15 December 2021

Fed Research

Review: Catching up to reality – first rate hike likely in May

Key takeaways

- The Fed doubles the tapering pace to USD30bn per month (up from USD15bn per month), implying an end to QE bond buying in March (from June). This opens the window for a rate hike as early as in spring (March or May).
- The Fed now signals three rate hikes in 2022 (up from 50% probability of one single rate hike in 2022 in the September projections).
- The reason for the hawkish shift is a combination of still high inflation (the Fed removed "transitory" from the statement) and a tighter labour market (expects maximum employment to be reached next year).
- Basically, the Fed catches up to reality and market pricing (and consensus among economists).
- We continue to expect three rate hikes in 2022. We now, however, expect the first rate hike will arrive in May (June previously). We still expect the next two rate hikes to arrive in September and December. We expect the hiking cycle will continue in 2023 with four rate hikes.
- FX: We continue to forecast EUR/USD at 1.10 in 12M and continue to see downside risk to this.
- Fixed Income: We continue to expect a further flattening of the US curve, as Fed hikes roll into the curve in 2022, and target 2% for the 10% US Treasury yield in 2022.

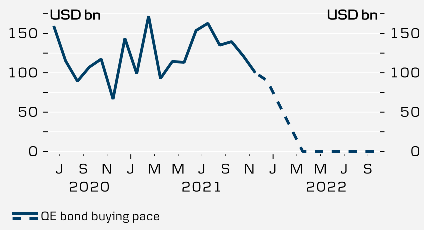
Fed: Not an "extended wait" from end of QE to first rate hike

The Fed made another hawkish shift at the December meeting and the Fed is catching up to market pricing and consensus among economists, as the economy is in good shape. CPI headline inflation is running at the highest level in 39 years, inflation expectations have risen (especially short-term), wage growth is stronger and the labour market is quite tight by many measures (as the decline in labour force seems more persistent than what the Fed and many economists believed just a few months ago). **The Fed still believes inflation will come down next year, despite retiring the word "transitory", but also that the US economy will reach maximum employment.**

The Fed doubles the tapering pace to USD30bn per month (starting from mid-January), implying QE bond buying ends in March (from June previously). The Fed now signals three rate hikes in 2022 (up from 50% probability of one single rate hike in 2022 in the September projections). **The hawkish shift was not a surprise given Fed Chair Jerome Powell's U-turn ahead of the meeting and hence the market reaction was limited.**

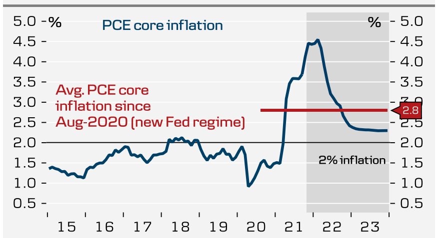
Powell repeated that omicron is a risk but that the impact on the economy is ambiguous. While the new variant may suppress demand, it may very well also suppress supply and hence be inflationary in nature (in line with what we have been arguing for a while).

Fed QE ends in March after the doubling of the tapering pace



Sources: Federal Reserve, Macrobond Financial, Danske Bank illustration

PCE core inflation likely to remain above 2% in coming years – the Fed retires "transitory"



Sources: BEA, Macrobond Financial, Danske Bank forecasts

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

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

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

During the Q&A session, Powell said he does not see an "extended wait" from the end of QE to the first rate hike. While we cannot rule out March, we now believe the first rate hike will arrive in May (from June previously). We still expect the next two rate hikes will arrive in September and December and four additional hikes in 2023.

FX:

Fed is now largely communicating what has already been priced and the Powell-pivot ("inflation is not transitory") was reflected during the press conference. As we have seen before, the event itself may easily give some leeway for markets to suddenly start looking ahead rather than focusing on potential volatility. As such, risk rallied somewhat after the event with e.g. RUB, ZAR, MXN and NOK a bit higher.

