28 April 2022

# Fed Research

## Preview: 50bp rate hike

### Key takeaways

- We expect the Federal Reserve to hike the target range by 50bp, a view shared by consensus and market pricing. We expect the Fed to signal that more 50bp rate hikes are likely in coming months in order to get quicker back to neutral.
- We expect the Fed to announce the balance sheet runoff to start in mid-May. We expect the cap to be set at USD95bn as outlined in the minutes.
- Our current Fed call is that the Fed will hike by 50bp in May, June and July and 25bp in September, November and December (a total of 225bp). We still see risks skewed towards faster rate hikes, as monetary policy remains too accommodative.
- FX: At present, we forecast EUR/USD in 1.05 in 12M and we see downside risks to this estimate.
- FI: We forecast that 10Y UST yields will move above 3% over the next three months. We have a 3.10% six months target.

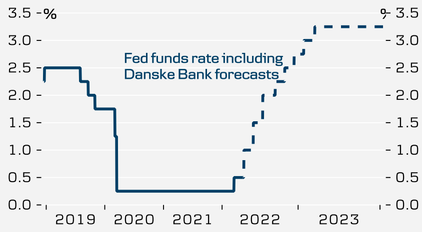
### Fed: Quickly back to neutral

**Since the latest meeting in March, FOMC members have made it clear that they desire to front-load rate hikes in order to get the Fed funds target rate quickly back to neutral**, as monetary policy remains too accommodative given the strong labour market and very high inflation rates. The only reason that the Fed did not hike by 50bp already in March was because of elevated geopolitical uncertainty and financial stress after the Russian invasion of Ukraine. **Hence, it is widely expected that the Fed will hike by 50bp, which is fully priced in markets.** St. Louis Fed President James Bullard said he would like to hike by 75bp but it does not seem like a consideration supported by the rest.

**It is one of the interim meetings without updated projections (no new dots).** We expect, however, that the statement and the press conference will reflect what we have heard from the Fed since the last meeting: that the Fed desires to get the policy rate quickly back to neutral.

**We expect the Fed will announce that the balance sheet runoff will begin in mid-May. We expect the cap to be set at USD95bn per month as outlined in the minutes from the March meeting (USD60bn for US Treasuries, USD35bn for mortgage-backed securities).** There is a lot of discussions about how much impact QT has on the real economy and some argue that it may be zero. A *Fed notes paper from 2019* finds that QT of 2% of GDP corresponds to approximately 20bp rate hike. A cap of USD95bn per month corresponds to a yearly cap of USD1,140bn or nearly 5% of annual US GDP, so the current QT plan corresponds to a 50bp rate hike in a year. The calculation assumes the cap is binding, which it mostly will not be for MBS. So even if there is an impact, it is quite small in the big scheme of things. We discuss the implications of QT in more details overleaf.

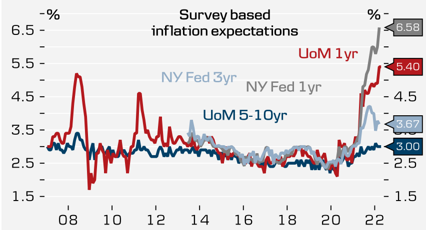
**Chart 1: Our Fed call**




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

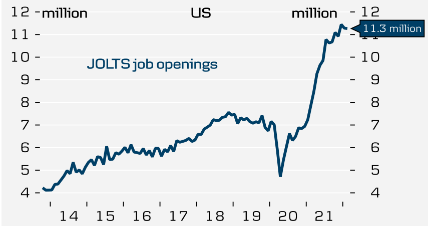
*Sources: Federal Reserve, Macrobond Financial, Danske Bank forecasts*

