Another steep rate hike coming at next week's Fed meeting

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Market Intelligence

The Federal Open Market Committee is not considering a 75-basis-point rate hike at its June meeting, according to Fed Chairman Jerome Powell.

Source: Federal Reserve

Continuing its push to rein in inflation, the Federal Reserve is likely to announce a 50-basis-point rate hike at its June 14-15 meeting.

Nevertheless, many economists expect elevated inflation to persist through the end of 2022.

The Fed has hiked rates twice so far in 2022. In March, the Fed raised its benchmark interest rate by 25 basis points; in May, it added another 50 basis points, the steepest hike since 2000.

Fed Chairman Jerome Powell said in May that the Federal Open Market Committee was not "actively considering" a 75-basis-point hike. Minutes from the Fed's early May meeting, released on May 25, indicated that increases of 50 basis points hikes would probably be necessary at the next few meetings in order to tame soaring inflation. The Fed's strategy for taming inflation also includes quantitative tightening.

The comments "give a glimmer of hope that they could adjust their policy tightening stance later in the year," said Ed Moya, senior market analyst for the Americas at OANDA, a foreign exchange company.

This is the fifth part of a series of articles examining the prospects for a U.S. recession and the Federal Reserve's efforts to achieve a "soft landing" for the economy.

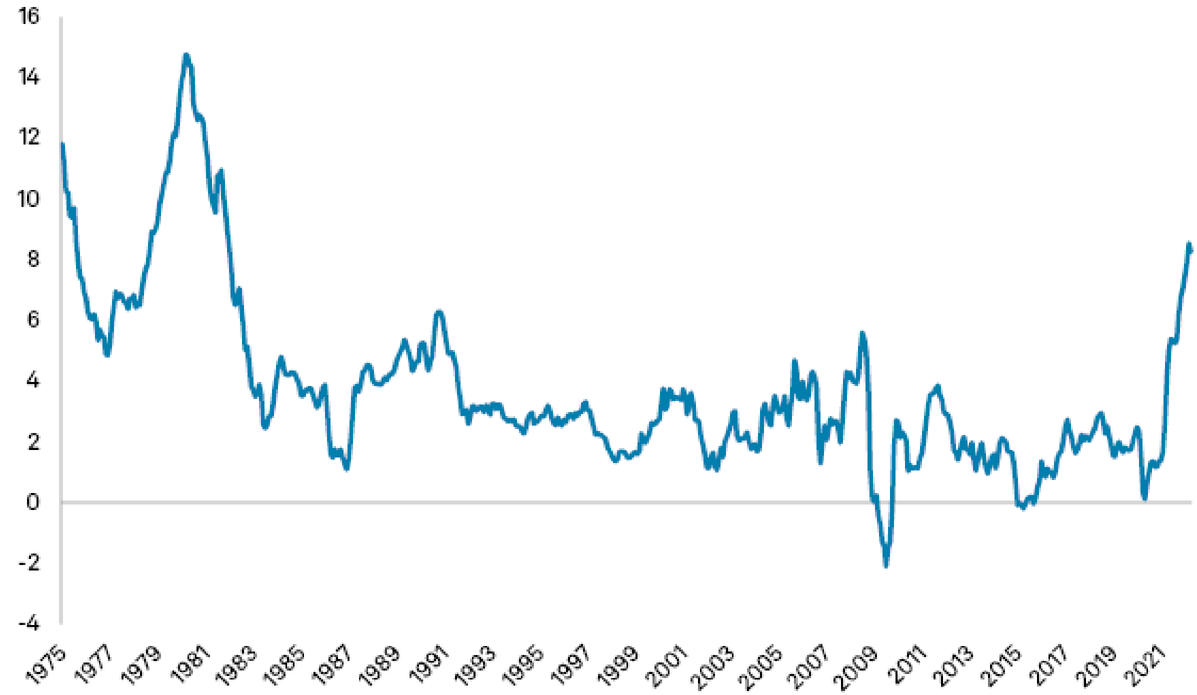
US Fed aims for soft landing as economists see recession odds growing

As inflation soars, consumers brace for a hard landing

As cheap-money era ends, smaller companies face capital crunch

Risk management, low unemployment insulate banks in case of recession

Consumer price index all items YOY change (%)
January 1975-April 2022



Data compiled May 26, 2022.
Based on data released May 11, 2022.
Data includes year-over-year change in non-seasonally adjusted consumer price index for all items.
Source: U.S. Bureau of Labor Statistics

