

US Macroeconomics

March 3, 2023

Joseph Lavorgna, Chief US Economist | 212.610.1741 | joseph.lavorgna@smbcnikko-si.com

The Fed is Making a Big Mistake

Fed policymakers have consistently beat the drum of the need to take rates into restrictive territory. Only recently has the bond market finally listened. **The fed funds futures market is now pricing a terminal rate of near 5.50%, above the current median FOMC estimate of 5.125%. This is the first time during this tightening cycle that the market is above the Fed's projections although this may change later this month.** Updated FOMC economic and financial forecasts will be released on March 22.

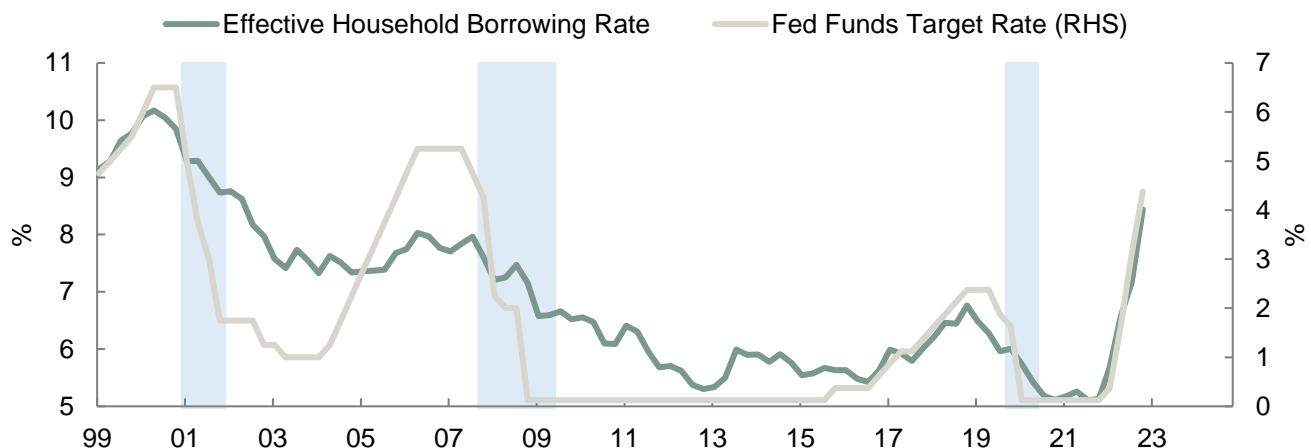
A reason for recent Fed hawkishness (in addition to stronger jobs, retail sales and inflation data) has been an easing of financial conditions. For example, **since last fall, the stock market is higher, treasury yields are lower, credit spreads are tighter, and the trade-weighted dollar is lower.** Worried this situation may give an already tight labor market an added fillip, monetary policymakers have pushed back. They have consistently told us of their desire to push the fund rate into restrictive territory and then to keep it there until there is confidence that inflation will fall back to 2%. More rate hikes are forthcoming. But is this wise, given how much the Fed has already done?

While financial conditions for businesses and investors may have eased since last fall, they have not eased for households, quite the opposite. Consumers are paying record high rates on mortgages, credit cards, auto loans and personal loans. Since households account for 70% of economic activity, a pullback in consumption would have profound negative effects elsewhere. Businesses will not overcome this. In other words, any stimulus emanating from the financial markets will not be enough to offset the anticipated drag from weaker household spending. Thus, the Fed's concern about easier "financial conditions" is misplaced and runs the risk of a major policy error in the form of a deep, long, and unnecessary consumer-led recession.

Record high household borrowing costs are illustrated in the chart below which shows a weighted average of mortgage, credit card, auto and personal borrowing. The effective household borrowing rate soared to a two-decade high last quarter because of rising fed funds, as the two series have moved one for one. Moreover, the increase in household borrowing rates has been the largest since at least the early 1980s. And households' borrowing costs are likely to go even higher given the Fed's intention to push the funds rate well above 5%.

Perhaps it is time for the Fed to remember there are lags in monetary policy, that it takes time for changes in interest rates to be fully felt in the economy. Why not wait and see how previous actions play out? This is what the Bank of Canada recently did. Why not the Fed? If the economy and inflation turn out stronger than expected, the Fed could always resume tightening. Unfortunately, our counsel is likely to go unheeded.

A Fed-engineered Record Rise in Borrowing Costs



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