16 March 2022

Fed Research

Review: Fed is still behind the curve despite signalling six further rate hikes

Key takeaways

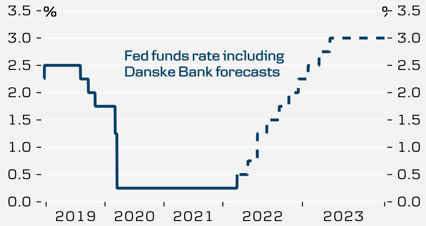
- As expected, the Fed hiked the Fed funds target range by 25bp to 0.25-0.50%.
- The Fed says that it "anticipates ongoing increases in the target range will be appropriate". The median dots signal an additional six 25bp rate hikes this year (1.75-2.00% by year-end).
- Fed says the economic implications of the Russian invasion and Western sanctions are *"highly uncertain"* but *"are likely to create additional upward pressure on inflation"*.
- Powell says that the US economy is strong enough to handle tighter monetary and financial conditions and more or less admitted that the Fed cannot take several factors into account when conducting monetary policy, as inflation is simply too high.
- Despite the rate hike, we are still of the view that the Fed is behind the curve and six additional 25bp rate hikes this year are probably not enough to curb inflation.
- We keep our Fed call unchanged, still expecting a total of 175bp rate hikes this year (25bp at each meeting but 50bp in June). We still expect an announcement on QT in May.
- FX: At present, we forecast EUR/USD in 1.08 in 12M and we see downside risks to this estimate, as the hiking cycle evolves further amid an economic slowdown which is set to hit European manufacturing relatively more negative (see page 3).

Fed: Needs to get inflation back down towards 2%

As expected, the Fed hiked the Fed funds target range by 25bp to 0.25-0.50% from 0.00-0.25% and says that it *"anticipates that ongoing increases in the target range will be appropriate"*. From a US monetary policy perspective, the rate hike marks the ends of the COVID-19 crisis. With respect to the ongoing Russian invasion of Ukraine and tough Western sanctions, Fed says that the economic *"implications for the US economy are highly uncertain but in the near-term the invasion and related events are likely to create additional upward pressure on inflation"*. We share that view, despite oil prices now being back below USD100/barrel.

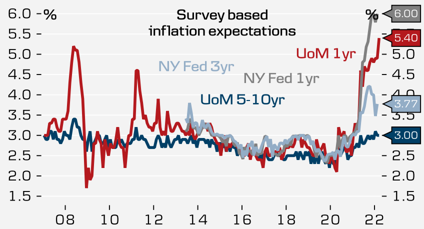
During the press conference, Fed Chair Jerome Powell spent a lot of time explaining how strong the US economy is and that it can handle tighter monetary policy, so Powell did not sound very concerned about the Fed creating a recession down the road by tightening monetary policy. Powell also emphasised that the Fed would like to tighten financial conditions further. **Basically, the Fed is in a situation, where it cannot take several factors into account when conducting monetary policy**, because inflation is already nearly 8% (the highest in 40 years) and the labour market is "extremely tight", as Powell mentioned.

Our Fed call



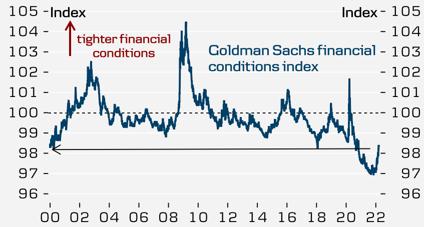
Note: Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index.
Sources: Federal Reserve, Macrobond Financial, Danske Bank forecasts

