Research Institute - Insight

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#US / #Monetary policy / #Inflation

Forecast Change

How much further will the Fed hike rates?

The direct spillover effects of banking sector turmoil and the information it provides about the lagged effects of past tightening mean we have reduced our forecast for the terminal policy rate. But we think the market has moved too far in pricing not even a full additional rate hike.

Key Takeaways

- The collapse of Silicon Valley Bank (SVB) and wider banking sector turmoil have seen the market dramatically reprice the near-term path of Fed policy.
- The market has pivoted from pricing in a higher terminal rate on the back of robust growth and inflation, to contemplating the first cut to rates within months.
- While it is hard to have conviction amid volatile pricing, we think these moves are an overreaction. The inflation picture is still concerning and the Fed wants to avoid the appearance of financial dominance.
- We still expect further hikes after that, but we see rates peaking lower than previously forecast, at a target range of 5.25-5.5% in June.
- Avoiding a systemic crisis is not the same thing as avoiding large spillovers. Financial conditions are tightening and sentiment will take a hit.
- Moreover, SVB's failure and ensuing turbulence are a reminder that the full impact of the Fed's rapid tightening over the last year is only now being felt by the economy.
- Rising rates cause and expose structural vulnerabilities in the economy. That is why our baseline has long been called 'Fed kills the cycle', and this episode increases our conviction that this cycle will end in a recession.

The narrative before SVB was all about resilience and sticky inflation

Right before the collapse of Silicon Valley Bank (SVB), the narrative driving markets was that the peak fed funds rate target would likely prove higher than the Federal Reserve (Fed) had been previously signalling.

Activity data for the first few months of 2023 seemed to show that the economy was bouncing back from what had looked like the beginning of a more widespread slowdown at the end of 2022. Business and consumer surveys returned to expansionary territory, retail sales were strong, and the labour market has been in incredibly robust health.

Inflation was also stronger than expected, and revisions to past data painted a much less encouraging picture about the underlying inflation trend through 2022. Core inflation appeared both higher and moving in the wrong direction at the end of last year.

Meanwhile, financial conditions eased significantly, with markets seemingly pricing in something like a "soft landing" scenario.

Indeed, the combination of stronger growth and inflation data and more accommodative financial conditions saw market participants start to discuss the possibility a "no landing", with growth and inflation both remaining high.

The Fed is committed to its price stability mandate so this was never a sustainable equilibrium. It's the Fed's job in this scenario to re-establish its grip on financial conditions and tighten them sufficiently so that the economy does 'land', one way or another.

This explains why Chair Powell struck such a hawkish tone in his testimony to Congress at the start of March.

He seemed to raise the prospect of increasing the pace of rate hikes back to 50bps at the March FOMC meeting, and he explicitly said that the Summary of Economic Projections would likely show a higher terminal rate. All of this saw the market move to price in a peak rate of 5.6%.

Have growth and inflation resilience been caused by 'long and variable' lags, or higher equilibrium rates?

Some of the apparent economic strength at the start of the year was the result of quirks around seasonal adjustment that will reverse in time. But there did also seem to be a more fundamental firming in the economy.

As Powell said in his Congressional testimony, this economic strength "raises the question of 'where's the neutral rate?'". Put another way, was the economy performing better because the lagged impact of monetary tightening was yet to be fully felt, or because policy was not as tight as it looked because the neutral rate (r*) is actually higher?

Our view is that lags are likely to be the primary explanation for economic strength. Financial stress peaked in about July last year (until its recent re-eruption), and our modelling suggests the maximum impact of financial stress occurs around 12 months later. This implies there is still plenty of monetary tightening in the pipeline set to weigh on the economy.

This is consistent with the standard idea that monetary policy has relatively long (and variable) lags.

However, it is possible that the transmission of monetary policy to the economy has sped up. Central banks have become more transparent about the likely path of policy, allowing markets to discount that path much earlier into a hiking cycle. This might bring forward some of the impact of higher rates.

Moreover, credit allocation in the economy has become increasingly driven by capital markets rather than banks, which would accelerate the impact of tighter financial conditions on economic decisions.

If transmission is quicker, and the economy has already weathered the full impact of monetary tightening, then the pick-up in the data would imply that not nearly enough tightening has been delivered to restore price stability. This would imply that r* is higher than expected, at least in the short term.

A higher short-term r* could be the result of several factors. The unusually high savings buffer enjoyed by households following the pandemic might have cushioned the normal impact of tighter financial conditions on consumer spending. And the shift towards a more proactive fiscal stance may have risen the interest rate consistent with a given growth rate.

It is the possibility of a higher r* that motivates our 'Fed has two bites of the cherry' scenario, which sees the Fed pushing the fed funds rate up to around 7% to bring about the necessary economic slowdown to restore price stability.

The collapse of SVB suggests that policy lags were more important than higher r*

The collapse of SVB has significantly changed the market's assessment on the likely path of Fed policy. In particular, the market is now pricing a peak rate of just 5% by May,implying no futher rate hikes are priced. The market then prices the first rate cut by September.

Our best assessment is that the collapse of SVB is not systemic, in the sense of being capable of bringing down the financial system. Admittedly, a lot can change very quickly in a sentiment-driven sector like banking. But we don't think SVB is big enough to risk the whole system, which is why it enjoyed the laxer regulatory regime that allowed some of its problems to develop in the first place.

And more importantly, the response from policy makers – insuring all deposits at SVB and launching a new liquidity facility for all banks – was substantial and ought to contain more serious contagion risks. Certainly, the impulse to run on smaller banks should be somewhat diminished by the implicit guarantee the FDIC seems to have given to the entire banking system.

But an absence of systemic crisis is not the same as the absence of spillovers. Financial conditions have tightened significantly as a result of this episode and could yet tighten further. We are not saying that worries are over.

Many banks will face higher financing costs as they compete to hold on to deposits, while lending activity is likely to become much more cautious. And the quid pro quo of the generous policy package is that the banking sector is likely to face more regulation in the future. Finally, wider economic confidence is likely to deteriorate following the news, which will also weigh on activity.

On top of these direct consequences, the collapse of SVB is also important for the policy outlook because of what it reveals about the economy. The failure lends support to the argument that recent economic strength was the result of policy lags, and the full impact of tightening is yet to be felt. And so short-term r* may not be as high as feared.

Rising interest rates always acts as the proverbial tide going out, and it is likely that other pockets of weakness will be exposed. Ultimately, that is why our base case is called 'Fed kills the cycle', and the failure of SVB is an important milestone on the journey to the recession that we expect.

We are lowering our expected terminal rate, but still think the market has moved too far post-SVB

We will discuss in a subsequent note the cutting cycle we expect the Fed to embark on once this recession begins.

But for now, we think the Fed remains in tightening mode, and believe the market has overreacted in its assessment of how the fed funds rate is likely to evolve in the short term.

The Fed delivered a 25bps hike at its March meeting. They were keen to avoid the impression of “financial dominance”, where policy is set in accordance with market needs rather than the state of the economy.

Following the March meeting, we expect a further two 25bps hikes, taking the terminal target range to 5.25-5.5% in June.

Authors

Luke Bartholomew, Paul Diggle, and Abigail Watt

This represents a 25bps lower terminal rate than we were previously forecasting in light of SVB’s collapse. But it also represents a much higher terminal rate than the market is pricing in, as we think the Fed will continue to tighten policy until it sees the whites of the eyes of disinflation even after this crisis.

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