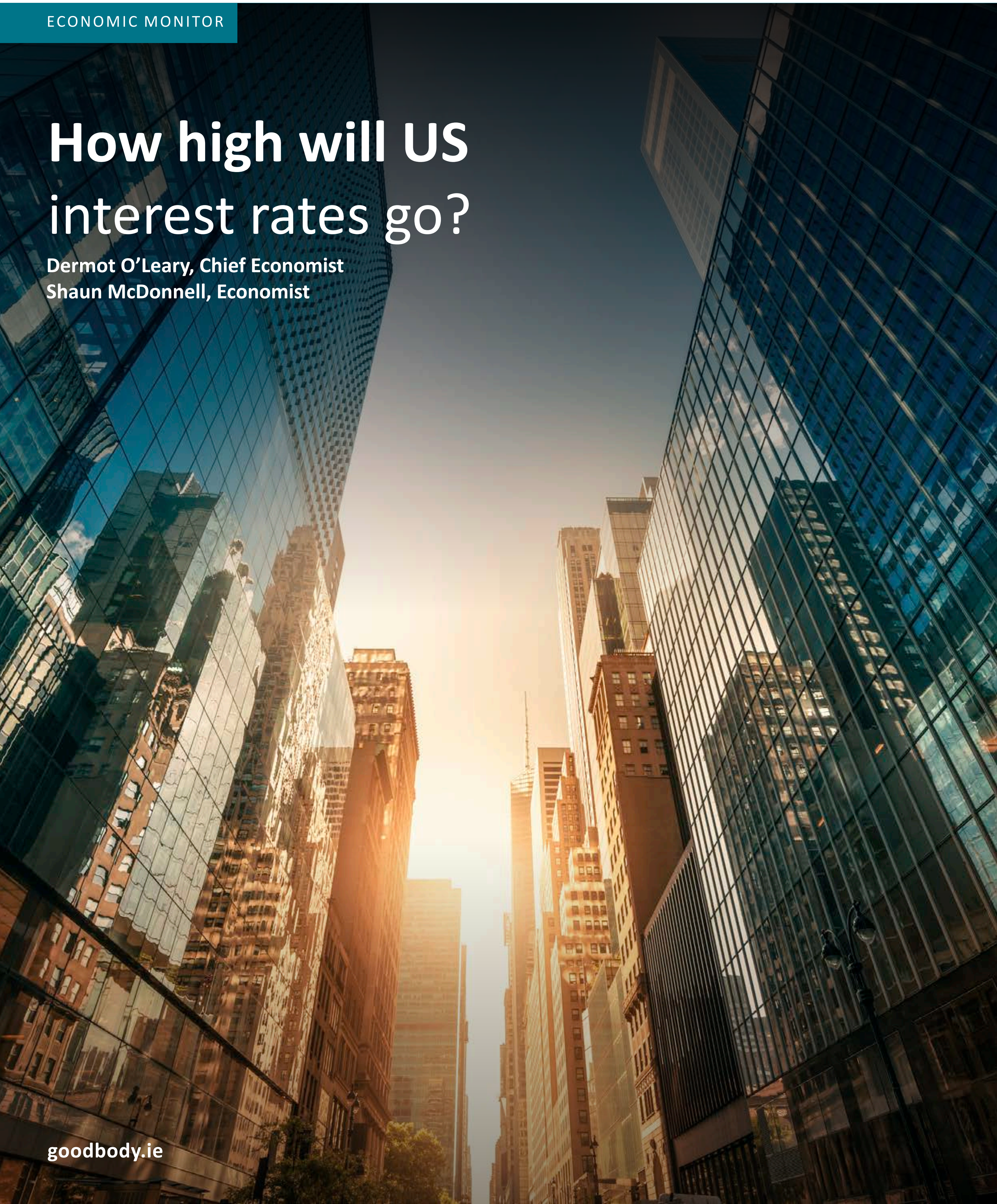
Economic Monitor
Q1 2022

ECONOMIC MONITOR

How high will US interest rates go?