**Chart 2: High inflation expectations**




*Sources: University of Michigan, New York Fed, Macrobond Financial*

**Chart 3: Very high labour demand**




*Sources: BLS, Macrobond Financial*

*Chief Analyst*
Mikael Olai Milhøj
+45 45 12 76 07
milh@danskebank.dk

*Senior Analyst*
Lars Sparresø Lykke Merklin
+45 45 12 85 18
lsm@danskebank.dk

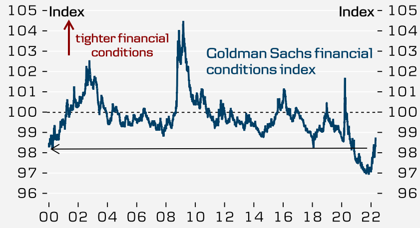
*Chief Analyst*
Arne Lohmann Rasmussen
+45 21 46 29 51
arr@danskebank.dk

*Chief Analyst*
Jens Nærvig Pedersen
+45 45 12 80 61
jenpe@danskebank.dk

**We continue to expect the Fed will hike by 50bp three meetings in a row (May, June and July) and 25bp on each of the last three meetings (September, November and December).** We expect the Fed to hike twice in early 2023. The biggest problem for the Fed is that monetary policy remains too accommodative. This can be shown in different ways. Firstly, 10yr US real rates have increased towards 0% but remains below neutral and hence monetary policy remains easy (see chart 5). Secondly, financial conditions are still very easy in a historical perspective and need to be tightened further (see chart 4). Both despite markets are pricing in a total of approximately 240bp further rate hikes this year. Thirdly, Taylor-rules suggest that the Fed funds rate should be much higher given how tight the labour market is and how high inflation is, even when trying to be "nice" to the Fed (see chart 6).

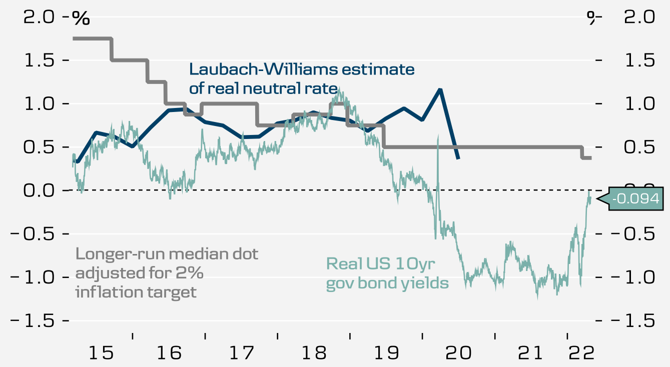
**So overall, we are still of the view that risks are skewed towards faster and more rate hikes and cannot rule out that the Federal Reserve needs to follow the "emerging market central bank playbook" by out-hiking expectations.**

Chart 4: Fed needs to tighten financial conditions further



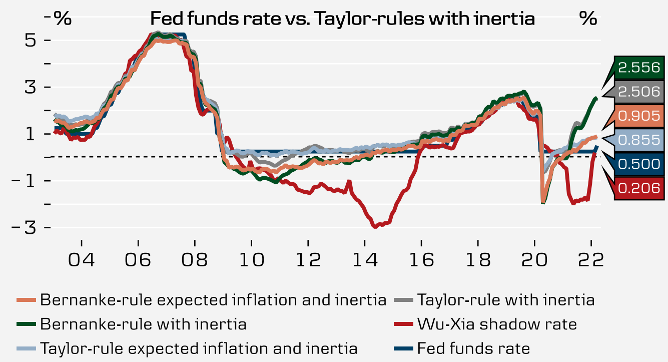

*Note: Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index.*
*Sources: Goldman Sachs, Bloomberg, Macrobond Financial*

Chart 5: 10yr real rates are still below neutral (i.e. monetary policy remains accommodative despite current marked pricing)




*Note: Past performance is not a reliable indicator of current or future results.*
*Source: Federal Reserve, Bloomberg, NY Fed, BEA, Macrobond Financial, Danske Bank*

Chart 6: Taylor-rules: The Fed is still behind the curve despite rate hike




*Note: Past performance is not a reliable indicator of current or future results.*
*Sources: Federal Reserve, BLS, University of Michigan, University of Chicago, NY Fed, Bernanke (2015), Taylor (1993), Macrobond Financial and Danske Bank estimations*

