18 January 2022

Fed Research

Preview: End of money printing brrrrr – (at least) four 25bp rate hikes this year and QT in September

Key takeaways

- At the upcoming January meeting, we expect the Fed to indicate that the first rate hike is likely in March if the economy develops in line with expectations, supported by the tight labour market and still very high inflation.
- It is one of the interim meetings without updated projections or dots.
- We have changed our Fed call now expecting four 25bp rate hikes this year (in March, June, September and December, up from three previously) and still four rate hikes in 2023. We expect the Fed to start reducing the balance sheet from September.
- Given the combination of a strong economy and high underlying inflation, we see risks as skewed towards more, not less, tightening. If this scenario plays out, the Fed is likely to hike 25bp at each meeting, not skipping interim meetings.
- Fixed Income: We have lifted our target to 2.25% for 10Y UST.

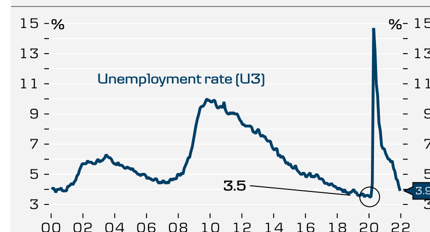
Fed under increasing pressure from tight labour market and high inflation

The December jobs report disappointed, as employment growth was just 199,000, well below consensus. Some are arguing that it means the Fed can stay more patient, all else equal, but we do not share that view and based on recent Fed speeches and interviews, it does not seem like consensus among FOMC members either. **To us, it is a sign that the labour market is even tighter than what we thought.** Employment growth is unlikely to pick-up until we see a more significant rebound in labour force participation. And if the labour force starts to pick, higher employment growth would most likely still be a signal that the labour market is tightening, as labour demand is very high.

CPI inflation reached 7.0% y/y in December 2021, the highest since June 1982. CPI core inflation is 5.5% y/y, both way above the 2% target. Short-term inflation expectations are still elevated and long-term inflation expectations in the University of Michigan consumer confidence survey is now 3.1% y/y, the highest since 2011. Many small businesses report they expect to hike output prices. **The trend is that economists, like ourselves, underestimate the underlying price increases and hence we think it is more likely that inflation will be higher, not lower, than we forecast.**

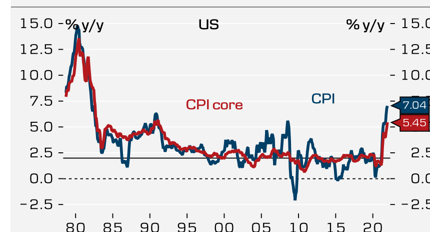
Therefore, we are changing our Fed call. We now expect the Fed to start the hiking cycle in March (from May previously) and to hike a total of four times this year (March, June, September and December) and four times in 2023. A March hike also seems likely when listening to recent comments from several FOMC members in January. **Given the tight labour market and high inflation, we think risks are skewed towards more tightening, not less.** Based on Fed's Christopher Waller's recent comments, it seems unlikely that the Fed is going to hike 50bp, but instead the Fed may hike 25bp at every meeting instead of skipping interim meetings like we got used to during the latest hiking cycle. We discuss further later in the piece.

Unemployment rate not far away from pre-covid levels – the labour market is tight despite still subdued total employment



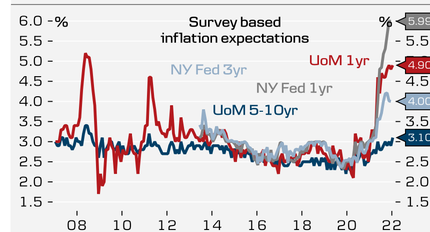
Sources: BLS, Macrobond Financial

Very high inflation



Sources: BLS, Macrobond Financial

The inflation narrative is still very much alive among consumers



Sources: University of Michigan, NY Fed, Macrobond Financial

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Another big question is when and how the Fed will start shrinking the balance sheet ("quantitative tightening", QT), as the Fed hinted it would prefer to start shrinking the balance sheet faster than last time and also at a faster pace. One reason is that the balance sheet is much higher, both in dollar terms and in percentage of GDP, compared to last time and the economy is seemingly in much better shape with a lower unemployment rate and higher inflation.

