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The Fed's road to inversion

US Special

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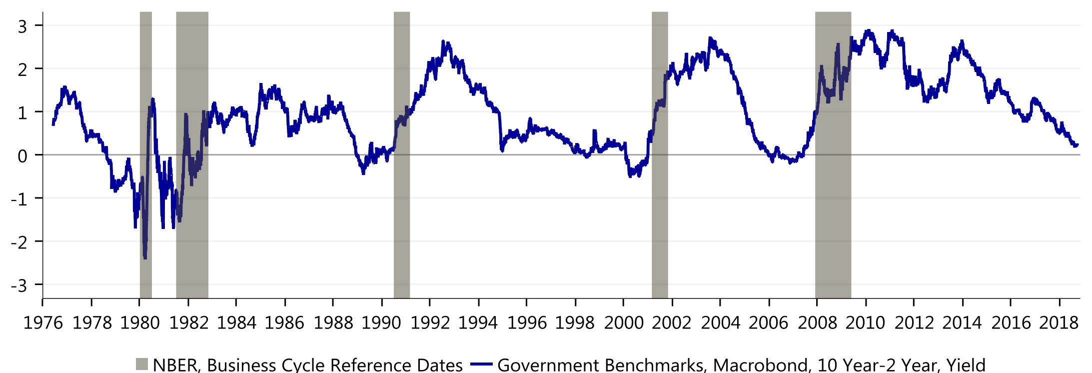
Summary

- While our earlier Fed calls reflected our expectation that the Fed would see the downside risks to the economic outlook and proceed cautiously, it appears that the FOMC has become overconfident and can now only be stopped by a major economic setback or a strong market signal.
- We think that the most likely scenario is that the FOMC will end its hiking cycle *after* the yield curve inverts in 2019.
- While the majority in the FOMC interprets inversion as a sign of monetary policy entering restrictive territory, we think that it is more likely a warning signal of a recession.

Caution to the wind

In 2015 and 2016 the Fed hiked only once each year, cautious about tightening monetary policy too early and too fast. Markets lost their confidence in the Fed's dot plot and were taken by surprise by the three rate hikes in 2017. While the Phillips curve remained invisible (or 'flat' as the believers prefer), the Fed had so much confidence in this theory that it hiked nevertheless. This year the Fed has already hiked three times and appears to be heading for a fourth in December. This despite the fact that wage growth is still below the rate that the Fed saw as a starting criterion back in early 2015. Also despite an escalating trade war between the US and China. While our earlier Fed calls reflected our expectation that the Fed would see the downside risks to the economic outlook and proceed cautiously, it appears that the FOMC has become overconfident and can now only be stopped by a major economic setback or a strong market signal. We think that the most likely scenario is that the FOMC will end its hiking cycle *after* the yield curve inverts.

Figure 1: A leading indicator (not) to be ignored?

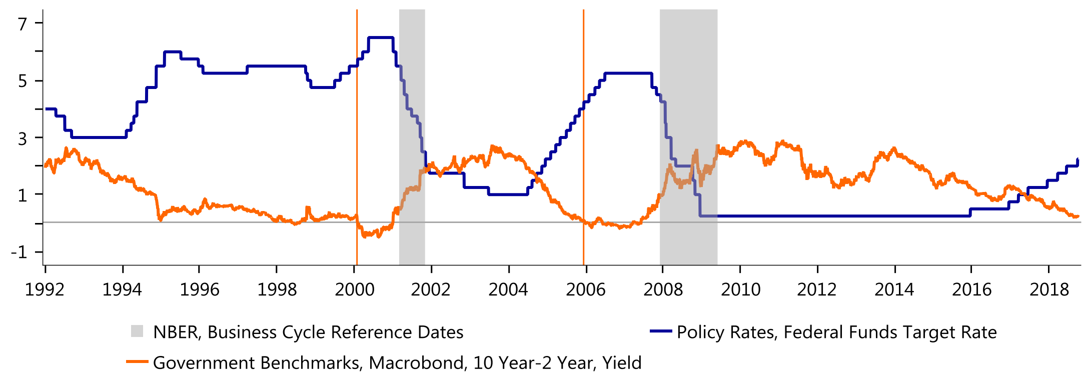


Source: Macrobond

History repeating itself

Blinded by strong coincident and lagging indicators, such as strong GDP growth and low unemployment, the Fed is dismissing an important leading indicator in the form of the yield curve, which is heading for an inversion if the Fed keeps up the pace of rate hikes. Historically, a yield curve inversion is followed by a recession in about 12-18 months. Therefore, we have been warning the Fed against inverting the yield curve. However, the majority in the FOMC appears willing to invert the yield curve, because they believe that this time is different. In their mind, an inversion would indicate that monetary policy is restrictive, not that a recession is imminent as history teaches us. So we are likely to see history repeating itself with the Fed inverting the yield curve, stopping the hiking cycle too late, causing or at least contributing to a recession.

