27 July 2022

Fed Research

Review: Front-loading to continue despite growth risks

- **As expected by both the analyst consensus and the markets, the Fed hiked the target range by 75bp to 2.25-2.50%.**
- **With inflation pressures still strong and broad-based, we continue to see risks tilted towards more front-loading, and adjust our Fed call to expect a 75bp hike in the September meeting, followed by 25bp in November and December.**
- **With both Fed Funds rate and real yields now around neutral, Fed will take more meeting-by-meeting with regard to the future rate hikes, which leaves the outlook for hikes later in the year very uncertain.**

As widely expected by both the market and analyst consensus, Fed hiked the Fed Funds target range by 75bp. Earlier in July market had speculated with even larger 100bp hike, but following the recent weak economic data and not least the Flash PMIs last Friday, the unanimous decision for a 75bp hike was clearly the base case. With both the Fed Funds Rate as well as longer real yields now around the Fed's estimate of the neutral level, Fed will take more meeting-by-meeting with regard to the future rate hikes. With inflation pressures still broad-based and labour market conditions strong, we see inflation risks still tilted to the upside in the near-term. Powell was clear that 'another unusually large increase could be appropriate at next meeting', and as such, we think Fed will continue front-loading the rate hike with one more 75bp hike in the September meeting.

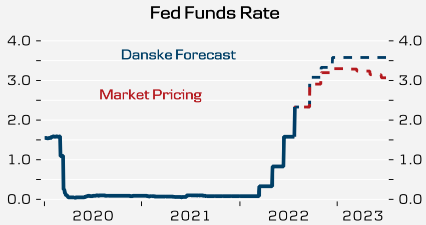
Ultimately, the weakening economic momentum will likely begin to ease the current inflation pressures towards the end of the year, which has already been evident in commodity prices over the summer. In addition, both market-based and consumers' inflation expectations have taken a step lower recently. The tighter financial conditions area also weighing on the US housing market with the MBA purchase index now at the weakest level since the beginning of the Covid-pandemic. We expect Fed to slow down the hiking pace to 25bp for November and December meetings, before finishing the hiking cycle at 3.50-3.75%. **Thus, we have lowered our expectation of the terminal rate, but now foresee even more aggressive front-loading than previously (50bp in Sep, Nov and Dec)**. The hiking pace will largely depend on the incoming data on not least inflation, labor market and longer-term inflation expectations.

Markets: Slightly dovish

With markets pricing out some probability mass for a continued 75bp hiking cycle the US curve bull steepened and the USD weakened. The relief was also very evident in equity markets with not least the duration sensitive indices like Nasdaq posting 4% gains. The rally in risk was also reflected in FX markets where notorious risk sensitive currencies, including SEK and NOK, lead gains.

Fundamentally, the "race to neutral" and the urgency of tightening financial conditions has been an important pillar in our overall strategic cautious stance to risky assets and our bullish USD view. This relief is likely to extend in the short-term putting at risk our call for a EUR/USD below parity over the coming month. That said, fundamentally we still see

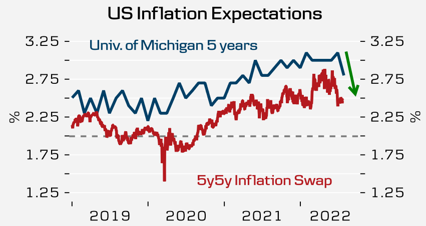
We expect Fed to continue front-loading in September



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

Sources: Macrobond Financial, Refinitiv Danske Bank forecasts

Longer-term inflation expectations have eased since the June meeting



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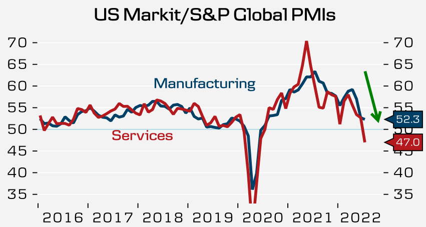
Sources: University of Michigan, Refinitiv, Macrobond Financial

