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Recipe for Recession: Pivoting Back to Larger Rate Hikes

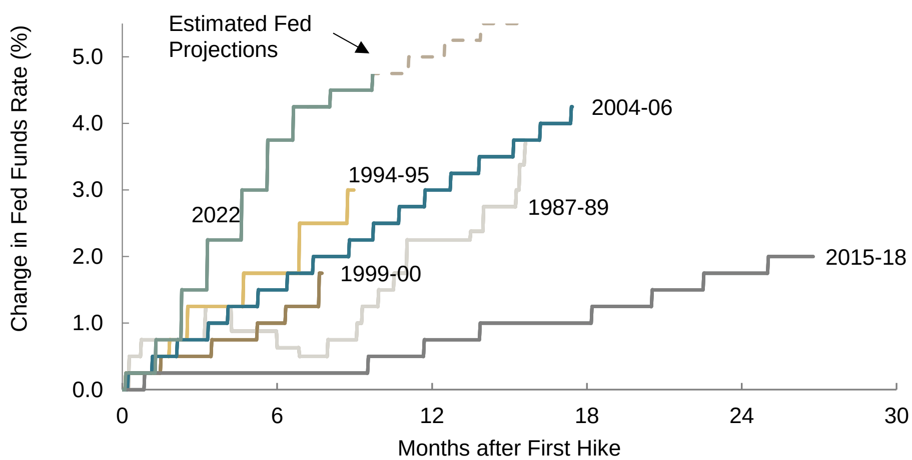
Chair Powell's statement that "If the totality of the data were to indicate that faster tightening is warranted, we would be prepared to increase the pace of rate hikes," caused investors to worry that the Fed will return to 50 basis point (bp) rate hikes as soon as this month. For this to happen, we would need to see stronger than expected employment, wages, and inflation to move 50 bps. A 25 bps hike is likelier.

Looking ahead to this month's meeting, **the FOMC is poised to increase its 2023 rate projections, lifting the median dot 50 bps from 5.125% to 5.625%**. However, the Fed is likely to keep some easing in place next year because of the dispersion of the dots and how many members would have to radically change their view from last December. For example, assuming the median 2023 rate forecast rises to 5.625%, for the funds rate to remain on hold next year, we would need one voter to increase his/her view 50 bps, two voters to increase 100 bps, three voters to increase 75 bps and four voters to increase 150 bps. This seems like tall order. Of course, the Fed could add just one hike next year, or policymakers could stay at 5.125% and take rate cuts off the table but from this lower peak rate. However, this does not jibe with Powell's comments, so more hikes this year followed by cuts next year makes the most sense.

While the bond market has finally gotten the message that the Fed means business, it is worth noting how much the Fed has already hiked rates. It is possible (perhaps even likely) that when the economy slows, it will catch policymakers and participants off guard. If so, the Fed may not deliver on these final rate hikes. As shown in the chart below, **the current rate hiking cycle dwarfs that of the past five**. This Fed has lifted rates at the fastest and biggest amount since the 16 months ending October 1981. But inflation was a lot higher then, having nearly hit 15% in 1980. Today inflation expectations remain contained.

We continue to believe the Fed has gone too far. The fact the 2s-10s treasury curve hit a new record low of -103 bps suggests as much. It is doubtful the Fed will be able to lift rates further and keep them there for an extended period as policymakers did from June 2006 to September 2007, given how gradual the preceding tightening cycle was. There were 17 consecutive 25 bp rate increases from June 2004 to June 2006, and household borrowing costs barely rose during this time. Remember the bond market conundrum?

For now, rate bearishness abounds. This will change. The key question is, when? Stay tuned.



Sources: FRB, Haver, SMBC Nikko

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