Hiking into recession

US special

RaboResearch
Global Economics & Markets
mr.rabobank.com

Philip Marey
Senior US Strategist
+31 6 138 929 58

Summary

- The FOMC realizes it is far behind the curve and is desperate to catch up. The Fed is front-loading its tightening cycle and likely to take big steps at the next couple of meetings.
- Now that the Fed is throwing caution to the wind, we expect them to hike into restrictive territory without interruption.
- While the series of negative supply shocks may not pull the US economy into recession, the Fed's late attempt to get inflation under control is likely to push the economy over the edge.
- The Fed's main policy error was to ignore the rise in inflation last year and getting blindsided. This has set in motion a wage-price spiral that will be very difficult to reverse without hiking the economy into recession.

Introduction

Recent speeches by FOMC participants and the minutes of the March meeting suggest that the Fed realizes it is far behind the curve and is desperate to catch up. The Fed is now front-loading its tightening cycle and likely to take big steps at the next couple of meetings. Therefore, we have raised our forecasts for May and June to 50 bps hikes per meeting from 25 bps. We still think that July will only see a 25 bps hike, but we no longer expect the FOMC to take a pause in September to assess the impact of both the negative supply shock from Ukraine and monetary policy tightening. Recent speeches and the minutes suggest that the FOMC is throwing caution to the wind. Therefore, we now expect that the Fed will continue to hike, albeit at a slower pace of 25 bps per meeting in the second half of the year. We summarize our rate forecasts in Table 1.

Table 1: Rabobank forecasts of target range for federal funds rate in 2022

FOMC meeting	*Size of rate hike (bps)*	*Target range (%)*
May 3-4	50	0.75-1.00
June 14-15	50	1.00-1.50
July 26-27	25	1.50-1.75
Sept 20-21	25	1.75-2.00
Nov 1-2	25	2.00-2.25
Dec 13-14	25	2.25-2.50

Source: Rabobank

This should bring the federal funds rate close to the neutral level (which the median FOMC participant thinks is 2.4%, see Table 2) by the end of the year. We expect the Fed to continue hiking beyond neutral early next year. However, as the economic outlook is deteriorating the

Fed's hiking cycle may already be too late. The recent inversions of the yield curve suggest that this hiking cycle might end prematurely and could very well be followed by another recession. In fact, we see two threats to the US economic expansion. The first is the exogenous threat from the impact of the negative supply shocks (supply chain disruptions and labor shortages), the second is the endogenous threat from the Fed's hiking cycle. We discuss them in chronological order.