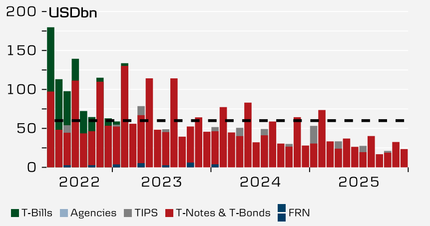
## QT likely to run a couple of years, but normalisation finishes

As mentioned above, we expect the Fed to announce a start of QT at the meeting next week. **The USD60bn/month cap on US Treasuries runoff looks sufficiently high to be a binding constraint this year and most of next year**, as many bonds on Fed's balance sheet mature (see chart 7). It may continue to be a binding constraint during QT if Fed reinvests maturing bonds in short-term bonds and Treasury bills. **Overall, Fed has a lot of flexibility to manage the US Treasury run off.**

**How much of the USD35bn/month cap on MBS runoff will be used depends on prepayments**. If prepayments are low (the weekly refinancing index has moved sharply lower, as mortgage rates have risen), Fed may opt to sell MBS outright even though the plan outlined in the FOMC Minutes hints that an eventual sale of MBS would be a switch operation to US Treasuries.

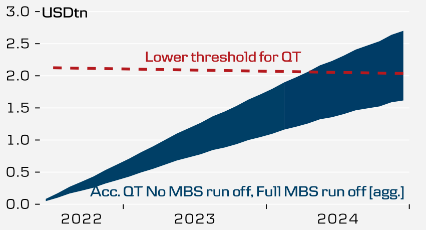
**The pace of QT is thus not set in stone in advance, which further makes it difficult to forecast when QT will conclude. With a great deal of uncertainty, we expect Fed to hit a lower threshold for reserve demand from banks in early 2024**. However, depending on MBS runoff and development in other autonomous factors, e.g. US Treasury cash balance, use of reserve repos etc. QT may continue past 2024. See chart 8 for illustration.

Chart 7. SOMA US Treasury maturities




Source: Macrobond Financial

Chart 8. It would take at least about 2Y for QT to conclude

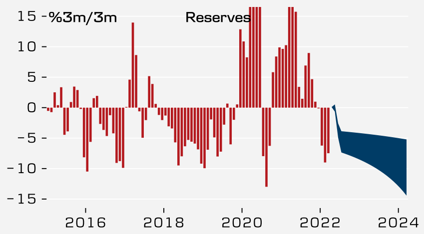



Source: Macrobond Financial

**Since the last round of QT from 2016-2019, Fed has introduced the standing repo facility (SRF).** The facility is not intended to be a permanent liquidity provider, but act as a backstop facility. Hence, the SRF should, in theory, help avoid a repeat of the stress seen in the repo market in September 2019, when Fed in the end tightened liquidity too much. For the SRF to be an efficient liquidity provider a wide range of counterparts needs to sign up. So far, only four banks have enrolled, which does not sound like a lot. Fed is working on tweaking the eligibility requirements to lure in more counterparts.

Fed makes a great deal out of stressing that runoff caps are higher now compared to last round of QT. In our view, this needs to be put into perspective of the overall size of the balance sheet and reserve supply. **Even if the full USD95bn/month cap is utilised the %-shrinkage in reserve supply would initially "only" be at par with tightening in 2018-19 at the height of last round of QT.** Overtime, the % decline would accelerate and thus also accelerate the pace of tightening (see chart 9)

Chart 9. Higher nominal caps, but same % reserve tigthening




Source: Macrobond Financial

## FX: EUR/USD likely to continue lower

**EUR/USD is likely to go even lower from here and downside risk to our 12M target at 1.05 seems very relevant to consider**. For Europe, very elevated commodity prices weigh on companies' profitability but also consumer's confidence and spending. In contrast, commodities are a (relative) boon for the US economy. Further, the tightening of US financial conditions and continued slowdown in China also (continue to) add downside risk to EUR/USD spot. At the Fed meeting itself, it seems likely that Powell will delivers what is already priced and expected by the market (and us). **As such, we do not expect a substantial USD strengthening on the announcement of a 50bp hike - but rather view the USD strength as continuous; as it has been over the last one and a half year.**