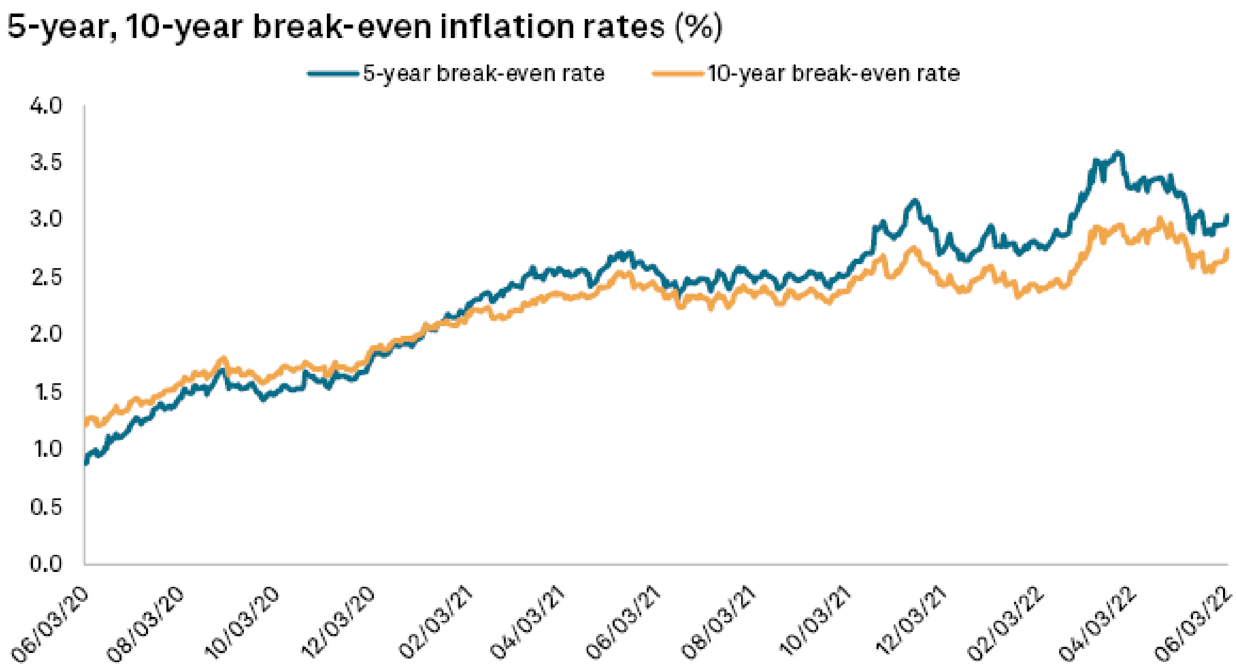
Price rises persist

The consumer price index, the market’s preferred inflation gauge, increased 8.6% from May 2021 to May 2022, the U.S. Bureau of Labor Statistics reported June 10. It was the largest increase since December 1981. Economists had forecast an 8.2% increase.

Increases of 50 basis points are likely at the June and July meetings because the Fed is "lagging behind the curve with fighting inflation," OANDA's Moya said in a May 25 note.

It is increasingly likely that 50-basis-points rate hikes will be the norm this year, said Beth Ann Bovino, chief U.S. economist at S&P Global Ratings.

"After the likely [50-basis-points] hike in June, we expect two more 50 bps hikes in July and September," Bovino said.



Data compiled June 6, 2022.
Represents five-year and 10-year break-even inflation rate or expected inflation rate derived from nominal Treasurys compared to inflation-indexed Treasurys of the same maturity between June 3, 2020, and June 3, 2022.
Source: Federal Reserve Bank of St. Louis

Although the previous rate hikes have not yet been effective in slowing rising prices, they are already influencing market-based inflation expectations, said Bob Schwartz, senior economist at Oxford Economics.

"Breakeven rates have come down," he said. The breakeven rate is the difference in yield between inflation-protected debt and nominal debt of the same maturity. "They appear to also be curtailing household inflation expectations, which is important for controlling actual inflation over the longer run."

