Behind-the-curve Fed signals more rate hikes

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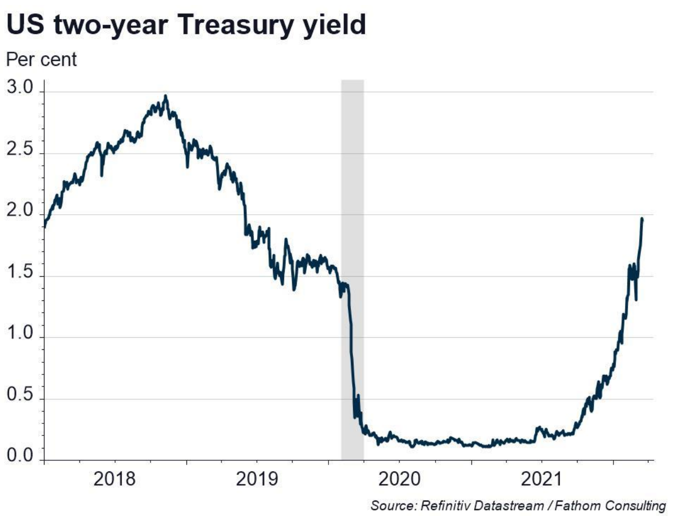
The US Federal Reserve lifted the fed funds target rate at its March meeting and indicated that this would be the first of seven rate increases this year. Although the March increase was widely expected, the number of rate increases signaled by the 'dot plot' for the rest of the year seemed to catch investors by surprise, with the 2-year Treasury yield increasing by 11 basis points on the day of the announcements. Despite this, equity investors reacted positively, with the S&P500 gaining 2.2% on the same day.



So far so good, because the Fed is in a tight spot. Tighten too quickly and it risks tipping the economy into recession; tighten too slowly and upward price pressures could become entrenched, requiring an even quicker pace of tightening that could prove more costly in economic terms to bring inflation under control further down the line.

Earlier in the pandemic Fed officials had labelled above-target inflation as transitory, saying it was due to factors such as supply chain disruptions and the price of second-hand cars. But as inflation has continued to rise, and the median CPI (which isn't affect by one-off shocks to individual items) has reached levels not seen since the early 1990s, reflecting how inflationary pressures have become more prolonged and widespread than the Fed had originally expected, the language from the Fed has become more hawkish in response.

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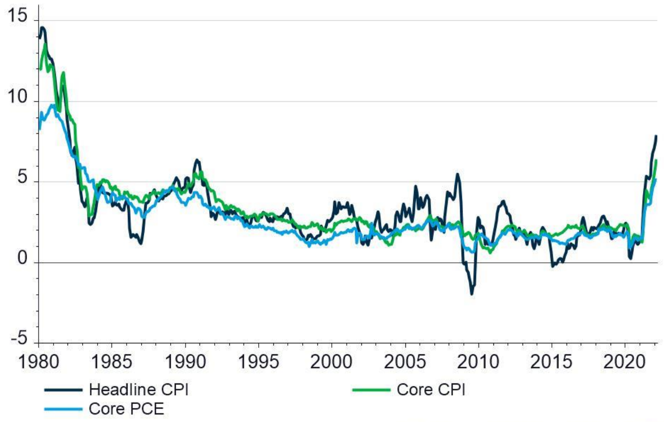
US inflation

Twelve-month percentage changes



Source: Refinitiv Datastream / Fathom Consulting

US median CPI

Twelve-month percentage change

Source: Refinitiv Datastream / Fathom Consulting

The medium term outlook for inflation remains uncertain. A general withdrawal of fiscal stimulus should ease inflationary pressures somewhat in the short to medium term. Meanwhile, many of the technological and demographic factors that had weighed on inflation before the pandemic have not disappeared. But Russia's invasion of Ukraine has triggered a spike in oil prices and further price pressures that are likely to push inflation higher in the near term: especially in Europe, but also in the US.

