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## Fed preview – a difficult decision

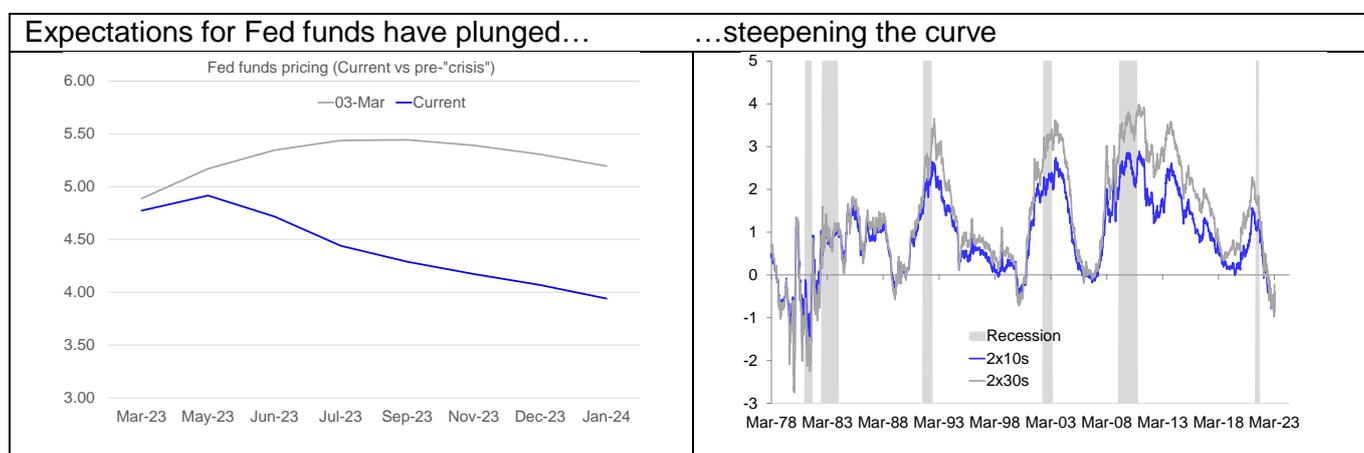
- **We expect the Fed to follow the ECB and tighten policy, albeit with a smaller 25bp hike...**
- **...with limited guidance on the policy outlook.**
- **We see Powell attempting to split financial and inflation concerns.**
- **We view the crisis as serious but not systemic, which means limited change to the policy path**

### A difficult decision...

The ructions in the US banking markets have left the Fed with a difficult decision. Inflation remains elevated, although the unfolding “crisis” has hit inflation expectations hard, especially at the short end, as oil prices decline. 2yr US inflation swap pricing has dropped from a peak of 3.0% in early March in the wake of the strong data during February, to ~2.4% this week. US inflation expectations across the curve are at a level that implies the Fed will get inflation back under control. If the current banking sector problems prove mild, the Fed will have lost the opportunity to keep its foot on the gas. This might encourage investors to believe that the Powell Put is back in action and financial conditions might loosen, with inflation expectations pushing higher. In contrast, if this is the start of “GFC 2”, then the Fed should be cutting rather than hiking. Markets are pricing in 20bp of hikes – an 80% chance of a 25bp hike. This is down from pricing in 43bp of hikes in early March, after Chair Powell hinted that he was prepared to accelerate the pace of hiking in his semi-annual testimony to Congress.

### ..but we see the Fed hiking another 25bp this week

We expect that the Fed will push ahead with a 25bp hike but it will likely be controversial and some FOMC members may vote against the move preferring to adopt a “Wait-and-see” approach. The regulatory response has been aggressive and we suspect sufficient. Central bankers are likely hoping that monetary policy can be separated from financial stability issues, as the ECB’s Lagarde attempted to do last week. This is no easy feat, especially once central banks’ balance sheets are involved in supporting financial stability. The Fed’s balance sheet has already expanded significantly since early March. Nonetheless, just because separating the financial stability mandate and the inflation mandate is difficult doesn’t mean the Fed shouldn’t try. Our baseline view is that the crisis is serious but not systemic. Regardless of whether the Fed hikes or not, we expect that Powell will play down the dots. The Fed will produce new forecasts but Powell will likely highlight the uncertainty under which these forecasts were drawn up and play down their reliability as a guide to future policy. We think the crisis may trim a little off the peak in rates and might lead to slightly earlier cuts that we had previously anticipated. However, looking at our GDP forecasts for the US economy, in the absence of the crisis, we would likely have revised them a little higher, which in turn would have implied higher inflation risks and argued for tighter policy. Thus any changes to our expectations for US growth this year will be limited.