## Fixed Income: Modest upside for 10Y UST

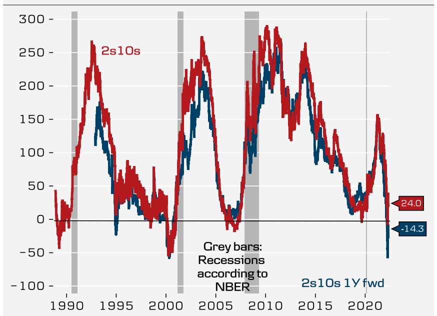
**The market is fully priced for 50bp rate hikes at the next three meetings and we do not expect that the FOMC meeting will change that.** However, there is as mentioned above a possibility that the market will start buying into an even more aggressive rate path.

The aggressive Fed repricing seen over the last two months has not been able to push market inflation expectations (break-evens) lower, and the recent rise in 10Y US nominal rated has been accompanying by a jump in real rates. **We assume that real rates will continue – through higher nominal rates - to rise as the rate hikes roll into the curve (see chart 11).**

**We also assume that the combination of high interest rate volatility and inflation volatility will lead to a higher term-premium (see chart 12).**

**All in all, we forecast that 10Y UST yields will move above 3% over the next three months. We have a 3.10% six months target**. For more see *Yield Outlook: Rate hikes are coming but a lot has been priced markets already*, April 26.

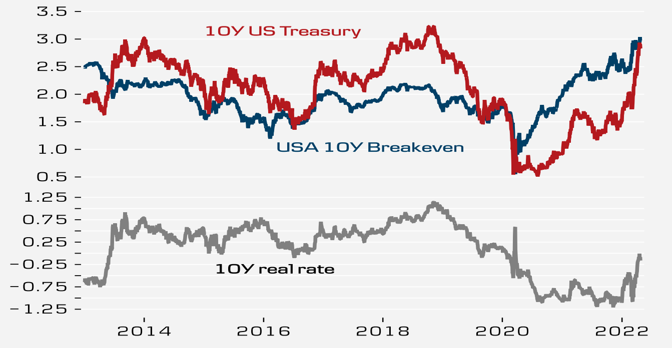
Chart 10: UST 2s10s curve to invert eventually




Note: Past performance is not a reliable indicator of current or future results.
Sources: Macrobond Financial, Bloomberg

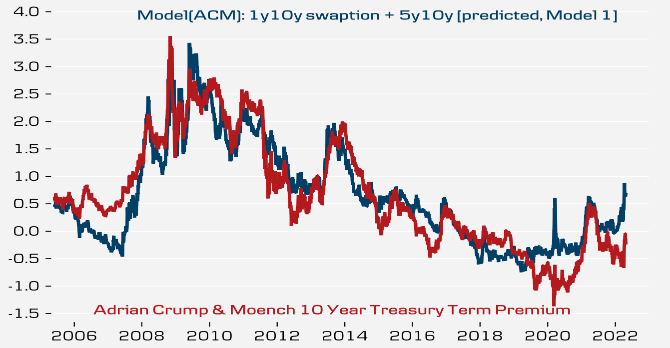
**The rise in the 10Y UST yield we forecast compared to our Fed funds forecast also means that we expect the 2s10s US curve to invert on a 12 month horizon (see chart 10)**. The graph to the right shows the 2s10s UST curve spot and 1Y forward. The forward 2s10s curve is significantly inverted.

Chart 11: Real yields on the rise as nominal yields are pushed higher ...




*Note: Past performance is not a reliable indicator of current or future results.*
*Sources: Macrobond Financial, Bloomberg*

Chart 12: ... 10Y UST term premium to rise further




*Note: Past performance is not a reliable indicator of current or future results.*
*Sources: Macrobond Financial, Bloomberg*

**Our Fed call summarised**

We expect the Federal Reserve to hike the Fed funds target range by 50bp at the May meeting, in line with consensus and market pricing. We expect the Fed to announce the beginning of QT (USD95bn cap, USD60bn for Treasuries and USD35bn for mortgage-backed securities).