The Fed says that the Fed funds target range remains the primary policy tool, so while the Fed hinted QT is likely to start at some point this year, we expect the Fed would like to hike a couple of times before starting. Hence, **we expect the Fed to announce QT in connection with the September meeting**. Given the Fed's run-off caps rose to USD50bn per month last time, **we imagine that the caps would be in the range USD75-100bn this time around.**

We do not have many details about the Fed's view on the balance sheet yet, despite the thorough discussion at the December 2021 meeting. For instance, we do not know whether the Fed would skip one rate hike in order to get the QT process started. That was what the Fed did last time, but the Fed seems less concerned about the impact this time around. **Our base is, however, that the Fed will initiate QT without skipping a rate hike.**

What if? The first step is to increase the number of rate hikes

The question is whether the Fed needs to tighten even faster, which we believe risks are skewed towards. A good case is to look at what is happening in emerging markets right now, where central banks in Russia, Czech Republic, Hungary and Poland are raising rates quickly due to high inflation.

The current 'narrative' both in markets and in the real economy is "inflationary", which may lead to persistently high inflation through higher inflation expectations. We know expectations are very powerful for actual economic development. **Despite the Fed turning more and more hawkish over the past six months, it has not been enough for the inflation narrative to go away, especially because the Fed so far just has caught up with current market pricing/reality.**

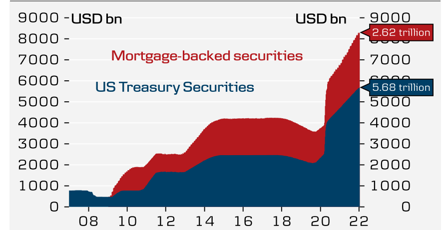
One way the Fed could put an end to the current narrative is to follow the emerging markets playbook, where central banks have tightened more than expected by markets and economists. The Fed can achieve this by hiking 25bp at several meetings in a row, which is in line with what Fed's Waller said last week. The Fed is likely to start QT even earlier in this scenario. We think there is a higher probability of this scenario playing out than a scenario with fewer than four rate hikes.

We only expect the Fed to hike 50bp instead of 25bp if things start to get out of control, forcing the Fed to step hard on the brakes.

We still have confidence in the Fed in the sense that we definitely do not believe the Federal Reserve would risk turning into the Central Bank of Turkey. The US experienced very high inflation in the 70's and credibility is everything for the Fed. **If inflation stay persistently high, the Fed would definitely do what it takes to bring it down. Unfortunately, it may cause a recession down the road if the Fed is forced to step hard on the brakes, as this is the only way to bring high inflation down through lower demand.**

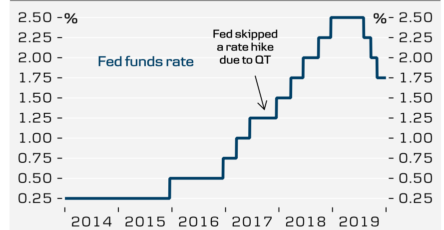
So what is the trigger for the Fed to tighten more? We think inflation is key. Both we and the Fed expect inflation to peak here in Q1. If that is not the case (because we once

We expect the Fed to start QT in H2 22, likely in September



Sources: Federal Reserve, Macrobond Financial

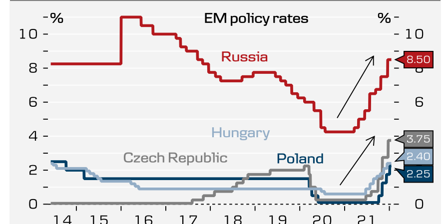
Fed skipped a rate hike when announcing QT in 2017



Note: Past performance is not a reliable indicator of current or future results.

Sources: Federal Reserve, Macrobond Financial

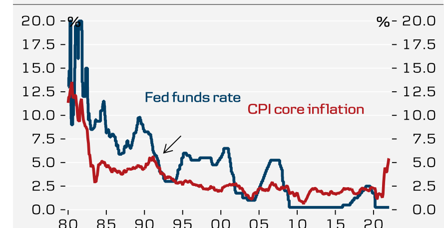
Higher policy rates in emerging markets because of high inflation



Note: Past performance is not a reliable indicator of current or future results.

Sources: National central banks, Macrobond Financial

The Fed funds rate was much higher last time core inflation was this high

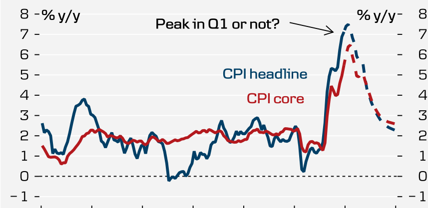


Note: Past performance is not a reliable indicator of current or future results.

Sources: Federal Reserve, BLS, Macrobond Financial

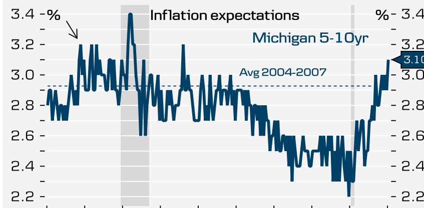
again underestimate underlying inflation pressure), the Fed is likely to hike more aggressively. The Fed is also likely to follow long-term inflation expectations from the University of Michigan closely. Right now they are running at 3.1% y/y and it did not move above 3.2% y/y before the financial crisis.

