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A Looming Credit Crunch — When Will the Fed Step in?

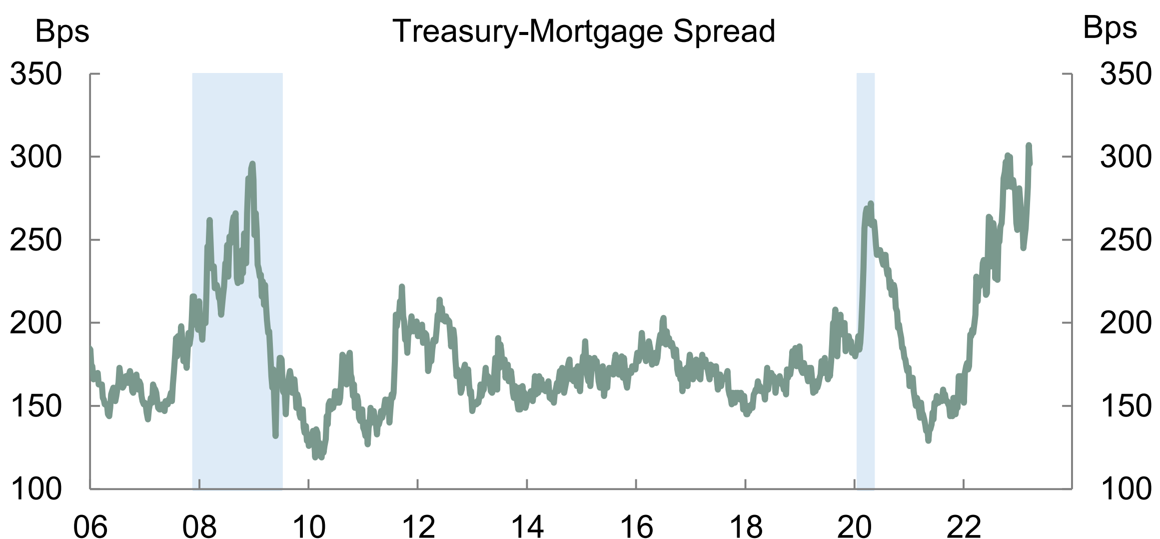
The futures market is discounting a 44% chance of a 25 basis point (bp) rate hike at the May 3rd FOMC meeting before discounting rate cuts thereafter. The June 14th FOMC meeting has a 20% chance of a rate cut. This chance then rises to nearly 60% at the July 26th meeting. These probabilities are broadly consistent with the historical record, which shows little time in between the last rate *hike* and the first rate *cut*.

Over 18 tightening cycles, the average is three months, but the median is just two months. Hence, **a June cut is possible if the economy deteriorates between now and then**. Lower than expected inflation will not be enough for a Fed pivot because inflation is a lagging indicator. If the economy is at risk of an imminent recession, monetary policymakers will take notice, especially with the possibility of a credit crunch turning what could be a mild recession into a deep one.

There are three employment reports between now and the June FOMC meeting, so there is plenty of time for the lagged effects of previous monetary tightening to show up adversely in the labor market. Perhaps the most important release though is the **Senior Loan Officers' Survey** (SLOS), which is due on May 8th. If a credit crunch is coming, this is one place where it will be evident.

The Q4 2022 SLOS report showed recessionary readings on lending standards for commercial real estate, consumer loans and commercial & industrial loans. This was before the funding crisis in the commercial bank industry. Our best guess is that lending standards have tightened more over the past several weeks relative to where they were last quarter. This further increases the probability of recession because less lending means less credit, a necessary ingredient to fund economic expansion.

One way investors can proxy banks' willingness to lend is through spreads. Take the mortgage market. In the chart below, we show the difference between the conforming 30-year fixed mortgage rate and the 10-year treasury note. While 10-year notes have rallied sharply over the past month, mortgage rates have not. In fact, the mortgage-treasury spread was 296 bps last week, down only a smidgeon from the near 40-year high seen in recent weeks. If mortgage lenders were eager to lend, this spread would be much narrower. This yawning gap is likely to be seen in tighter residential lending standards when the next SLOS is released.



Sources: Freddie Mac, Federal Reserve, Haver, SMBC Nikko

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