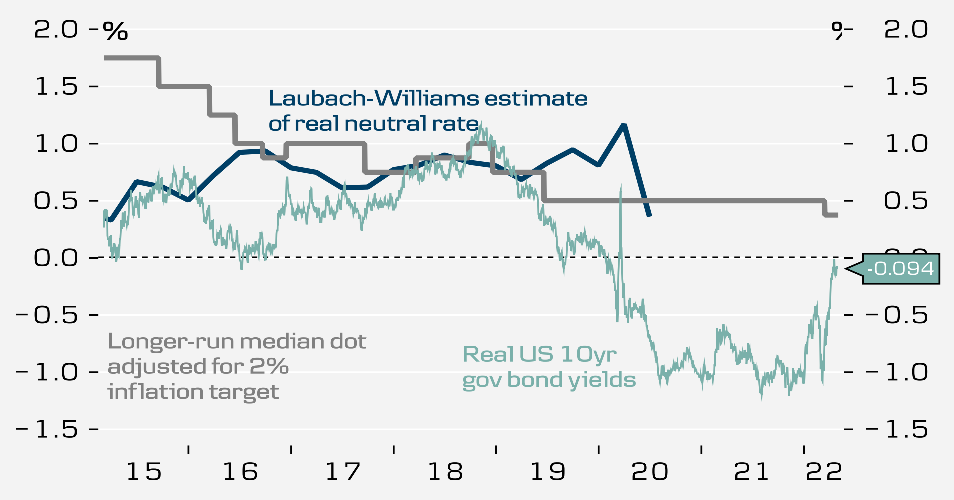
We still believe that the Fed is behind the curve and the Fed needs to do more to increase real rates/tighten financial conditions.

Our current Fed call is that the Fed will hike by 50bp in May, June and July and 25bp at the meetings in September, November and December. We expect the Fed to hike by 25bp in January and March.

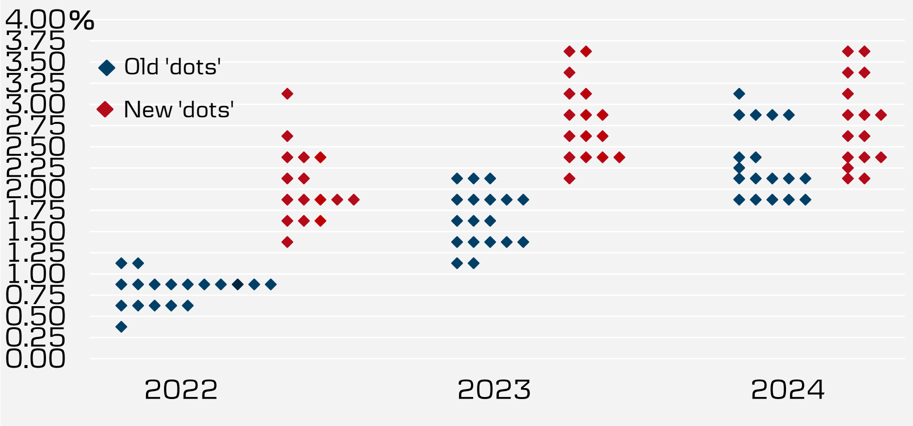
We still see risks skewed towards faster and more rate hikes given the strong economy, hot labour market and not least very high inflation. We cannot rule out that the Federal Reserve needs to follow the "emerging market central bank playbook" by out-hiking expectations.

## Fed charts

**Monetary policy is still accommodative**

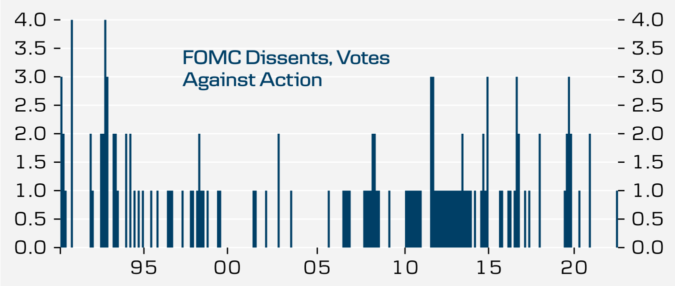


March 'dots' vs. December 2021 'dots'



