US Macroeconomics

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Wither the Pivot?

Monetary policymakers are singularly obsessed with lowering inflation. '"Our focus right now is really on moving our policy stance to one that is restrictive enough to ensure a return of inflation to our 2% goal over time, it's not on rate cuts," according to Chair Powell. **The Fed's latest forecasts show the funds rate rising another 75 basis points sometime next year with the first rate cuts not happening until 2024**. Despite these hawkish words and forecasts, the futures market continues to look for a pivot in Fed policy around the middle of next year. The bond market is not listening, and history is on its side.

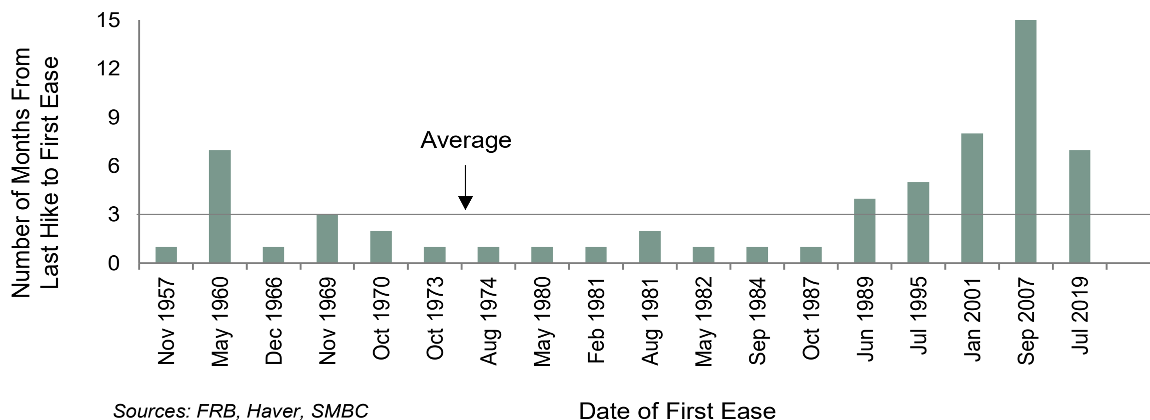
In the past, the Fed has gone from hiking to easing relatively quickly. Only once did the Fed stay on extended hold (2006-07). For example, **in the 18 episodes since 1957 when the Fed has increased interest rates on "multiple" occasions, the time from the last hike to the first cut has been just three months**. However, the last few cycles have seen a lengthening in that time to around eight months. All tightening episodes are illustrated in the chart below. A pivot is likely to happen sooner than Chair Powell is saying for two reasons.

The first reason is the cumulative amount of tightening. **The FOMC has lifted interest rates by 400 bps in the last nine months, which is the biggest amount since 1981**. Moreover, the Fed has shrunk its balance sheet by $400 billion during time, which we estimate is worth an additional 50 bps in rate hikes. This massive tightening of policy is significantly constraining interest-sensitive activity as evidenced by the real estate sector. Home sales and residential construction are falling at double-digit rates. No doubt, a housing recession has begun, a worrisome sign for the broader economy since a downturn in the former has always presaged a nationwide recession. It is no wonder the bond market is telling us the Fed has done enough. We agree.

The second reason is the level of real interest rates. According to our calculations, **the real rate as derived from the TIPS market and adjusted for the secular decline in R-star has risen to its highest level in over 20 years**. In fact, the real rate rose to 250 bps in September, which is significantly higher than where it peaked ahead of the 2001 (105 bps) and 2007 (145 bps) pivots. Consequently, monetary policy is highly restrictive, perhaps much more so than Chair Powell thinks. With housing in recession and the broader economic outlook worsening, it is unlikely the Fed will be able to stay on hold through 2023. Hence, bond market easing expectations should be validated.

We want to wish everyone happy holidays and happy New Year. Publication will resume in early January.

The time in between the last rate hike and the first rate cut has averaged just three months



Sources: FRB, Haver, SMBC

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