Still very high inflation expectations



Sources: University of Michigan, New York Fed, Macrobond Financial

Fed needs to tighten financial conditions further



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

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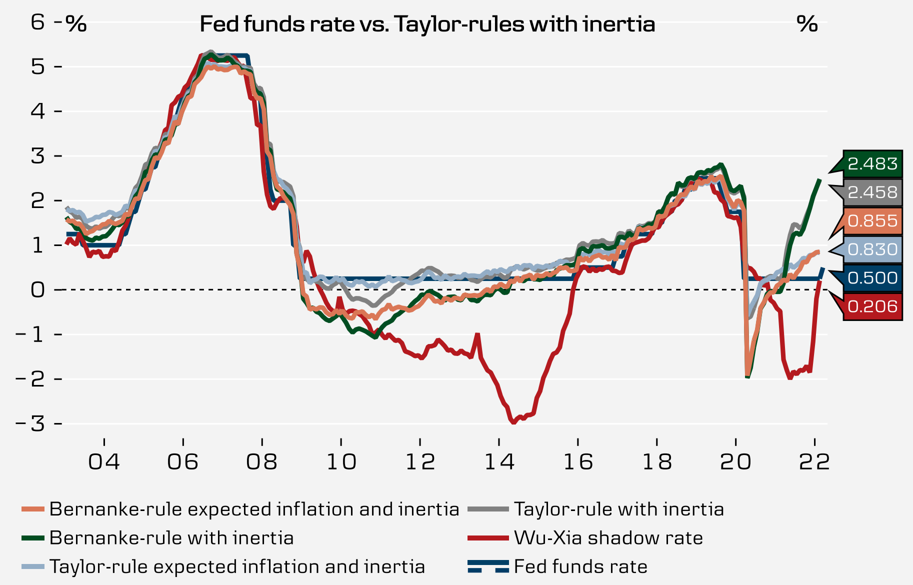
The median dots show a median target range of 1.75-2.00% by the end of this year (six 25bp rate hikes, one at each meeting) and 2.50-2.75% next year (three additional 25bp rate hikes next year). This is quite an upward revision compared to the December 2021 projections, where the Fed signalled a total of three rate hikes this year.

Despite the rate hike, we are still of the view that the Fed is behind the curve and hence that six additional 25bp rate hikes this year are probably not enough. A Taylor-rule approach, even when trying to "be nice" to the Fed, suggests that the Fed is still at least 25bp behind the curve, if not more. Real rates are also still very low and financial conditions very accommodative, despite markets pricing in 6.4 25bp rate hikes this year. **It is interesting that seven FOMC members out of 16 agree with this view by signalling a total of 175bp rate hikes or more this year.** Powell said that in hindsight, the Fed should have tightened earlier and did not rule out a bigger rate hike down the road saying that the Fed will move faster if needed. St Louis Fed President James Bullard dissented calling for a 50bp rate hike.

We keep our Fed call unchanged, still expecting a total of 175bp rate hikes this year, but we now expect the Fed to hike by 50bp at the June meeting (now that the Fed started by 25bp instead of 50bp). We still see risks skewed towards the Fed hiking more and not less. Markets are pricing in an approximately 40% probability of the Fed hiking by 50bp already in May. The probability declined by the end of the press conference, probably because Powell said that an announcement on QT may come as early as May. We doubt that the Fed will announce both QT and hike by 50bp, but the Fed may be forced to do so if inflation continues to surprise to the upside ahead of the May meeting. **Powell's comments on QT support our long-held view that the Fed will announce QT in May.**

Taylor-rules: The Fed is still behind the curve despite rate hike



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

FX: Fed supports a stronger USD

EUR/USD initially went a bit lower after the announcement, but this was later reversed. In our view, this hike was a landmark event in economic history, not due to any particular surprise but rather as this marks the end to US yields being at the zero lower bound and we have now moved effectively from Fed-merely-talking-about-maybe-talking-about-rate-hikes – to hikes. Given the outlook from Powell and the updated forecasts, it seems very likely there will be at least 100bp in carry differential between US and Europe in just a few months. While in G10 space, we rarely see carry differentials as a key driver of spot, this will likely continue to support a stronger USD over the coming months amid many other USD-positive factors. **At present, we forecast 1.08 in 12M and we see downside risks to this estimate as the hiking cycle evolves further amid an economic slowdown, which is set to hit European manufacturing relatively more negative.**

Our Fed call summarised

The first Fed rate hike in March was not a surprise, but the Fed made another hawkish shift by signalling that it anticipates six additional 25bp rate hikes this year (taking the Fed funds target range to 1.75%-2.00%). Fed Chair Powell says that the US economy is strong, the labour market is extremely tight and inflation is too high. Powell also downplays the risk of recession down the road, as demand is strong.