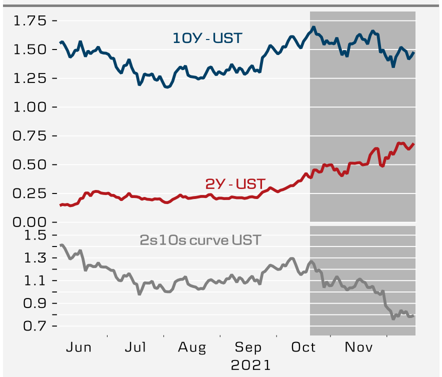
EUR/USD spot was largely unchanged which is likely a reflection that what happened during the meeting was both priced and communicated. **Looking ahead, however, we expect spot to continue drifting lower.** While one could argue the lack of effect in spot EUR/USD also implies that everything has been priced here, we would caution against such a view. Indeed, we have seen before that spot EUR/USD may react very differently to an event versus where it will go a few weeks later. Thus, we see the underlying narrative as drifting in favour of a stronger dollar, irrespective of Fed now being more in line with our view on macro. Hence, **we continue to forecast EUR/USD at 1.10 in 12M and continue to see downside risk to this.**

FI: Curve flattening extends

The hawkish message from the Fed extended the recent flattening of the 2s10s US curve, as especially the monetary sensitive front-end of the yield-curve moved higher, whereas the impact on the long-end of the was more muted. The long-end of the curve furthermore received support from the unchanged longer-term dot at 2.50%. **Overall, however, the move higher in yields was relative modest**, also taking into account that equity markets reacted positively to the announcement. 10Y real rate rates moved higher on the announcement as the 10Y breakeven rate fell on the announcement, which is as expected as Fed tightens monetary policy.

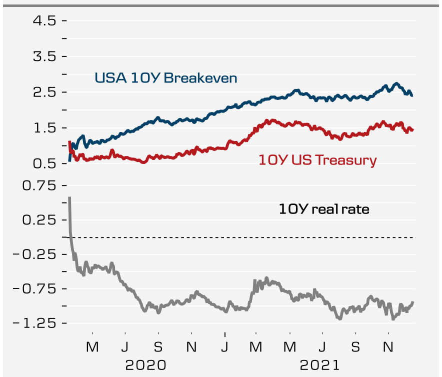
We continue to expect a further flattening of the US curve, as Fed hikes roll into the curve in 2022. But it does not mean that the long-end will not move higher in 2022. **We continue to target 2% for the 10% US treasury yield in 2022** as Fed hikes and as real rates move higher as monetary stimuli are removed and inflation expectations stay around the current level.

The 2s10s curve continued to flatten on Fed message



Note: Past performance is not a reliable indicator of future results. Source: Macrobond

10Y US real rate to move higher in 2022



Note: Past performance is not a reliable indicator of future results. Source: Macrobond

Our Fed call summarised

The Fed doubled its tapering pace to USD30bn per month, up from USD15bn per month previously, implying QE ends in March (from June previously). The Fed now signals three rate hikes in 2022 (up from 50% probability of a rate hike in 2022 in the September projections).

To us, it seems like the Fed has catch up to reality and the current and expected economic situation. The Fed is now aligned with market pricing and consensus among economists.

We still expect three rate hikes in 2022. We now expect the Fed will hike for the first time in May (from June previously). With the doubling of the tapering pace, balance of risk is tilted to a rate hike as early as in March. We still expect the next two rate hikes will arrive in September and December.

We expect the Fed to hike four times in 2023.