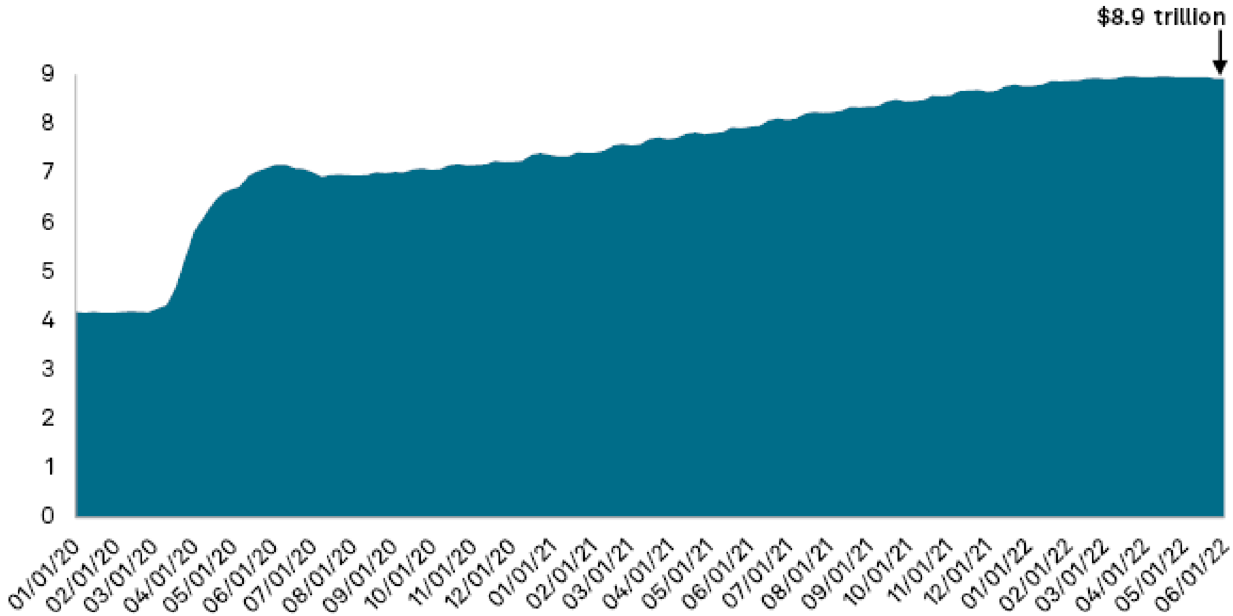
Inflationary pressure in the economy — including supply-chain issues, rising prices, shifting consumer demand — will persist for most of 2022, said Wayne Winegarden, senior fellow at Pacific Research Institute.

"Assuming the fiscal pressures subside, it will likely take until the late third quarter to start feeling some relief," Winegarden said.

The rate hikes are already beginning to ripple through the economy, said Bovino of S&P Global Ratings.

"Higher prices are starting to weigh on affordability and household purchasing power, reducing demand and putting downside pressure on prices," she said. "In a sense, this is doing some of the Fed’s work for them."

Federal Reserve balance sheet ($ trillion)



Data compiled June 6, 2022.
Represents total assets less eliminations from consolidation between Jan. 1, 2020, and June 1, 2022.
Source: Federal Reserve Bank of St. Louis

Quantitative tightening

Markets also await details about the Fed's plan for quantitative tightening, as the Fed has indicated it will begin to reduce its record-level bond holdings by up to $95 billion per month.

The Fed will likely continue to reduce its Treasury holdings in June, ramping up the cutbacks to $30 billion and as much as $60 billion in July and in subsequent months, Oxford Economics' Schwartz said. It will also shrink its holdings of mortgage-backed securities by $20 billion in June and up to $30 billion per month beginning in July.

Scaling back its mortgage-backed securities could require selling the securities prior to maturity rather than allowing them to mature without replacement, said Pacific Research Institute's Winegarden.

"I think the [mortgage-backed securities] sales will become difficult politically as the housing market weakens and the Fed will not want to further stress this market," Winegarden said, referring to the risk that rising mortgage rates will create affordability problems for some buyers, further slowing the housing market.

"Since the inflationary pressures will still be strong, this will likely lead to continued quantitative tightening, but at a slower pace than the Fed is currently planning," he said.

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