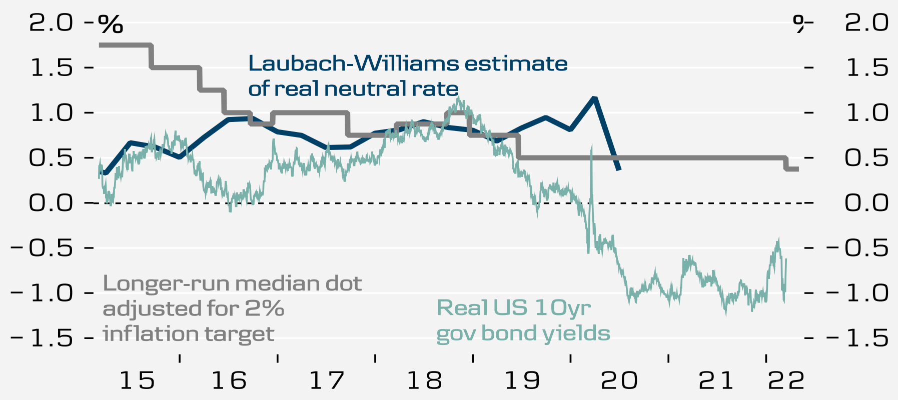
We still believe that the Fed is behind the curve and the Fed needs to do more to increase real rates/tighten financial conditions.

We expect the Fed to hike by an additional cumulative sum of 175bp this year (including a 50bp rate hike in June, 25bp on all other meetings). We still see risks skewed towards the Fed hiking more than what we are pencilling in.

We expect the Fed to announce QT at the next meeting in May.

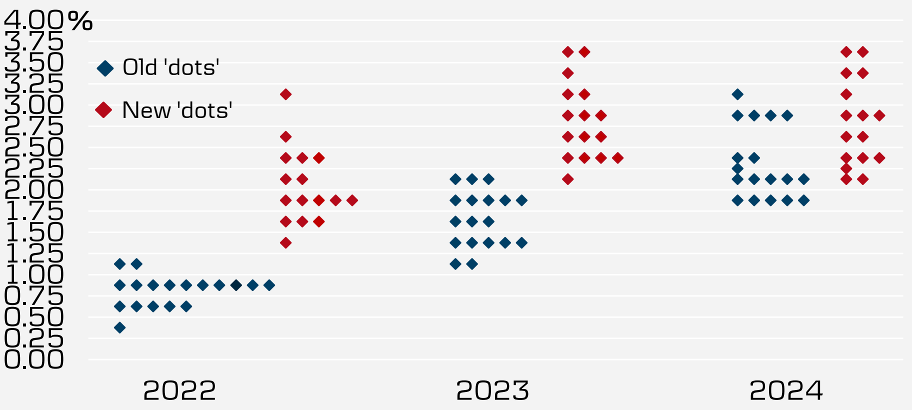
Fed charts

Monetary policy is still accommodative



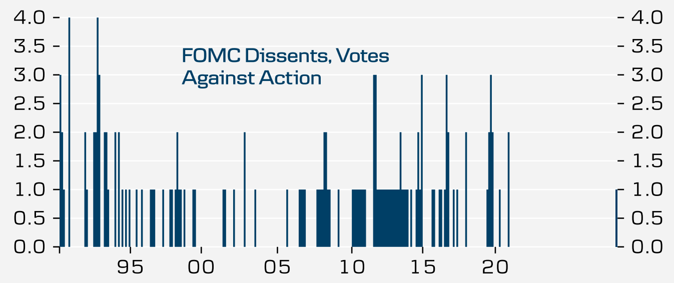
Note: Past performance is not a reliable indicator of current or future results.
Source: Federal Reserve, Bloomberg, NY Fed, BEA, Macrobond Financial, Danske Bank

March 'dots' vs. December 2021 'dots'



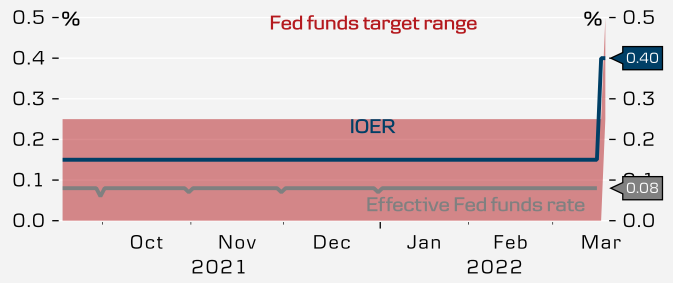
Sources: Federal Reserve, Danske Bank

The FOMC members usually work by consensus



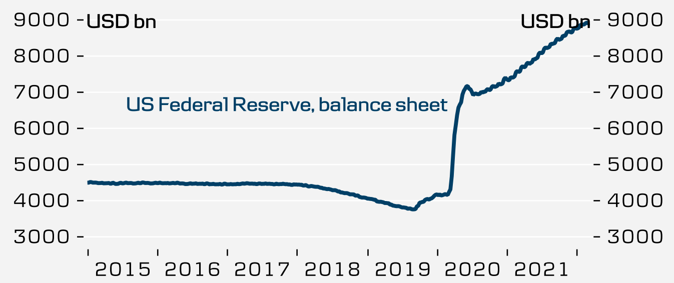
Source: St Louis Fed, Macrobond Financial, Danske Bank