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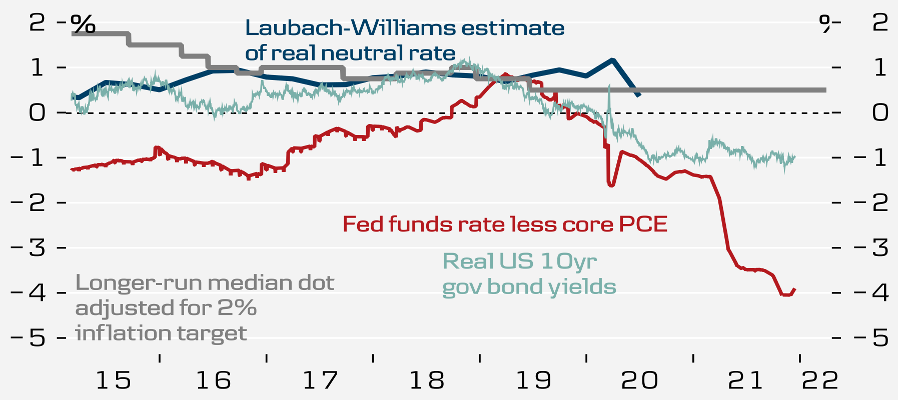
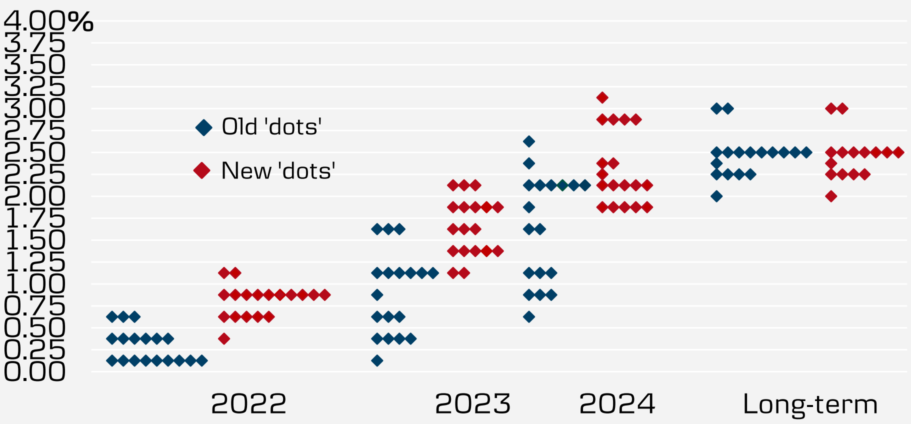
Fed charts

Monetary policy is still accommodative



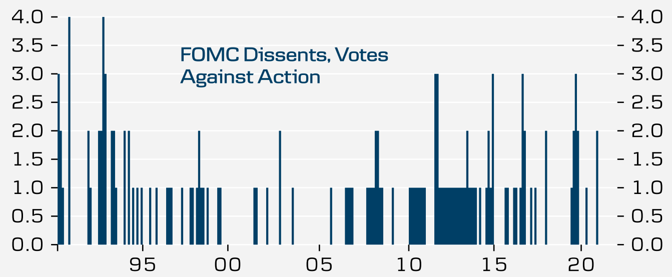
Note: Past performance is not a reliable indicator of current or future results.
Source: Federal Reserve, Bloomberg, NY Fed, BEA, Macrobond Financial, Danske Bank

New Fed dots vs old



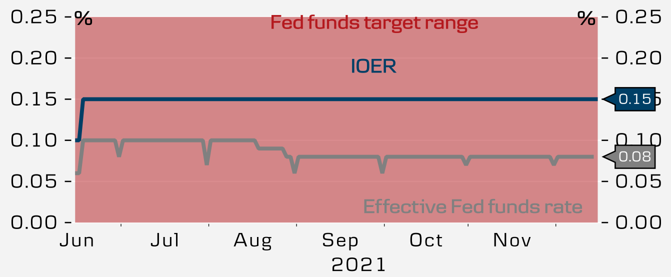
Sources: Federal Reserve, Danske Bank

The FOMC members usually work by consensus



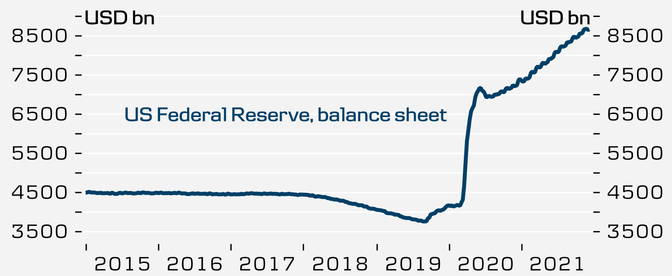
Source: St Louis Fed, Macrobond Financial, Danske Bank