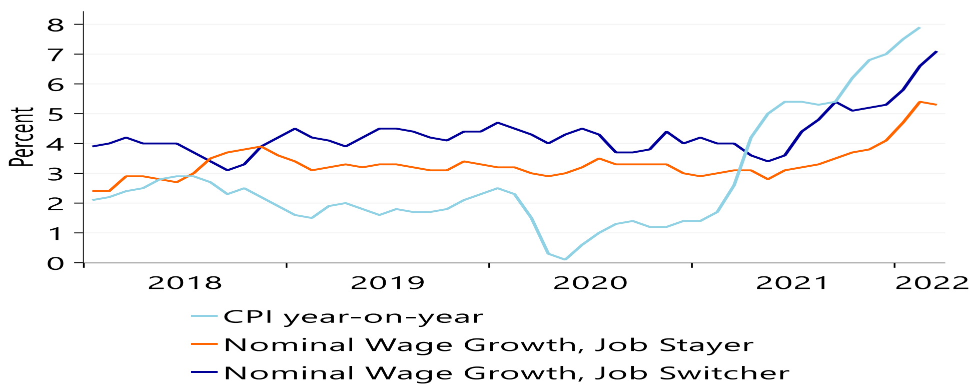
The exogenous threat to the economy

The first weak spot in US economic momentum will be in H2 when the global economy is expected to get a major hit from the Ukraine crisis. While the direct impact of the negative supply shock from the Russian invasion of Ukraine and the subsequent sanctions will be less severe for the US than for Europe, it will at least slow down the US economy. Of course, as a major oil and gas producer the US also gains from higher prices, but these gains will benefit these US producers rather than US consumers. Consequently, wealthy Americans – through their asset portfolios – are more likely to benefit than low income households. In fact, the latter will be punished heavily by higher prices. And these are also the people that are likely to run out of savings – boosted by the COVID relief checks from the Trump and Biden administrations – earlier than high income households. So yes, America is better able to deal with an oil crisis than in the 1970s, but only on aggregate. Instead of an international income transfer from the US to the Middle East, it is now a domestic income transfer from consumers to producers, and from the poor to the rich. Since this shock to the US economy is of a new variant, its effect is difficult to predict. If the impact is larger than anticipated by the Fed, the aggressive rate hikes might come at exactly the wrong time. What if low income households get squeezed by both higher prices and higher interest rates? What if higher prices erode their budgets, deplete their savings and then these households can only borrow at rates that they cannot afford? Hiking into this uncertain environment at a high pace only increases the risk that the economy is pushed into recession.

The endogenous threat to the economy

However, assuming that the US recovery survives the slowdown in the second half of this year, the Fed is likely to push the economy into recession next year. Our expectation is not just based on the Fed's current state of panic, and the inversion of the yield curve, but also on the wage-price spiral that appears to have started in the US. At this stage, slowing down the economy severely or pushing it into recession is probably the only way to terminate this process. In other words, if it is not by accident, then it will have to be by design that the Fed's monetary policy tightening causes a recession.

Figure 1: Wage-price spiral



Source: Macrobond

We discussed the formation of the wage-price spiral in the US section of our *Monthly Outlook* this month, but we repeat it here briefly. Initially, nominal wage growth continued to fall when CPI inflation started to rise in April last year. However, by June, wage growth started to rise as well. Especially, job switchers started to benefit from the tight labor market. By July, their wage growth had already risen above 4%, while wages of job stayers grew at a slower pace until December. This divergence between job switchers and job stayers supported the hypothesis that lack of bargaining power due to the secular decline in unionization rates in the US would prevent a wage-price spiral. However, in recent months, wage growth of job stayers has accelerated and stood at 5.3% in March. This is still below the 7.1% of job switchers, but already well above 4%. This suggests that the low unionization rates in the US may not prevent a wage-price spiral. In fact, 'efficiency wages' give firms a reason to accelerate wage increases in order to prevent their job stayers from becoming job switchers. In other words, unions may not be necessary to strengthen the bargaining power of workers. The fact that wage growth has spread to job stayers suggests to us that inflation has become even more persistent. Consequently, it will take restrictive monetary policy to get inflation back under control.

Conclusion

From the perspective of monetary policy, the window of opportunity for a soft landing seems to have closed. The wage-price spiral appears to have started already and terminating this now is likely to take a shallow recession. What's more, by starting late and trying to catch up, the pace of the hiking cycle that Powell seems to have in mind does not allow time for damage assessment. At the moment, it appears proponents of a pause between 'close to neutral' and 'beyond neutral' have been reduced to a minority. The Fed is trying to catch up by taking steps at every meeting. However, it is probably too late to engineer a soft landing. The Fed's main policy error was to ignore the rise in inflation last year as we feared in [Is the Fed going to be blindsided by inflation?] This has set in motion a wage-price spiral that will be very difficult to reverse without hiking the economy into recession.

Table 2: Median projections of FOMC participants (March 2022)

Variable	*2022*	*2023*	*2024*	*Longer run*
GDP growth	2.8 (4.0)	2.2 (2.2)	2.0 (2.0)	1.8 (1.8)
Unemployment	3.5 (3.5)	3.5 (3.5)	3.6 (3.5)	4.0 (4.0)
PCE inflation	4.3 (2.6)	2.7 (2.3)	2.3 (2.1)	2.0 (2.0)
Core PCE inflation	4.1 (2.7)	2.6 (2.3)	2.3 (2.1)	
Federal funds rate	1.9 (0.9)	2.8 (1.6)	2.8 (2.1)	2.4 (2.5)

Source: FOMC, March 16, 2022 (December 15, 2021)

RaboResearch
Global Economics & Markets
mr.rabobank.com

Global Head

Jan Lambregts
+44 20 7664 9669
Jan.Lambregts@Rabobank.com

Macro Strategy

Global

Michael Every
Senior Macro Strategist
Michael.Every@Rabobank.com

Europe

Elwin de Groot
Head Macro Strategy
Eurozone, ECB
+31 30 712 1322
Elwin.de.Groot@Rabobank.com

Stefan Koopman
Senior Macro Strategist
UK, Eurozone
+31 30 712 1328
Stefan.Koopman@Rabobank.com

