US Macroeconomics

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The Road Ahead

Following the March employment report, the futures market is discounting a roughly 70% chance of a 25 basis point (bp) May 3rd rate hike. **Since the Fed almost never disappoints market expectations when they lean firmly on one side, another (and final) rate hike should be expected**. This would push the range of the fed funds rate up to 5 to 5.25%. This of course had been the median FOMC forecast at the start of the year but had then been revised up last month before the flare-up in regional banking began.

For the Fed to stay on the sideline next month, one of two developments need to occur. One, the March consumer price index (CPI), due this Wednesday, would have to meaningfully surprise to the downside. Two, financial conditions would need to dramatically tighten in a way that stokes fears of systemic financial risks. How likely is this?

It is doubtful the March CPI report will provide monetary policymakers with an excuse to pause. While the headline CPI is projected to rise 0.3%, **the core CPI is estimated to rise 0.4% which is enough to push the year-over-year rate a couple of tenths higher to 5.7%**. Higher shelter costs are the predominant driver of elevated core inflation. While rents are set to slow sharply in the months ahead, the Fed's obsession with anchoring inflation expectations means that policymakers will continue to err on the side of doing more tightening rather than less (or at least until the economy shows clear signs of significant deterioration).

The ongoing credit crunch in banking, exacerbated by deposit flight from smaller regional banks, should show intensification when the April Senior Loan Officers' Survey is released on May 8th. The Fed will have this data when it meets on May 3rd and will likely impact the tone of the FOMC statement. However, systemic risks have been reduced because of the Fed's aggressive use of its discount window.

Over the last four weeks, Fed lending to US banks has increased over $400 billion. This offsets nearly two-thirds of the quantitative tightening that began a year ago and is the primary factor lifting equity prices. Our research has found a near one-for-one movement in Fed liquidity and the level of the stock market over the past several years. Consequently, we doubt financial conditions can tighten enough to keep the Fed from raising rates next month.

If the Fed completes its tightening cycle next month, history suggests that a pivot from hiking to rate cuts could come quickly. We count 18 rate hiking episodes since 1951. The average time from the last hike to the first ease is just three months, and the median time is even less at two months.

The futures market is pricing a small chance of a rate cut at the July 26th meeting and a full 25 bp cut at the September 20th meeting. While this is completely consistent with the historical record, the market only has about 200 bps of rate cuts priced in over the next couple of years. This is not enough.

If the economy goes into recession later this year as the Index of Leading Economic Indicators suggests, the Fed will probably cut a lot more than 200 bps. In addition, there is a chance that when the Fed begins trimming the funds rate, it will be in 50 rather than 25 bp increments, given how forceful policymakers were in raising interest rates.

Historically, the average Fed rate cutting cycle is 400 bps. So, if the past is prologue, investors could see the funds rate back down near 1%. And if the Fed is lowering rates as much as we expect, policymakers are also probably restarting quantitative easing just as they did during the mini-cutting cycle of 2019. Stay tuned.

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