Leading indicators point towards slowing growth



Sources: Markit/S&P Global, Macrobond Financial

Analyst
Antti Ilvonen
antti.ilvonen@danskebank.com

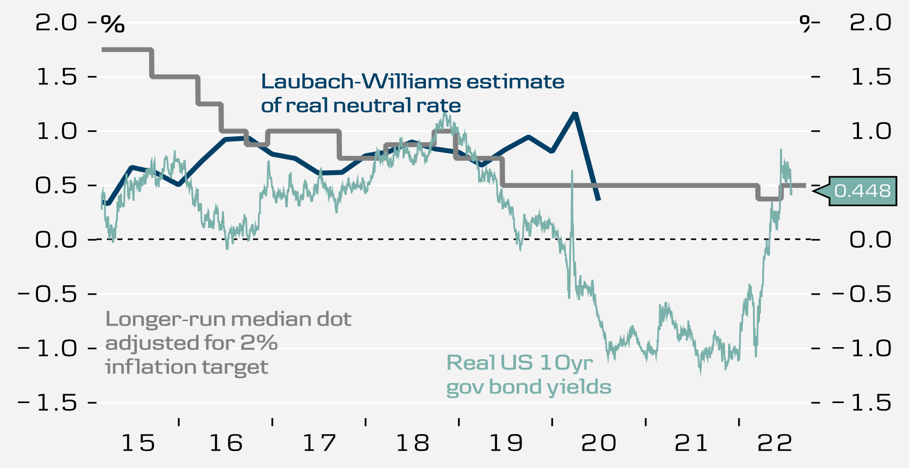
Chief Analyst
Mikael Olai Milhøj
milh@danskebank.dk

Chief Analyst
Kristoffer Kjær Lomholt
klom@danskebank.dk

drivers like terms-of-trade and cost adjusted productivity levels as favouring a lower EUR/USD on a 3-6M horizon. Hence, we still prefer selling this EUR/USD rally although the timing in the near-term will be tricky. As growth weakens and the Fed continues to tighten, we are still of the view that this will revert us to an environment favouring a stronger USD and CHF at the expense of cyclically sensitive currencies. It is not before we see a full pivot from central banks (still too soon) and/or clear signs of a global CAPEX boom (unlikely short-term) that we fundamentally will reconsider this call. Either way the coming months' macro data will prove increasingly important for trading strategic trends vs tactical fluctuations.

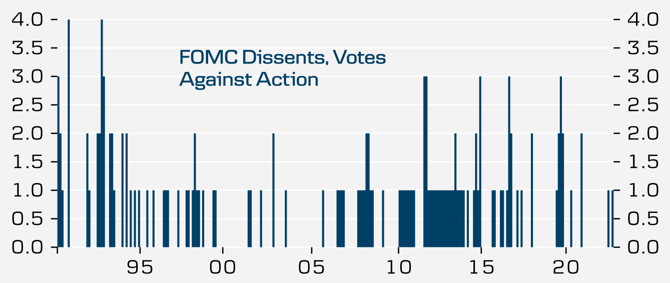
Fed charts

Real rates finally above neutral



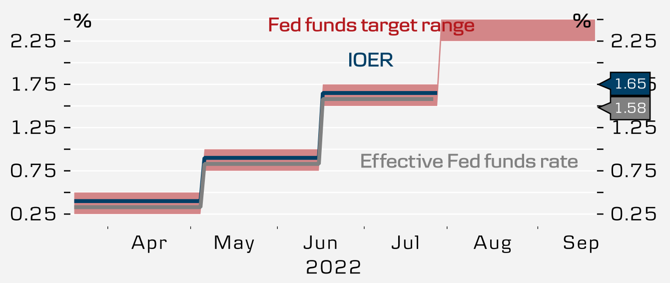
Note: Past performance is not a reliable indicator of current or future results.
Source: Federal Reserve, Refinitiv, NY Fed, BEA, Macrobond Financial, Danske Bank

The FOMC members usually work by consensus



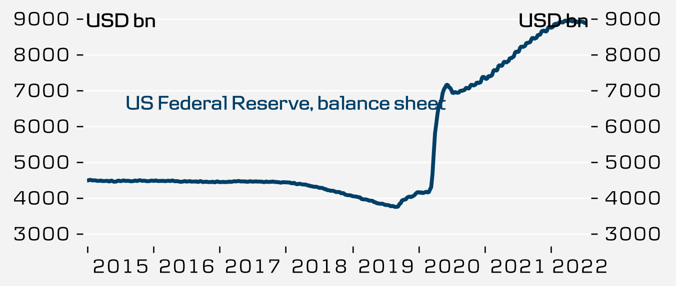
Source: St Louis Fed, Macrobond Financial, Danske Bank