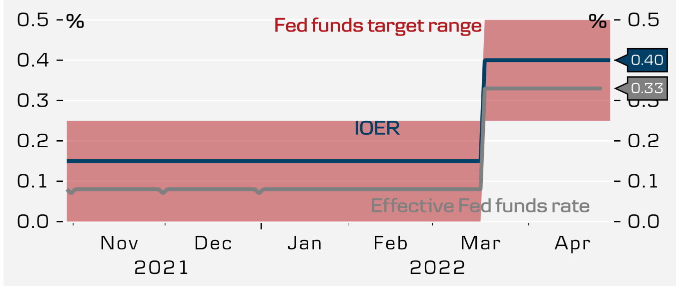

*Sources: Federal Reserve, Danske Bank*

The FOMC members usually work by consensus



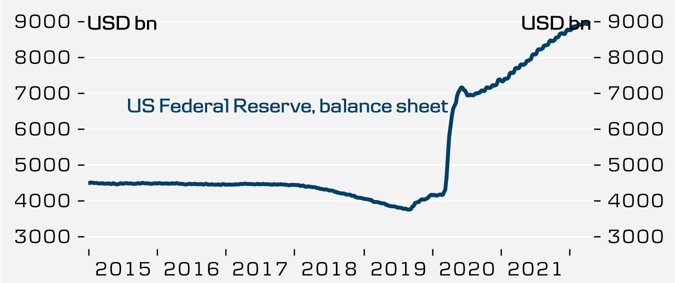

*Source: St Louis Fed, Macrobond Financial, Danske Bank*

Effective Fed funds rate stable around 33bp



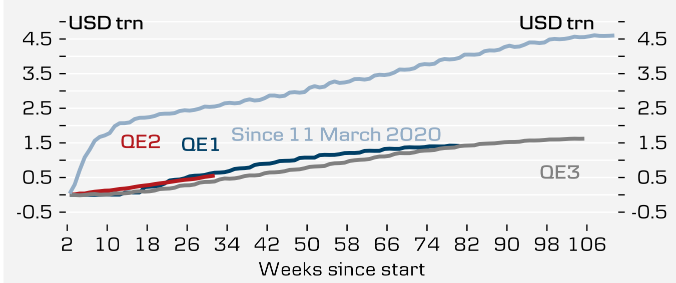

*Note: Past performance is not a reliable indicator of current or future results.*
*Source: Federal Reserve, Macrobond Financial, Danske Bank*

The Fed is set to announce QT at the May meeting




*Source: Federal Reserve, Macrobond Financial, Danske Bank*

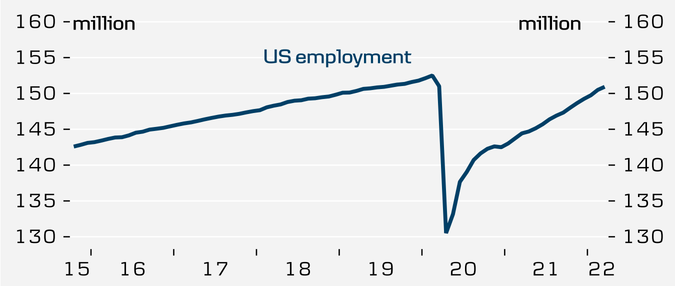
Fed bought a lot of bonds during QE




*Sources: Federal Reserve, Macrobond Financial*

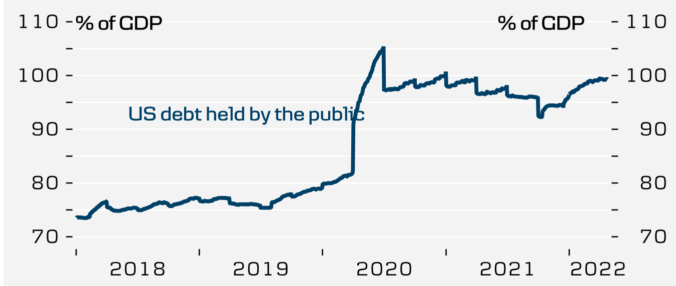
## Macro charts

Maximum employment despite lower level than pre-covid (lower labour force)