Will inflation start to moderate in Q2?



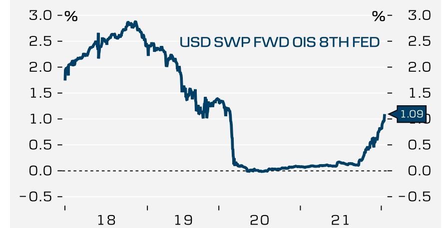
Sources: BLS, Macrobond Financial, Danske Bank forecasts

Further increases in long-term inflation expectations would not be a good sign



Sources: University of Michigan, Macrobond Financial

Markets are fully pricing in four rate hikes from the Fed this year

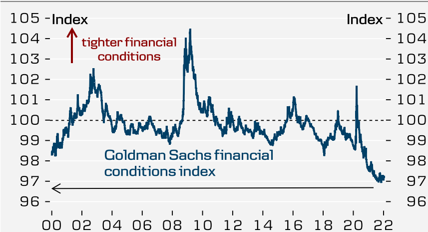


Note: Past performance is not a reliable indicator of current or future results.

Sources: Bloomberg, Macrobond Financial

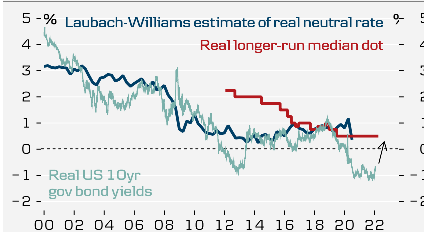
Basically, what the Fed should achieve is tightening of financial conditions, which are still very easy in a historical perspective, and closing the real rate gap. Financial conditions and real rates are still very negative despite markets are now pricing in four rate hikes (100bp), which is one reason why risks are skewed towards more rate hikes. The Fed may need to get "ahead of the curve" to put an end to the inflation narrative in markets and the real economy. We also see signs that markets are starting to price in a higher probability of the Fed hiking the Fed funds target range without skipping interim meetings with markets pricing in a total of 55bp rate hikes by June (we have three "live" meetings: March, May and June), which seems fair given the current environment.

Financial conditions are too easy



Sources: Bloomberg, Goldman Sachs, Macrobond Financial

Real rates are still trading around minus 1% and need to get closer to neutral



Note: Past performance is not a reliable indicator of current or future results.

Sources Laubach-Williams, Bloomberg, Federal Reserve, Macrobond Financial

Fixed Income: 10Y UST yields heading for 2.25%

Our new Fed forecast also has ramifications for our 10Y US treasury forecasts. We have for a long time argued that 10Y UST would hit 2% during 2022, as the market price in Fed hikes and the actual rate hikes roll into the curve. However, **we have now lifted our target to 2.25% for 10Y UST.**

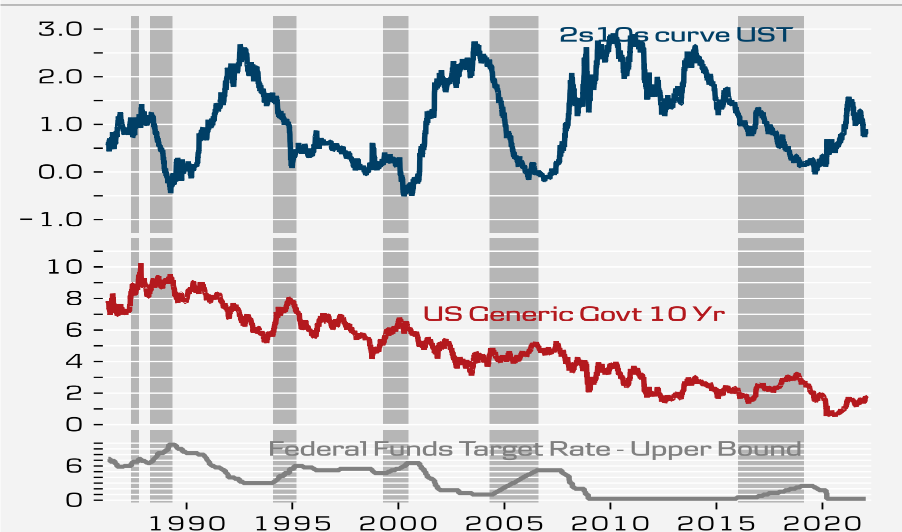
The more aggressive rate hike path we now forecast adds upside to the whole UST curve and intensify the 2s10s flattening pressure on the curve. The grey ranges in the chart below show the 2s10s UST curve and the outright 10Y UST during Fed hiking periods. We see that the curve flattens during hiking periods, but equally important the 10Y yield also moves higher.