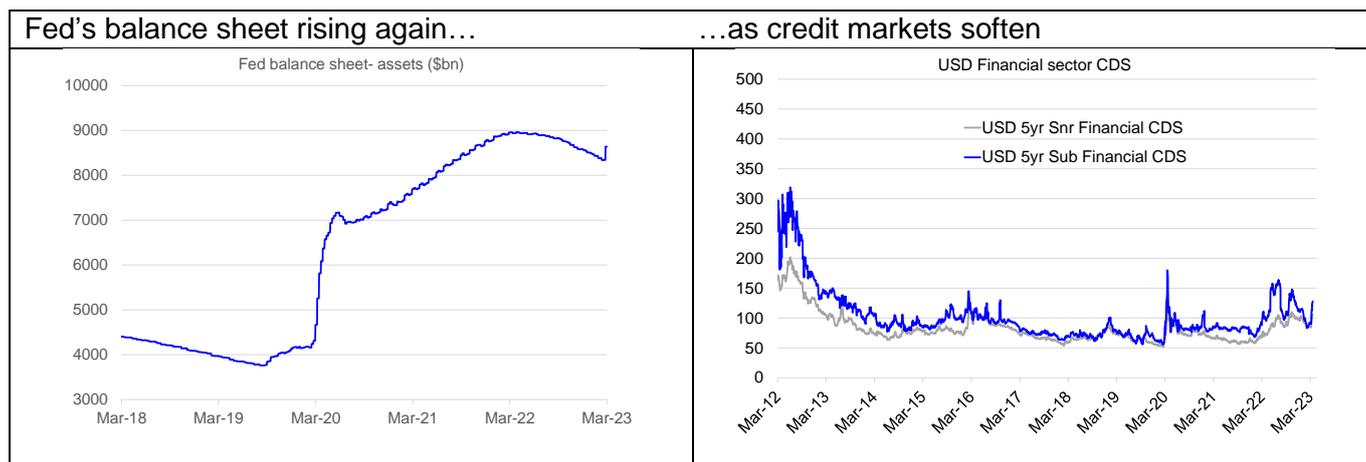


Source: Bloomberg

**Markets ahead of economists/analysts on the way down, just as they were on the way up...**

For most of 2022, markets were much better at pricing the Fed than analysts, pricing in much faster hikes. Now the market is pricing in aggressive cuts in contrast to analysts who are much more cautious. Markets are prioritising the financial stress, while analysts still see the inflation threat lingering despite recent developments.

The pricing of the Fed funds futures strip shows the first 25bp rate cut fully priced in by the July meeting. In contrast the consensus of the Bloomberg poll shows analysts upgrading their forecasts for the peak in rates from 5.0% to 5.5%, with the Fed hiking an additional 25bp in both May and June. The Bloomberg survey dates were 10~15 March, which is after SVB collapsed. That said we suspect that the later submissions will have had a lower peak, although it is not possible to check. 72% of respondents said that the failure of SVB would reduce the likelihood (or pace) of near-term hikes, while 44% said that it would reduce the policy rate peak. 21% of respondents said it would not impact the pace or the peak. None said that it would increase the peak or the pace of hikes.



Source: Bloomberg

**DXY safe haven demand hit by plunging Fed policy rate pricing.**

The market turmoil that started with the failure of SVB remains primarily a fixed income/financial sector affair to date. The S&P is down less than 3% led by financials. The VIX currently sits at 23, which is close to its one-year and five-year averages and below 30, which is traditionally seen as indicating elevated uncertainty. FX volatility remains low as well. The main beneficiary in the G10 complex is the yen, where the drop in interest rate expectations has been limited by the low initial starting point. USD/JPY is up ~ 3% so far this month. The second best performing G10 currency month to date is CHF, also a relative low yielder. Spread compression looks to have been the driving factor, with the large drop in UST yields a drag on USD, countering its safe haven appeal. NOK, AUD and CAD are the worst performers this month as souring risk appetite hits commodity prices, especially oil.

In the short run, we think that the drop in UST yields looks overdone and in the event of a reversal, the US dollar may outperform vs safe havens. However, in such a scenario the upside would be limited by the likely pick up in risk appetite. The relatively muted FX moves in the recent turmoil suggest relative muted moves as the crisis fades into the background. Consequently, our currency forecasts are little changed and we still see the greenback softening modestly through end 2023.

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