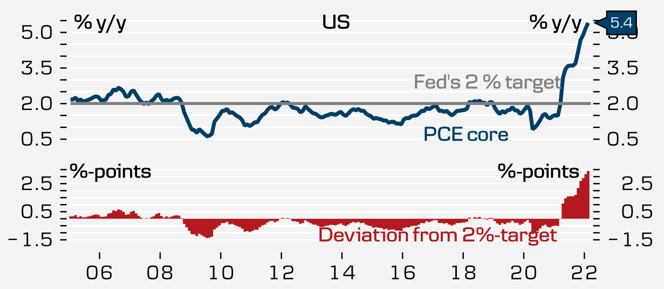

*Source: BLS, Macrobond Financial, Danske Bank*

US debt has been quite stable since the increase in the early days of the pandemic



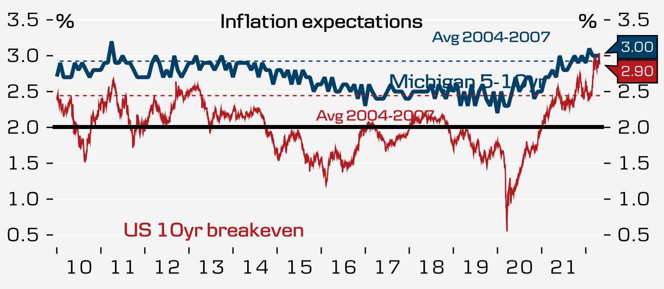

*Sources: US Treasury, Federal Reserve, Macrobond Financial*

**Very high PCE inflation**




*Source: BEA, Macrobond Financial, Danske Bank*

**Long-term inflation above the 2004-07 average**




*Note: Past performance is not a reliable indicator of current or future results.*
*Source: Michigan, Bloomberg, Macrobond Financial, Danske Bank*

## Disclosures

This research report has been prepared by Danske Bank A/S ('Danske Bank'). The authors of this research report is Mikael Olai Milhøj, Chief Analyst, Arne Lohmann Rasmussen, Chief Analyst, Jens Nærvig Pedersen, Chief Analyst, and Lars Sparresø Lykke Merklin, Senior Analyst.

### Analyst certification

Each research analyst responsible for the content of this research report certifies that the views expressed in the research report accurately reflect the research analyst's personal view about the financial instruments and issuers covered by the research report. Each responsible research analyst further certifies that no part of the compensation of the research analyst was, is or will be, directly or indirectly, related to the specific recommendations expressed in the research report.

### Regulation

Danske Bank is authorised and subject to regulation by the Danish Financial Supervisory Authority and is subject to the rules and regulation of the relevant regulators in all other jurisdictions where it conducts business. Danske Bank is subject to limited regulation by the Financial Conduct Authority and the Prudential Regulation Authority (UK). Details on the extent of the regulation by the Financial Conduct Authority and the Prudential Regulation Authority are available from Danske Bank on request.

Danske Bank's research reports are prepared in accordance with the recommendations of the Danish Securities Dealers Association.

### Conflicts of interest

Danske Bank has established procedures to prevent conflicts of interest and to ensure the provision of high-quality research based on research objectivity and independence. These procedures are documented in Danske Bank's research policies. Employees within Danske Bank's Research Departments have been instructed that any request that might impair the objectivity and independence of research shall be referred to Research Management and the Compliance Department. Danske Bank's Research Departments are organised independently from, and do not report to, other business areas within Danske Bank.

Research analysts are remunerated in part based on the overall profitability of Danske Bank, which includes investment banking revenues, but do not receive bonuses or other remuneration linked to specific corporate finance or debt capital transactions.

### Financial models and/or methodology used in this research report

Calculations and presentations in this research report are based on standard econometric tools and methodology as well as publicly available statistics for each individual security, issuer and/or country. Documentation can be obtained from the authors on request.

### Risk warning

Major risks connected with recommendations or opinions in this research report, including as sensitivity analysis of relevant assumptions, are stated throughout the text.

### Expected updates

Ad hoc.

### Date of first publication

See the front page of this research report for the date of first publication.