Figure 2: History repeating itself



Source: Macrobond

What's more, if we look at the economy we should keep in mind that GDP growth in 2018 is boosted by large tax cuts. However, these effects are likely to fade in 2019 and beyond, unless we see further tax cuts. Meanwhile, the trade war with China will raise taxes on imports, raising costs for importing US firms, and undermining consumer purchasing power. At the same time, retaliation by the Chinese government will make it more difficult for US firms to export to this large market. Finally, emerging economies are feeling the pain of rising US interest rates and the rise in protectionism. This will also undermine global growth, and indirectly US growth.

Three roads to inversion

From the September projections of the FOMC participants we know that they want to hike three times in 2019, if the economy evolves as they expect. However, according to our calculations the third rate hike of 2019 would invert the yield curve in the FOMC scenario with core inflation at 2.1% by the end of 2019. In turn, that would signal a recession by early 2021 in our view. In contrast, recent statements by Fed Chair Powell and others suggest that the majority in the FOMC interprets an inversion as a sign that monetary policy is in restrictive territory, but not as a recession signal. At the same time, the FOMC projections suggest that the Fed does not want to go too far into restrictive territory. Therefore, we assume that one hike into inversion will be enough to stop the Fed. Not because the FOMC believes that a recession is on the horizon, but because they believe they have gone far enough into restrictive territory. In our view, they will have gone too far by then, raising the risk of recession above 50%. By the time we get to 2020 we expect the signs to be clear, even to the Fed. This would prevent them from carrying out their planned 2020 hike. Therefore, we would expect the third hike of 2019 to be the last in the hiking cycle in this scenario.

However, if the economy loses steam earlier than anticipated by the FOMC - which would not come as a surprise to us -, the Fed would invert the yield curve at the second hike of 2019,

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assuming that core inflation would remain at 2.0%. (Note that higher core inflation has a steepening effect on the yield curve.) This would signal a recession by late 2020.

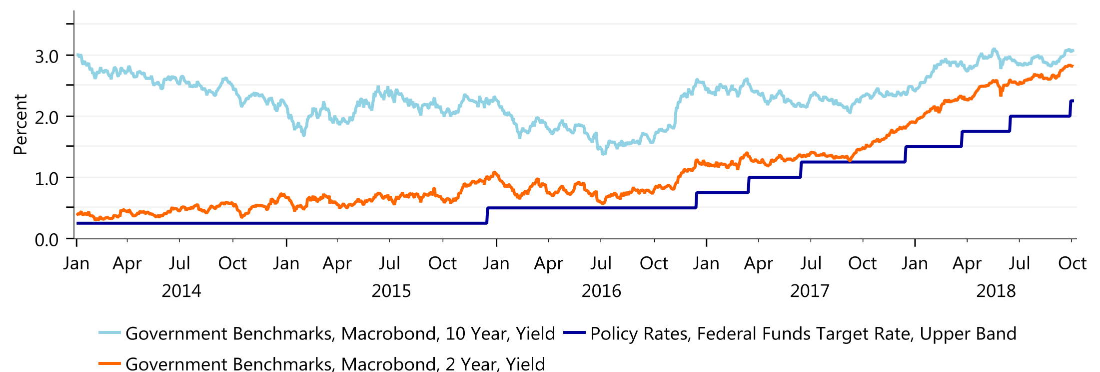
A third scenario would be a single hike by the Fed in the first quarter of 2019, which could invert the curve if core inflation drops below 2.0% again or if the global outlook depresses the longer end of the US treasury yield curve. Given our downbeat global outlook, we expect the latter to be the most likely scenario. Therefore, our baseline scenario is a single hike in March 2019, followed by an inversion of the curve (2-10 spread) in Q2. The latter would lead to a pause in the Fed's hiking cycle, because the FOMC would interpret this as a sign that monetary policy is mildly restrictive. In contrast, we think that this will be the end of the Fed's hiking cycle as recession risk becomes elevated. The inversion would signal a recession in the fall of 2020.

At present, the risk to our baseline scenario seems tilted to the upside. The yield curve may invert later than we now expect and that would also delay the end of the Fed's hiking cycle. Therefore our main risk scenario is a second hike by the Fed in June, followed by an inversion, and the end of the hiking cycle.

Conclusion

Last week we added a fourth rate hike, in December, to our Fed call for 2018. For 2019 we expect the Fed to continue hiking until *after* the yield curve inverts. Our baseline scenario is a single hike in March (previously our forecast was September), followed by inversion and the end of the hiking cycle. The risks to our baseline are tilted to the upside. If the yield curve does not invert until Q3, we expect a second and final hike in June.

Figure 3: Heading for inversion



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A summary of the methodology can be found on our website www.rabobank.com

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