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US oil prices

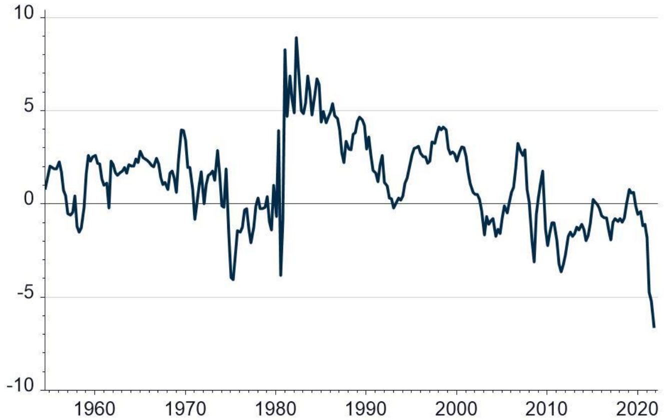
USD per barrel, ten-day moving average

Source: Refinitiv Datastream / Fathom Consulting

By comparison with other periods of higher inflation, the Fed is behind the curve on several measures. For example, in the period since 1990, inflation was 2.3% on average when the Fed started tightening policy. Currently, inflation is 7.9%. The real rate of interest was -7.6% before the Fed increased rates this week compared to an average of 2.3% at the start of the typical policy tightening in this period. The difference between the 10Y and 2Y US Treasury yields, commonly referred as the slope of the yield curve, is also a lot narrower now than it has previously been at the start of tightening cycles: 0.2% now versus 1.3% on average. An inverted yield curve is widely considered as a harbinger of recession.

US real fed funds rate

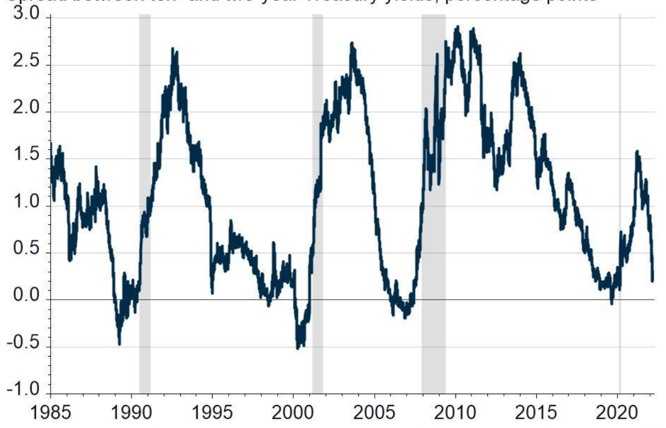
Per cent



Source: Refinitiv Datastream / Fathom Consulting

US yield curve

Spread between ten- and two-year Treasury yields, percentage points

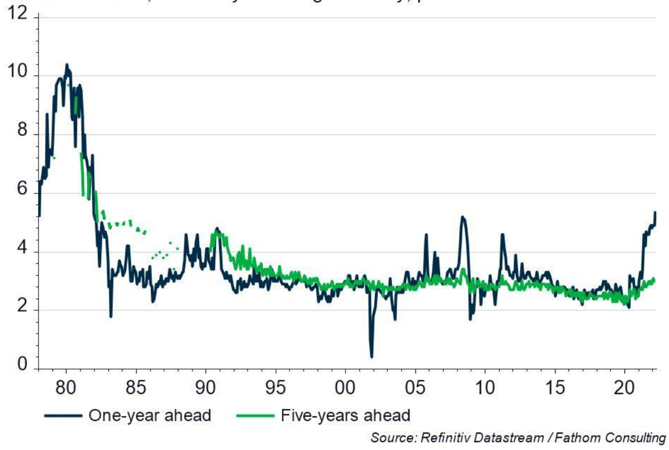


Source: Refinitiv Datastream / Fathom Consulting

For now, the market seems happy enough with the Fed's policy stance. The Fed will be very keen to keep its credibility intact, and keeping a lid on inflation expectations will be key to doing so. The University of Michigan survey shows that US households expect above-target levels of inflation to persist over the next 12 months. Longer-term inflation expectations appear well anchored and are a lot lower than they were in the early 1980s, at least according to this measure. But any further uptick in this metric could put the Fed in an uncomfortable spot, and prompt it either to signal a faster pace of tightening or to risk losing some of its hard-won credibility. Some market-based measures have started drifting higher in recent weeks, raising the stakes.

US inflation expectations

Inflation forecast, University of Michigan survey, per cent



Source: Refinitiv Datastream / Fathom Consulting

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