Effective Fed funds rate stable around 8bp



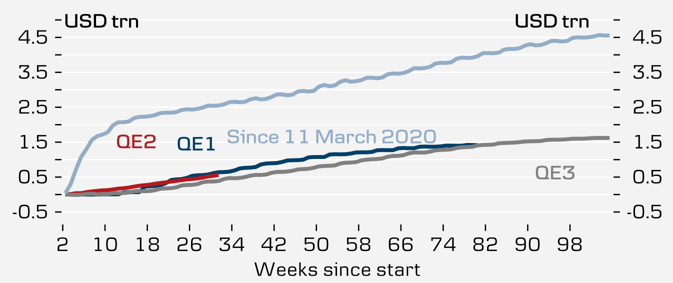
Note: Past performance is not a reliable indicator of current or future results.
Source: Federal Reserve, Macrobond Financial, Danske Bank

The Fed will soon start reducing the balance sheet (QT)



Source: Federal Reserve, Macrobond Financial, Danske Bank

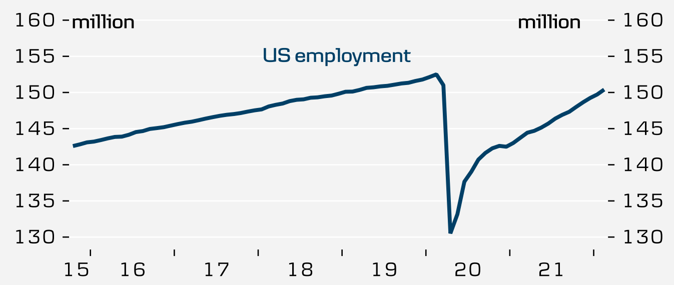
Fed bought a lot of bonds during QE



Sources: Federal Reserve, Macrobond Financial

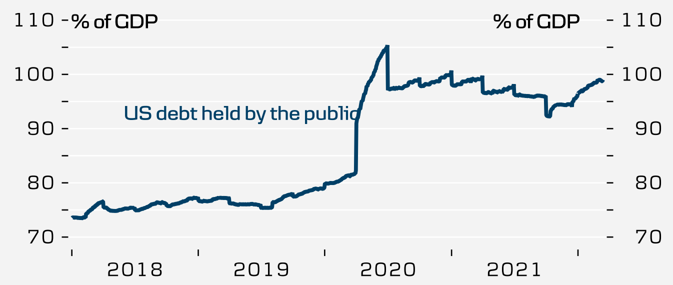
Macro charts

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



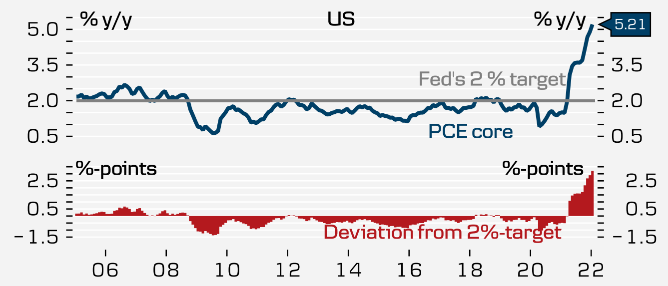
Source: BLS, Macrobond Financial, Danske Bank

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



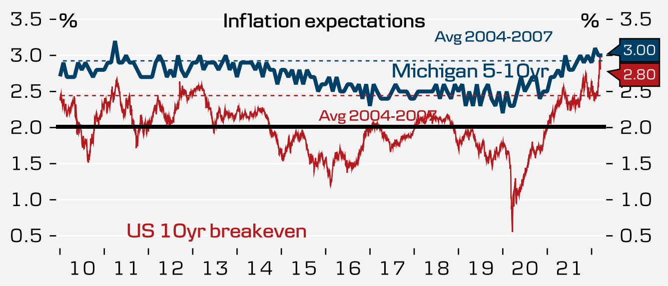
Sources: US Treasury, Federal Reserve, Macrobond Financial

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

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