US Macroeconomics

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The Wisdom of Crowds

The bond market is presently looking for the Fed to raise the funds rate 25 basis points (bps) to 4.875% but then to begin cutting rates this summer. **Midyear 2023 Fed rate cuts would be entirely consistent with the historical record**, which shows a strong tendency for tightening cycles to be quickly reversed.

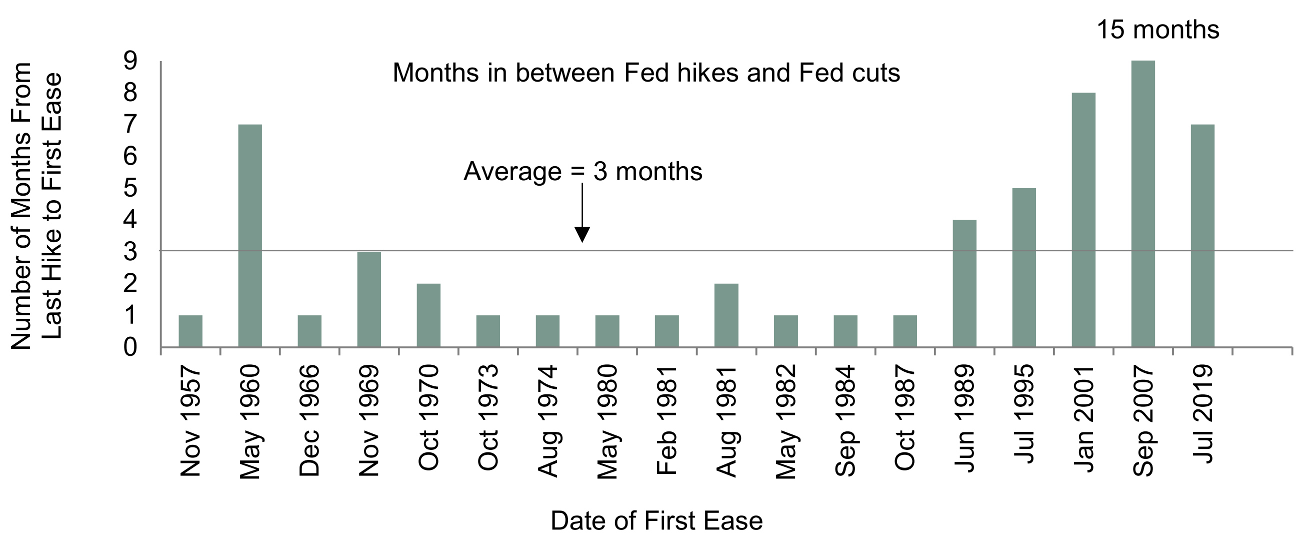
If the Fed hikes tomorrow, the funds rate will have risen 475 bps in just 12 months. **The current tightening cycle is already the fastest and largest since 1981-82**. But inflation and interest rates were much higher then. Prices were rising nearly 15% per annum, and the funds rate nearly hit 20%.

Moreover, it is not just the change in interest rates that matters. **The level of interest rates is also much too restrictive as evidenced by a two-decade high in household borrowing costs**. This explains why residential housing is in recession, and consumer confidence is hovering in recessionary territory. Consumption is poised to turn lower in the months immediately ahead.

The Fed already has gone too far and will compound today's restrictive environment with higher short-term rates and more quantitative tightening. The bond market has known this, reflected in a deeply inverted treasury yield curve since last fall. In the process, **investors expect the Fed to pivot, cutting interest rates by 25 bps at the July 26th FOMC meeting**. This matches the historical record.

As shown in the table below, **the average time from the last rate hike to first rate cut is three months, and the median time is two months**. Granted the time has lengthened over the last five cycles with an average pause of eight months. But none of these previous tightening cycle experienced the aggressiveness of the Fed's actions nor the historic inversion of the yield curve that ensued.

The bottom line is that the bond market is properly anticipating a shift in Fed policy. But where we differ is on the amount of Fed easing that is likely to come. Alas that is a discussion for a different day. For now, all eyes are on the outcome of tomorrow's FOMC meeting.



Source: FRB, Haver, SMBC Nikko

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