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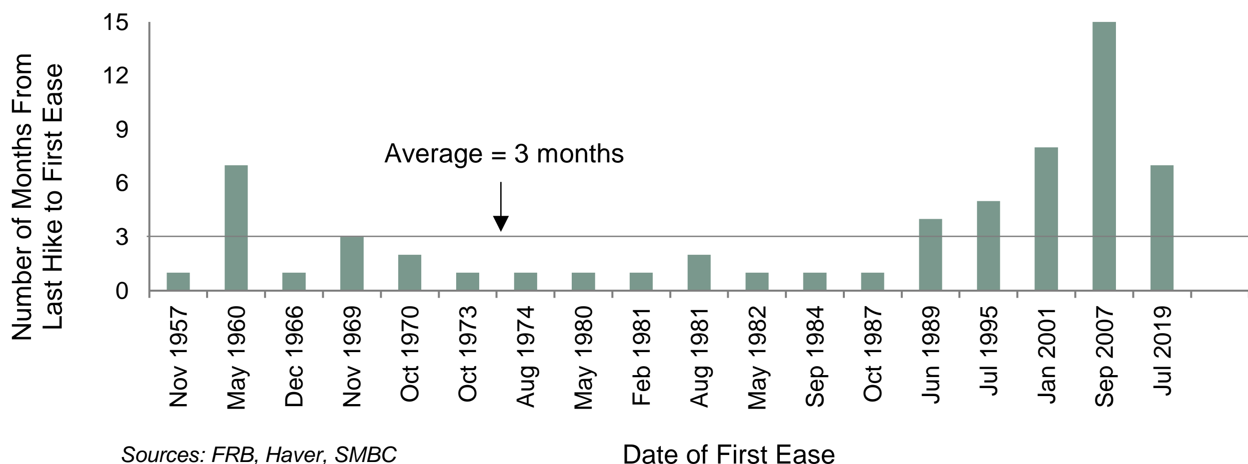
The Fed Pivot is Still Alive and Well

Over the past week, numerous Fed officials including Chair Powell reinforced the need for more interest rates hikes with the likelihood that the funds rate would then stay elevated at its ultimate peak. The fed futures market reacted by lifting its estimate of the terminal rate to 5.20% at present from a recent low of 4.86% last Thursday. Assuming the Fed continues to move in 25 basis points (bps) increments, which there is no reason to believe otherwise, the funds market is discounting a hike in March, another one in May and about a one in three chance of final hike in June. But what is really interesting is what happens next.

The futures market continues to look for rate cuts later this year possibly beginning as early as September but certainly by November. The fed funds rate is expected to fall further over the course of next year finishing no higher than 3.50% which represents at least 175 bps in rate cuts. In other words, bond investors still do not believe the Fed will be able to keep rates in highly restrictive territory for long. History is on the market's side.

The chart below shows the time it takes for the Fed to pivot. **The average time over the last 18 tightening cycles from the last rate hike to the first rate cut is just three months**. But notice there were a handful of times when the reversal was just one month. Most of these happened during the inflationary 1970s and early 1980s. Today, policymakers are acutely aware of this and thus have pushed back against a 2023 pivot for this reason. Instead, the Fed's forecasts point to a long pause like the one following the 2004 to 2006 tightening cycle.

While it is worth noting that the recent pivots have been longer than three months, averaging eight months over the last five cycles, the market may still be right for one simple reason. The current Fed in its desire to not repeat the same past mistakes has raised much more aggressively than in any of the prior five tightening cycles. **From March 2022 to March 2023, the FOMC will have lifted the funds rate by 450 bps, which is the largest and fastest tightening since 1981**. In response, the Treasury yield curve has deeply inverted while inflation expectations have remained anchored. This signals that monetary policy is already too restrictive. If so, it remains just a matter of time before today's record low unemployment rate begins to move up, in which case this time will not be different. The bond market will be right again. Stay tuned.



Sources: FRB, Haver, SMBC

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