## General disclaimer

This research has been prepared by Danske Bank A/S. It is provided for informational purposes only and should not be considered investment, legal or tax advice. It does not constitute or form part of, and shall under no circumstances be considered as, an offer to sell or a solicitation of an offer to purchase or sell any relevant financial instruments (i.e. financial instruments mentioned herein or other financial instruments of any issuer mentioned herein and/or options, warrants, rights or other interests with respect to any such financial instruments) [('Relevant Financial Instruments').]

This research report has been prepared independently and solely on the basis of publicly available information that Danske Bank A/S considers to be reliable but Danske Bank A/S has not independently verified the contents hereof. While reasonable care has been taken to ensure that its contents are not untrue or misleading, no representation or warranty, express or implied, is made as to, and no reliance should be placed on, the fairness, accuracy, completeness or reasonableness of the information, opinions and projections contained in this research report and Danske Bank A/S, its affiliates and subsidiaries accept no liability whatsoever for any direct or consequential loss, including without limitation any loss of profits, arising from reliance on this research report.

The opinions expressed herein are the opinions of the research analysts and reflect their opinion as of the date hereof. These opinions are subject to change and Danske Bank A/S does not undertake to notify any recipient of this research report of any such change nor of any other changes related to the information provided in this research report.

This research report is not intended for, and may not be redistributed to, retail customers in the United Kingdom (see separate disclaimer below) and retail customers in the European Economic Area as defined by Directive 2014/65/EU.

## Disclaimer related to distribution in the United States

This research report was created by Danske Bank A/S and is distributed in the United States by Danske Markets Inc., a U.S. registered broker-dealer and subsidiary of Danske Bank A/S, pursuant to SEC Rule 15a-6 and related interpretations issued by the U.S. Securities and Exchange Commission. The research report is intended for distribution in the United States solely to 'U.S. institutional investors' as defined in SEC Rule 15a-6. Danske Markets Inc. accepts responsibility for this research report in connection with distribution in the United States solely to 'U.S. institutional investors'.

Danske Bank A/S is not subject to U.S. rules with regard to the preparation of research reports and the independence of research analysts. In addition, the research analysts of Danske Bank A/S who have prepared this research report are not registered or qualified as research analysts with the New York Stock Exchange or Financial Industry Regulatory Authority but satisfy the applicable requirements of a non-U.S. jurisdiction.

Any U.S. investor recipient of this research report who wishes to purchase or sell any Relevant Financial Instrument may do so only by contacting Danske Markets Inc. directly and should be aware that investing in non-U.S. financial instruments may entail certain risks. Financial instruments of non-U.S. issuers may not be registered with the U.S. Securities and Exchange Commission and may not be subject to the reporting and auditing standards of the U.S. Securities and Exchange Commission.

## Disclaimer related to distribution in the United Kingdom

In the United Kingdom, this document is for distribution only to (I) persons who have professional experience in matters relating to investments falling within article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (the 'Order'); (II) high net worth entities falling within article 49(2)(a) to (d) of the Order; or (III) persons who are an elective professional client or a per se professional client under Chapter 3 of the FCA Conduct of Business Sourcebook (all such persons together being referred to as 'Relevant Persons'). In the United Kingdom, this document is directed only at Relevant Persons, and other persons should not act or rely on this document or any of its contents.

## Disclaimer related to distribution in the European Economic Area

This document is being distributed to and is directed only at persons in member states of the European Economic Area ('EEA') who are 'Qualified Investors' within the meaning of Article 2(e) of the Prospectus Regulation (Regulation (EU) 2017/1129) ('Qualified Investors'). Any person in the EEA who receives this document will be deemed to have represented and agreed that it is a Qualified Investor. Any such recipient will also be deemed to have represented and agreed that it has not received this document on behalf of persons in the EEA other than Qualified Investors or persons in the UK and member states (where equivalent legislation exists) for whom the investor has authority to make decisions on a wholly discretionary basis. Danske Bank A/S will rely on the truth and accuracy of the foregoing representations and agreements. Any person in the EEA who is not a Qualified Investor should not act or rely on this document or any of its contents.

**Report completed:** 28 April 2022, 14:25 CET

**Report first disseminated:** 28 April 2022, 14:45 CET