Dermot O'Leary, Chief Economist
Shaun McDonnell, Economist



Economic Monitor

Welcome to Economic Monitor – a quarterly publication where we explore the key themes shaping the global economy. In this issue, we examine the hawkish turn in the US Federal Reserve's communications and ask: how high will US interest rates go?

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How far should US interest rates go?

If Federal Reserve (Fed) Chair Jay Powell had a new year's resolution to force a sizable market rethink on how far US interest rates will rise this year, he has already achieved it.

The biggest market theme this year has been the hawkish turn in the Fed's communications. Having thrown out the view that the spike in inflation would prove to be "transitory" at the end of 2021, Powell doubled down on his concerns at the first Federal Open Markets Committee (FOMC) meeting of the year. In what are likely to become the buzzwords for central banking in 2022, Powell committed the Fed to being "humble and nimble" in navigating interest rate policy in the context of labour shortages, supply-chain difficulties, and what is still an uncertain global environment with COVID-19.

His newly found humbleness is an admission that the Fed got it wrong in its initial sanguine attitude to inflation, forcing it to be nimbler about rising interest rates over the coming months.

The market has got the message. From an expectation of three 0.25% interest rate rises in 2022, the market now expects seven, with a further two by the end of 2024. This would take the Fed's main interest rate to 2.25% by end-2024. While up on earlier expectations, the question that will continue to dominate markets this year is whether the expectation is now appropriate. In other words, how high can interest rates go over the coming years? The answer to this question will have profound implications for appetites to risk, asset allocation and valuations.

This time is different

Mark Twain once said: "History doesn't repeat itself, but it often rhymes". There has been a lot of unprecedented events over the last two years, making comparisons difficult, but helpful, nonetheless. Let's look briefly at some of these previous cycles.

The most recent rate hiking cycle (2015-2018) saw the Fed raising interest rates on nine separate occasions over three years, moving the Fed Funds rate from 0.25% to 2.5%. An inflation rate of 1.4%, using the Fed's preferred gauge, the core PCE deflator, was historically low when this rate hiking cycle began. The unemployment rate was 5.0%.

In the mid-2000s, the Fed raised rates 17 times, bringing rates from a low of 1% in mid-2004 to a peak of 5.25% two years later. Unemployment was 5.6% when the Fed began tightening policy, while inflation stood at 2.4%.

Current labour market conditions are much tighter and inflation is much higher than both those periods. The unemployment rate, at 3.9%, is already close to its pre-pandemic levels, while core inflation at 4.6% is at its highest level in more than 30 years. This time is very different, justifying the Fed's pledge to be nimble.

More market messaging needed

Every three months, each member of the FOMC must set out their expectations of growth, inflation, and interest rates over the short and medium-term. The next release is likely to include more upward revisions to their inflation and interest rate forecasts in 2022 and 2023. While short-term rate movements are important, medium-term expectations of interest rates are arguably more important. Will the Fed choke off the expansion by raising rates too much?

One of the key concepts in this decision is the so-called "natural real rate of interest", also known as "R-star". This refers to the short-term interest rate, adjusted for inflation, that is expected to prevail when the economy is at full strength and inflation is stable. This rate has fallen progressively over decades, mainly due to the decline in the US economy's potential growth rate. The Fed estimated R-star to be close to 1% prior to the pandemic.

The short-term real interest rate currently stands in deeply negative territory at -4.5%, its lowest ever level.

With the US economy already close to full capacity and expected to grow above its potential growth rate this year, the Fed is a long way from R*. The market continues to believe that interest rates will hit a choke point that will force the Fed into stopping well below its estimated "natural rate". This will continue to dominate the market narrative. While the Fed may have been late in realising that it was time to take the monetary punchbowl away, we believe markets are still somewhat too relaxed about the extent to which the Fed mean it this time.

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Q1 2022: in brief

The Fed has turned the dial up, conveying a more hawkish narrative and signalling a tougher stance on inflation.

