US Macroeconomics

June 30, 2023

Troy Ludtka, Senior US Economist | 212.224.5483 | troy.ludtka@smbcnikko-si.com
Joseph Lavorgna, Chief US Economist | 212.893.1528 | joseph.lavorgna@smbcnikko-si.com

What do the Latest Fed Estimates of the Neutral Rate Show?

The neutral rate of interest is a theoretical concept that attempts to calculate the economy-wide balancing point. When the fed funds rate is above this point, the economy slows, and inflation decelerates. The opposite is the case when the fed funds rate is below this point. The economy speeds up and inflation accelerates.

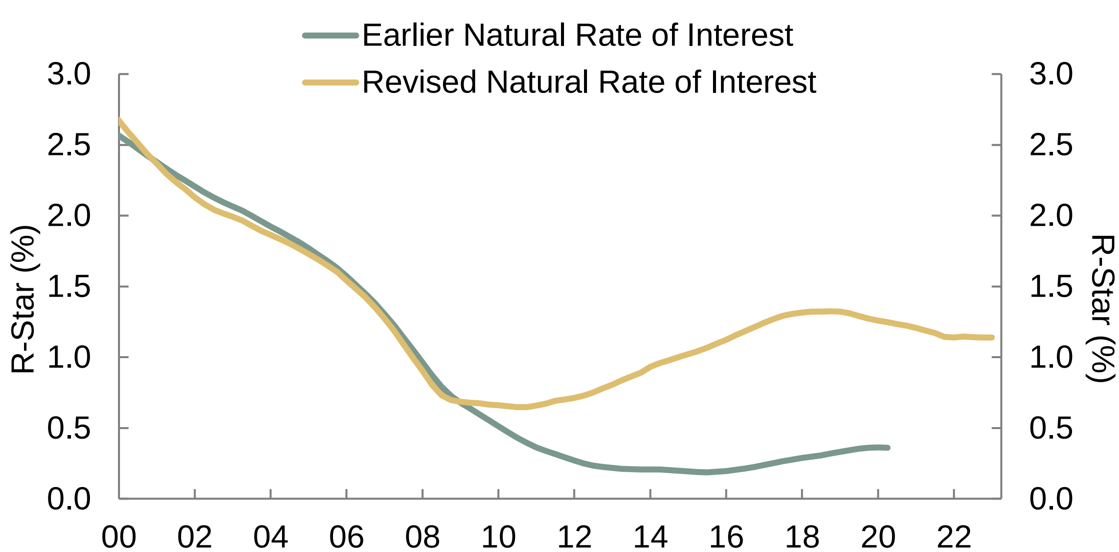
Although interest rates may be slightly restrictive according to Fed Chair Powell, they may still need to rise further. The fact that some economic data such as the interest-sensitive housing sector could be reaccelerating is consistent with the Powell view.

The primary determinant of the neutral (or natural) rate of interest is long term potential growth — which is a mainly a function of productivity and to a lesser extent demographics. Hence, slower potential GDP growth should warrant a lower neutral rate. But there is another factor that influences the real equilibrium rate. That is debt. The fact that debt levels have grown so dramatically since before the financial crisis is another reason why the neutral may have fallen. The economy cannot handle higher rates because of excessive debt service costs.

The neutral rate is never really known. It is a theoretical guesstimate. But since it is important to the FOMC, investors pay close attention to what it is doing and whether monetary policy is tight enough to achieve the Fed's objectives. The New York Fed had been publishing its estimate of the neutral rate but stopped publishing it in mid-2020. Fortunately, that has changed with the Bank restarting its periodic estimates last month. What do the NY Fed's latest estimates show?

Prior to last month's update, **the last Fed estimate of the natural rate was around just 35 basis points** (bps). But updated estimates show that figure was revised up to 125 bps. While the natural rate has fallen since then, the NY Fed's current estimate is 115 bps. That is big change from where it had been before. **Monetary policy may not be at tight as previously thought**. Perhaps this is a reason why the Fed has remained so hawkish. Policy has been too loose.

However, given the uncertainty of what is the "true" natural rate, it is possible that the Fed's estimates are much too high which means the Fed is embarking on a major policy error. After all, that is what the inverted treasury curve has been telling us for some time. But for now, the Fed is not paying attention. Barring a shockingly weak employment report, another rate hike is coming next month.



Sources: Federal Reserve, New York Federal Reserve Bank, SMBC Nikko

Disclaimers

This document is provided by SMBC Nikko Securities America, Inc. ("SMBC Nikko"), the US-registered broker-dealer affiliate of Sumitomo Mitsui Banking Corporation, for informational purposes only. This document was prepared by SMBC Nikko's economist(s). The views statements, assumptions and forecasts expressed herein are those of the author(s) and do not reflect the judgment of any other person or of SMBC Nikko, it does not constitute an offer, or solicitation of the sale or purchase, of securities or other investments. The information contained herein is obtained or derived from sources believed to be reliable, but SMBC Nikko and the author(s) make no representations as to its accuracy or completeness. In some cases, such information may be incomplete or summarized. This document has been prepared based on assumptions and parameters determined by the economist(s) in good faith. The assumptions and parameters used are not the only ones that could have been selected, and therefore no guarantee is given as to the accuracy, completeness, or reasonableness of any such quotations, disclosures, or analyses. Past performance is not a reliable indicator of any future results.

This document has been prepared for and is directed at institutional investors and other market professionals and is not intended for use by retail customers. It does not take into account any specific investment objective, financial situation, or particular need of any recipient. The information contained herein should, for whatever purpose, be used solely at the discretion and responsibility of the recipient. SMBC Nikko and its affiliates do not accept any liability or responsibility for any results in connection with the use of such information. Recipients are responsible for making final investment decisions and should do so at their own discretion after conducting a careful examination of all documentation delivered prior to execution, explanatory documents pertaining to listed securities, prospectuses, and other relevant documents, and their own independent analysis and assessment of the merits of any transaction. The financial instruments discussed may be speculative and may involve risks to principal and interest.

Conflicts of Interest Disclosures

The views statements, assumptions and forecasts expressed herein may differ from those expressed in globally branded research produced by SMBC Nikko or its affiliates. The trading desks of SMBC Nikko and its affiliates trade or may trade as principal in the financial instruments that are the subject of this material, and the author(s) of this document may have consulted with the trading desks while preparing this document. The proprietary interests of SMBC Nikko and its affiliates may conflict with those of the recipient. SMBC Nikko and its affiliates may seek to do business with the companies mentioned in this material and the trading desks may have accumulated, be in the process of accumulating, or accumulate long or short positions in the financial instruments mentioned and may have acquired them at prices no longer available. The trading desks may also have or take positions inconsistent with the views expressed in this document or may have already traded on those views.

This material is not a research report, and neither this material nor its author(s) is subject to SMBC Nikko policies and procedures that apply to the globally branded research reports and research analysts of SMBC Nikko and its affiliates or to legal requirements designed to promote the independence of investment research. It is not subject to any prohibition on dealing ahead of the dissemination of investment research. This means that on the date of this document, SMBC Nikko, its affiliates, and their respective directors, representatives, or employees, may have a long or short position in any of the instruments mentioned in this document and may make a market or trade in instruments economically related to the securities, derivatives or other underlying assets mentioned herein, in each case either as principal or as agent.

No part of the author(s) compensation was, is, or will be, directly or indirectly related to the specific recommendations or views expressed herein. The personal views of authors may differ from one another.

Distribution, possession or delivery of this document in, to or from certain jurisdictions may be restricted or prohibited by law. Recipients of this document are required to inform themselves of and comply with all such restrictions or prohibitions.