There is a risk that that the 2s10s curve will invert during 2022. Especially if the market starts to price that, the Fed will need to "trigger" a recession to cool inflation. We might also see a new "bond yield conundrum", as Japanese and European investors buy the "high-yielding" US treasuries. In our view, the Fed will try mitigate an inversion of the 2s10s curve using QT given that an inversion in itself would intensify market speculations that Fed is about to trigger a recession.

Hence, if we are correct that QT will come much earlier in the hiking cycle this time it should add a higher term-premium equal to a steeper 5s10s curve everything equal. It should also lower the risk of e.g. 50bp hikes or five hikes in 2022. We forecast that the 2s10s curve will flatten to 35bp on a 12-month horizon.

We will later this week publish Yield Outlook, where we will look more into details with our yield projections.

Higher 10Y UST yields and flatter 2s10s when Fed hike interest rates (grey ranges:: Fed hiking periods)



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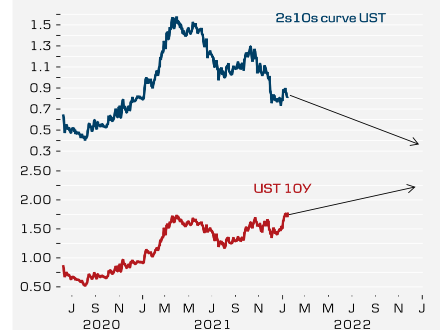
Source: Macrobond, Bloomberg, Danske Bank

Further upside for 10Y UST treasury yields and more 2s10s flattening in 2022



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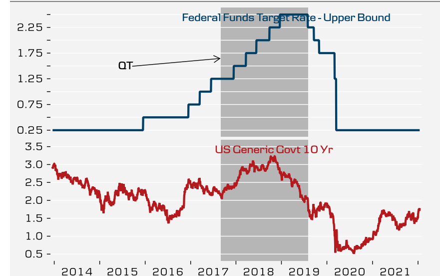
Source: Macrobond, Bloomberg, Danske Bank

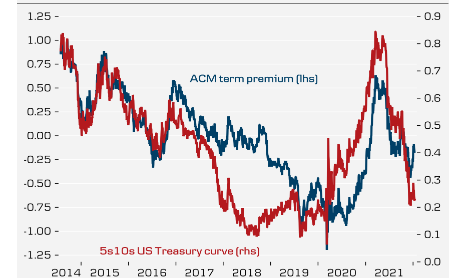
Especially upside to 10Y UST as QT is initiated



Note: Past performance is not a reliable indicator of current or future results.

Source: Macrobond, Bloomberg, Danske Bank

QT adds to a higher term premium and a steeper 5s10s curve (everything equal)



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Source: Macrobond, Bloomberg, Danske Bank

Appendix: The 2017-19 QT experience

The Federal Reserve outlined the balance sheet runoff process in connection with its June 2017 meeting, see *Addendum to the Policy Normalization Principles and Plans"*, 14 June 2017. According to the plan, the Fed only reinvested principal payments exceeding gradually rising the caps. The Federal Reserve anticipated that the cap from maturing Treasury securities would be USD6bn initially rising in steps of USD6bn at three-months intervals over 12 months until the cap reached USD30bn per month. For mortgage-backed securities, the Federal Reserve anticipated an initial cap of USD4bn increasing to USD20bn over 12 months, so that the balance sheet run-off would not exceed USD50bn per month eventually.

The Federal Reserve agreed to follow the plan at the September 2017 meeting starting from October 2017, see *FOMC statement September 2017*. The Fed was basically hiking once per quarter by that time but skipped the rate hike in September 2017 in order to start the balance sheet run-off.

In connection with the March 2019 meeting, the Federal Reserve said it would start reducing the caps again with the aim of ending the balance sheet run-off by September 2019, see *Balance Sheet Normalization Principles and Plans*, 20 March 2019. Simultaneously, the Federal Reserve announced it would start re-investing some principal payments received from mortgage-backed securities in Treasury, as the Federal Reserve desired to hold mostly US Treasuries in the long-run.

The Federal Reserve started buying T-bills in October 2019, see *press release 11 October 2019*.

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This research report has been prepared by Danske Bank A/S ('Danske Bank'). The author of this research report is Mikael Olai Milhøj, Chief Analyst.

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