The market now expects the following interest rate rises:

7 in 2022

1 in 2023

1 in 2024

-4.5% the short-term real interest rate is at its lowest level ever

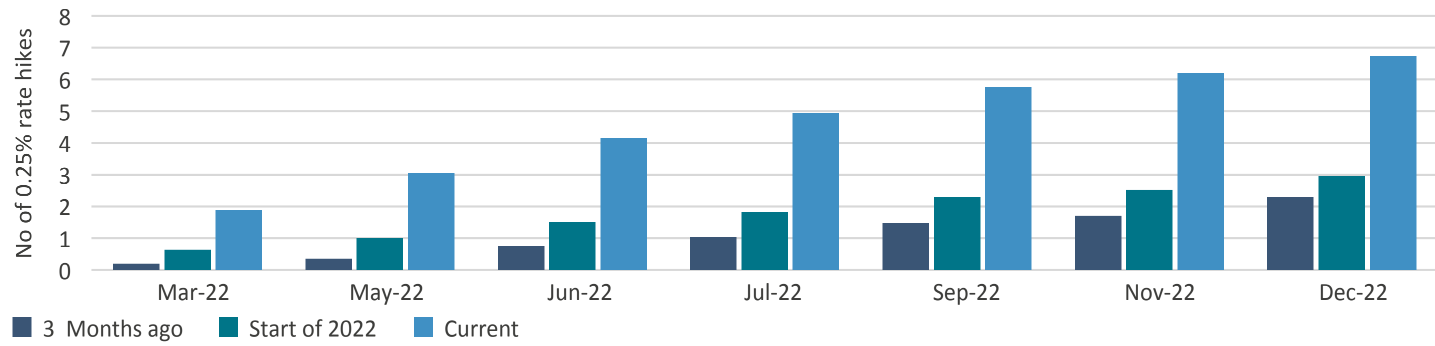
Before the pandemic, R* was estimated to be close to **1%**

3.9% Unemployment rate

Core inflation **4.6%**

Economic Monitor in three charts

1. Number of US interest rate hikes by FOMC meeting



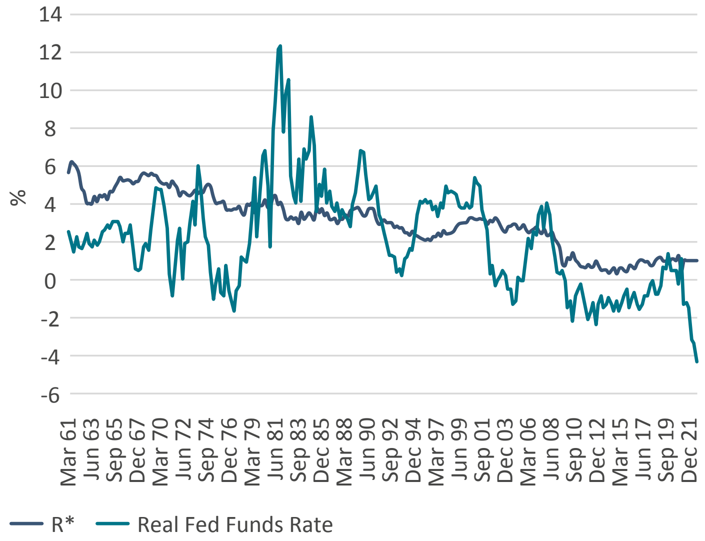
Source: Federal Reserve.

2. Interest rate hiking cycles compared

	2000s	2010s	Current*
Interest rate at start	1.00%	0.25%	0.25%
Interest rate at end	5.25%	2.50%	2.25%
Number of rate hikes	17	9	8
Inflation rate at start	2.40%	1.40%	4.60%
Unemployment rate	5.60%	5.00%	3.90%
Date of first rate rise	Jun-04	Dec-15	Mar-22
Months of cycle	24	36	33

*based on current market exceptions

3. A long way back to normal: US real interest rates are at a record low



Source: Bloomberg, as of 1 February 2022.

With the US economy already close to full capacity and growth above its potential growth rate expected in 2022, the Fed is a long way from the natural rate of interest, or R* as it is commonly called.

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