Effective Fed funds rate stable around 8bp



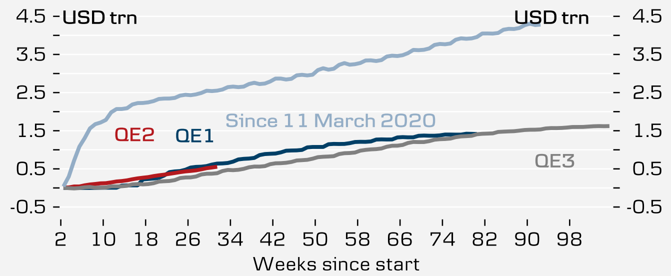
Note: Past performance is not a reliable indicator of current or future results.
Source: Federal Reserve, Macrobond Financial, Danske Bank

US balance sheet will no longer be supported by QE bond buying from March



Source: Federal Reserve, Macrobond Financial, Danske Bank

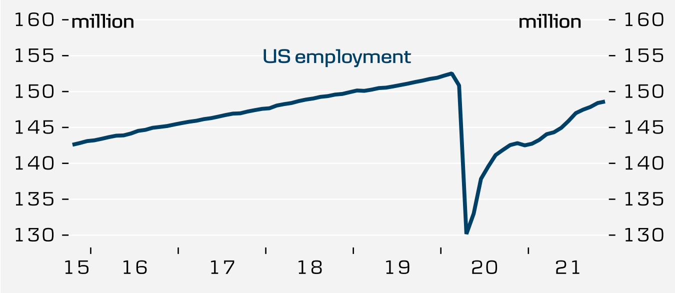
Fed has bought a lot of bonds during QE



Sources: Federal Reserve, Macrobond Financial

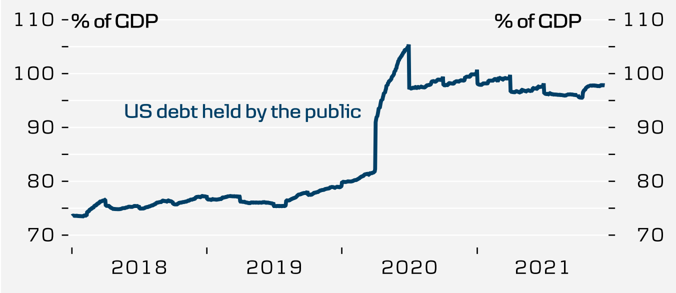
Macro charts

Employment remains significantly below pre-corona levels but mostly because people have left the labour force



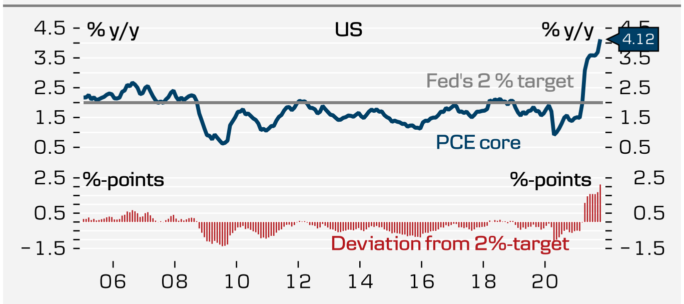
Source: BLS, Macrobond Financial, Danske Bank

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



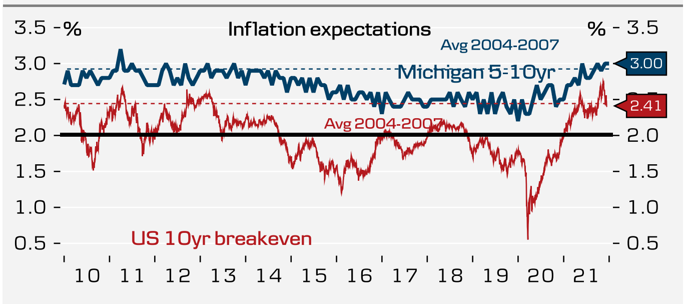
Sources: US Treasury, Federal Reserve, Macrobond Financial

Very high PCE inflation



Source: BEA, Macrobond Financial, Danske Bank

Long-term inflation expectations have risen since 2020 but remain well-anchored



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

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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.

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