Effective Fed funds stable in the middle of the range



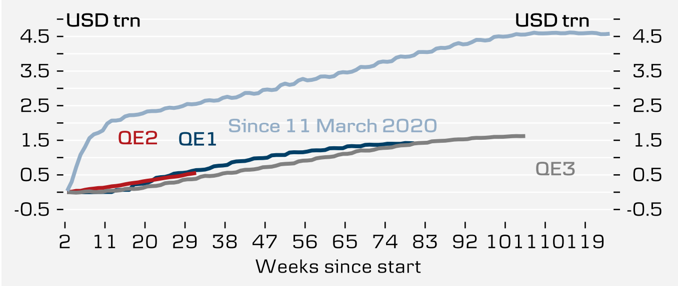
Note: Past performance is not a reliable indicator of current or future results.
Source: Federal Reserve, Macrobond Financial, Danske Bank

The Fed has initiated QT



Source: Federal Reserve, Macrobond Financial, Danske Bank

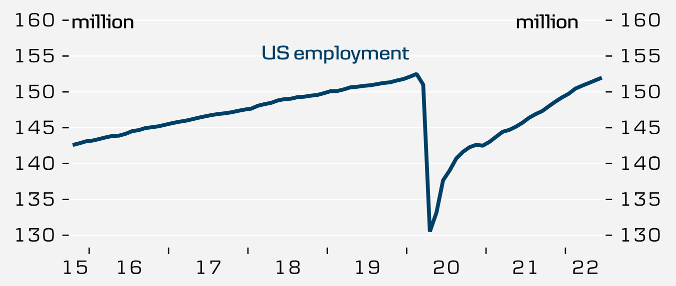
Fed bought a lot of bonds during QE



Sources: Federal Reserve, Macrobond Financial

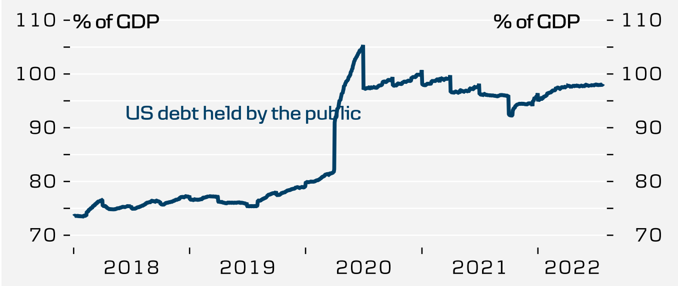
Macro charts

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



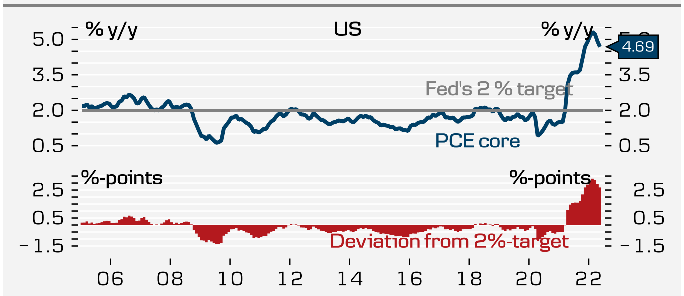
Source: BLS, Macrobond Financial, Danske Bank

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



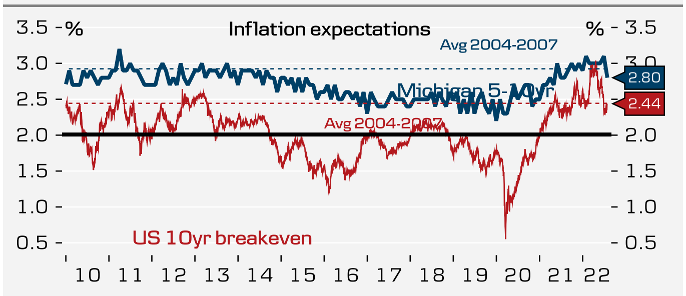
Sources: US Treasury, Federal Reserve, Macrobond Financial

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

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This research report has been prepared by Danske Bank A/S ('Danske Bank'). The authors of this research report are Mikael Olai Milhøj, Chief Analyst, Antti Ilvonen, Analyst and Kristoffer Kjær Lomholt, Chief Analyst

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