retail customers in the European Economic Area as defined by Directive 2014/65/EU.

Disclaimer related to distribution in the United States

This research report was created by Danske Bank A/S and is distributed in the United States by Danske Markets Inc., a U.S. registered broker-dealer and subsidiary of Danske Bank A/S, pursuant to SEC Rule 15a-6 and related interpretations issued by the U.S. Securities and Exchange Commission. The research report is intended for distribution in the United States solely to 'U.S. institutional investors' as defined in SEC Rule 15a-6. Danske Markets Inc. accepts responsibility for this research report in connection with distribution in the United States solely to 'U.S. institutional investors'.

Danske Bank A/S is not subject to U.S. rules with regard to the preparation of research reports and the independence of research analysts. In addition, the research analysts of Danske Bank A/S who have prepared this research report are not registered or qualified as research analysts with the New York Stock Exchange or Financial Industry Regulatory Authority but satisfy the applicable requirements of a non-U.S. jurisdiction.

Any U.S. investor recipient of this research report who wishes to purchase or sell any Relevant Financial Instrument may do so only by contacting Danske Markets Inc. directly and should be aware that investing in non-U.S. financial instruments may entail certain risks. Financial instruments of non-U.S. issuers may not be registered with the U.S. Securities and Exchange Commission and may not be subject to the reporting and auditing standards of the U.S. Securities and Exchange Commission.

Disclaimer related to distribution in the United Kingdom

In the United Kingdom, this document is for distribution only to (I) persons who have professional experience in matters relating to investments falling within article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (the 'Order'); (II) high net worth entities falling within article 49(2)(a) to (d) of the Order; or (III) persons who are an elective professional client or a per se professional client under Chapter 3 of the FCA Conduct of Business Sourcebook (all such persons together being referred to as 'Relevant Persons'). In the United Kingdom, this document is directed only at Relevant Persons, and other persons should not act or rely on this document or any of its contents.

Disclaimer related to distribution in the European Economic Area

This document is being distributed to and is directed only at persons in member states of the European Economic Area ('EEA') who are 'Qualified Investors' within the meaning of Article 2(e) of the Prospectus Regulation (Regulation (EU) 2017/1129) ('Qualified Investors'). Any person in the EEA who receives this document will be deemed to have represented and agreed that it is a Qualified Investor. Any such recipient will also be deemed to have represented and agreed that it has not received this document on behalf of persons in the EEA other than Qualified Investors or persons in the UK and member states (where equivalent legislation exists) for whom the investor has authority to make decisions on a wholly discretionary basis. Danske Bank A/S will rely on the truth and accuracy of the foregoing representations and agreements. Any person in the EEA who is not a Qualified Investor should not act or rely on this document or any of its contents.

Report completed: 15 June 2022, 23:42 CEST

Report first disseminated: 15 June 2022, 23:55 CET