Teeuwe Mevissen
Senior Macro Strategist
Eurozone
+31 30 712 1509
Teeuwe.Mevissen@Rabobank.com

Bas van Geffen
Senior Macro Strategist
ECB, Eurozone
+31 30 712 1046
Bas.van.Geffen@Rabobank.com

Maartje Wijffelaars
Senior Economist
Italy, Spain, Portugal, Greece
+31 88 721 8329
Maartje.Wijffelaars@Rabobank.nl

Wim Boonstra
Senior Advisor
+31 30 216 2666
Wim.Boonstra@Rabobank.nl

Americas

Philip Marey
Senior Macro Strategist
United States, Fed
+31 30 712 1437
Philip.Marey@Rabobank.com

Christian Lawrence
Senior Cross-Asset Strategist
Canada, Mexico
+1 212 808 6923
Christian.Lawrence@Rabobank.com

Mauricio Une
Senior Macro Strategist
Brazil
+55 11 5503 7347
Mauricio.Une@Rabobank.com

Gabriel Santos
Macro Strategist
Brazil
+55 11 5503 7288
Gabriel.Santos@Rabobank.com

Asia-Pacific

Wouter van Eijkelenburg
Economist
Australia, New Zealand, India, ASEAN
+31 6 103 44 147
Wouter.van.Eijkelenburg@Rabobank.nl

FX Strategy

Jane Foley
Head FX Strategy
G10 FX
+44 20 7809 4776
Jane.Foley@Rabobank.com

Christian Lawrence
Senior Cross-Asset Strategist
LatAm FX
+1 212 808 6923
Christian.Lawrence@Rabobank.com

Rates Strategy

Richard McGuire
Head Rates Strategy
+44 20 7664 9730
Richard.McGuire@Rabobank.com

Lyn Graham-Taylor
Senior Rates Strategist
+44 20 7664 9732
Lyn.Graham-Taylor@Rabobank.com

Credit Strategy & Regulation

Matt Cairns
Head Credit Strategy & Regulation
Covered Bonds, SSAs
+44 20 7664 9502
Matt.Cairns@Rabobank.com

Bas van Zanden
Senior Analyst
Pension funds, Regulation
+31 30 712 1869
Bas.van.Zanden@Rabobank.com

Paul van der Westhuizen
Senior Analyst
Financials
+31 88 721 7374
Paul.van.der.Westhuizen@Rabobank.com

Cas Bonsema
Analyst
ABS
+31 30 712 1849
Cas.Bonsema@Rabobank.com

Energy & Metals

Ryan Fitzmaurice
Strategist
+1 212 916 7874
Ryan.Fitzmaurice@Rabobank.com

Agri Commodity Markets

Carlos Mera
Head of ACMR
+44 20 7664 9512
Carlos.Mera@Rabobank.com

Michael Magdovitz
Senior Commodity Analyst
+44 20 7664 9969
Michael.Magdovitz@Rabobank.com

Andrew Rawlings
Commodity Analyst
+44 20 7664 9756
Andrew.Rawlings@Rabobank.com

Client coverage

Wholesale Corporate Clients

Martijn Sorber	Global Head	+31 30 712 3578	Martijn.Sorber@Rabobank.com
Hans Deusing	Europe	+31 30 216 9045	Hans.Deusing@Rabobank.com
Neil Williamson	North America	+1 212 808 6966	Neil.Williamson@Rabobank.com
Adam Vanderstelt	Australia, New Zealand	+61 2 8115 3102	Adam.Vanderstelt@rabobank.com
Ethan Sheng	Asia	+852 2103 2688	Ethan.Sheng@Rabobank.com
Ricardo Rosa	Brazil	+55 11 5503 7150	Ricardo.Rosa@Rabobank.com

Financial Institutions

Marcel de Bever	Short Term Interest Rates	+31 30 216 9740	Marcel.de.Bever@Rabobank.com
Henk Rozendaal	Interest Rate Derivatives	+31 30 216 9423	Henk.Rozendaal@Rabobank.com
Huib Verbeek	Bonds	+31 30 216 9612	Huib.Verbeek@Rabobank.com
Sjoerd van Peer	Solutions	+31 30 216 9072	Sjoerd.van.Peer@Rabobank.com

Capital Markets

Herald Top	Global Head of Capital Markets	+31 30 216 9501	Herald.Top@Rabobank.com
Christopher Hartofilis	Capital Markets USA	+1 212 808 6890	Christopher.Hartofilis@Rabobank.com
Ian Baggott	Capital Markets Asia	+852 2103 2629	Ian.Baggott@Rabobank.com
Willem Kröner	Global Head of Equity Capital Markets	+31 30 712 4783	Willem.Kroner@Rabobank.com
Harman Dhami	DCM Syndicate	+44 20 7664 9738	Harman.Dhami@Rabobank.com
Crispijn Kooijmans	DCM FIs & SSAs	+31 30 216 9028	Crispijn.Kooijmans@Rabobank.com
Bjorn Alink	DCM Securitisation & Covered Bonds	+31 30 216 9393	Bjorn.Alink@Rabobank.com
Othmar ter Waarbeek	DCM Corporate Bonds	+31 30 216 9022	Othmar.ter.Waarbeek@Rabobank.com
Joris Reijnders	DCM Corporate Loans	+31 30 216 9510	Joris.Reijnders@Rabobank.com
Brian Percival	DCM Leveraged Finance	+44 20 7809 3156	Brian.Percival@Rabobank.com

Disclaimer

Non Independent Research

This document is issued by Coöperatieve Rabobank U.A. incorporated in the Netherlands, trading as "Rabobank" ("Rabobank") a cooperative with excluded liability. The liability of its members is limited. Authorised by De Nederlandsche Bank in the Netherlands and regulated by the Authoriteit Financiële Markten. Rabobank London Branch (RL) is authorised by De Nederlandsche Bank, the Netherlands and the Prudential Regulation Authority, and subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. Further details are available on request. RL is registered in England and Wales under Company no. FC 11780 and under Branch No. BR002630. This document is directed exclusively to Eligible Counterparties and Professional Clients. It is not directed at Retail Clients.

This document does not purport to be impartial research and has not been prepared in accordance with legal requirements designed to promote the independence of Investment Research and is not subject to any prohibition on dealing ahead of the dissemination of Investment Research. This document does NOT purport to be an impartial assessment of the value or prospects of its subject matter and it must not be relied upon by any recipient as an impartial assessment of the value or prospects of its subject matter. No reliance may be placed by a recipient on any representations or statements made outside this document (oral or written) by any person which state or imply (or may be reasonably viewed as stating or implying) any such impartiality.

This document is for information purposes only and is not, and should not be construed as, an offer or a commitment by RL or any of its affiliates to enter into a transaction. This document does not constitute investment advice and nor is any information provided intended to offer sufficient information such that is should be relied upon for the purposes of making a decision in relation to whether to acquire any financial products. The information and opinions contained in this document have been compiled or arrived at from sources believed to be reliable, but no representation or warranty, express or implied, is made as to their accuracy, completeness or correctness.

The information contained in this document is not to be relied upon by the recipient as authoritative or taken in substitution for the exercise of judgement by any recipient. Any opinions, forecasts or estimates herein constitute a judgement of RL as at the date of this document, and there can be no assurance that future results or events will be consistent with any such opinions, forecasts or estimates. All opinions expressed in this document are subject to change without notice.

To the extent permitted by law, neither RL, nor other legal entities in the group to which it belongs accept any liability whatsoever for any direct or consequential loss howsoever arising from any use of this document or its contents or otherwise arising in connection therewith.

Insofar as permitted by applicable laws and regulations, RL or other legal entities in the group to which it belongs, their directors, officers and/or employees may have had or have a long or short position or act as a market maker and may have traded or acted as principal in the securities described within this document (or related investments) or may otherwise have conflicting interests. This may include hedging transactions carried out by RL or other legal entities in the group, and such hedging transactions may affect the value and/or liquidity of the securities described in this document. Further it may have or have had a relationship with or may provide or have provided corporate finance or other services to companies whose securities (or related investments) are described in this document. Further, internal and external publications may have been issued prior to this publication where strategies may conflict according to market conditions at the time of each publication.

This document may not be reproduced, distributed or published, in whole or in part, for any purpose, except with the prior written consent of RL. By accepting this document you agree to be bound by the foregoing restrictions. The distribution of this document in other jurisdictions may be restricted by law and recipients of this document should inform themselves about, and observe any such restrictions.

A summary of the methodology can be found on our website