

US Daily: Moving to Seven Rate Hikes in 2022 (Mericle/Hatzius)

- Following this morning's strong CPI print, we are raising our Fed forecast to include seven consecutive 25bp rate hikes at each of the remaining FOMC meetings in 2022 (vs. five hikes in 2022 previously). We continue to expect the FOMC to hike three more times at a gradual once-per-quarter pace in 2023Q1-Q3 and to reach the same terminal rate of 2.5-2.75%, but earlier.
- We see the arguments for a 50bp rate hike in March. The level of the funds rate looks inappropriate, and the combination of very high inflation, hot wage growth, and high short-term inflation expectations means that concerns about falling into a wage-price spiral deserve to be taken seriously. We could imagine the FOMC concluding that even a meaningful risk of an outcome as serious as a wage-price spiral requires a more aggressive and immediate response.
- So far, though, most Fed officials who have commented have opposed a 50bp hike in March. We therefore think that the more likely path is a longer series of 25bp hikes instead. St. Louis Fed President James Bullard became the first FOMC participant to call for a 50bp hike earlier today, and we would consider changing our forecast if other participants join him, especially if the market continues to price high odds of a 50bp move in March.

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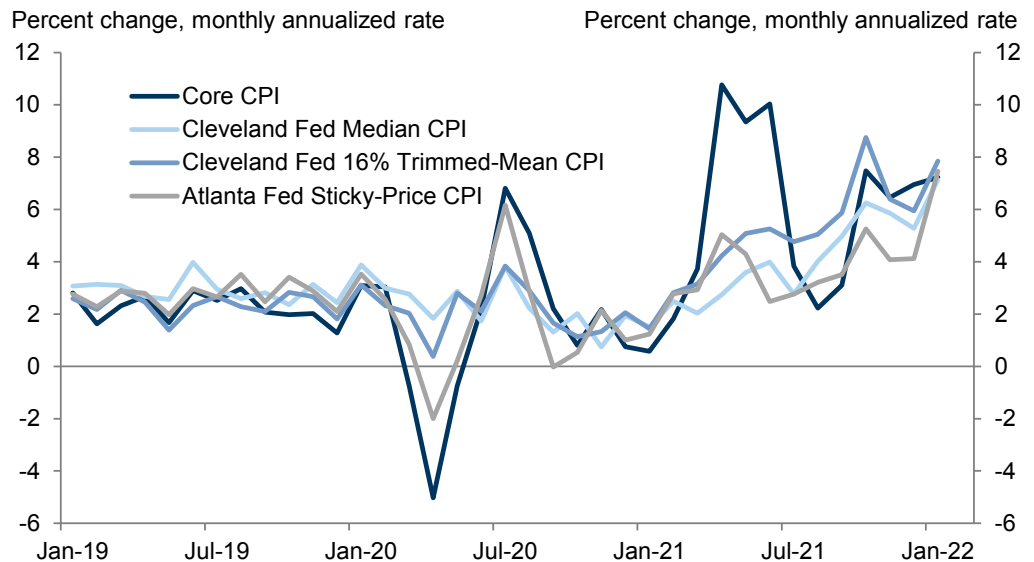
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Moving to Seven Rate Hikes in 2022

The January CPI report released this morning was very firm, with every key measure of the underlying trend running hot last month (Exhibit 1). This follows a strong average hourly earnings print in the January employment report last week that added to the evidence that wage growth is running hot too.

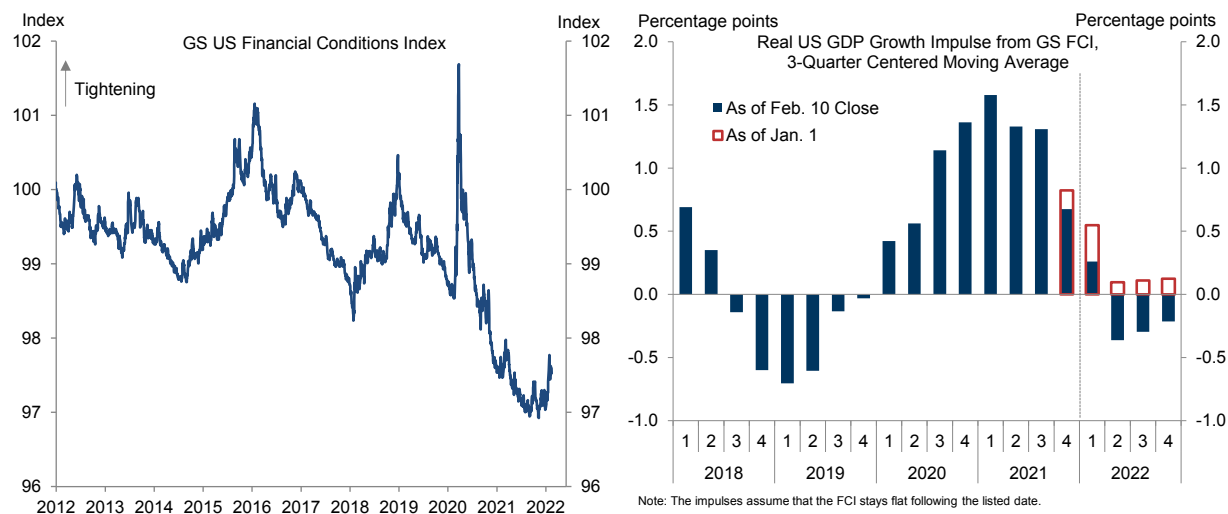
In response to the recent data, we are raising our Fed forecast to include seven consecutive 25bp rate hikes at each of the remaining FOMC meetings in 2022 (vs. five hikes in 2022 previously). This includes the June meeting, when we expect the FOMC to both hike and announce the start of balance sheet reduction. We continue to expect the FOMC to hike three more times at a more gradual once-per-quarter pace in 2023Q1-Q3 and to reach the same terminal rate of 2.5-2.75%, but earlier.

Exhibit 1: All Measures of the Underlying Inflation Trend Were Very Strong in the January CPI Report



Source: Federal Reserve, US Bureau of Labor Statistics, Goldman Sachs Global Investment Research

The bond market reacted strongly to today’s inflation news and is now pricing over six hikes this year. But financial conditions have only tightened moderately so far, and this means that the negative impulse to GDP growth is still limited (Exhibit 2). As we noted earlier this week, this suggests that more tightening is likely to be required to generate the slowdown that the economy needs.

Exhibit 2: While the Bond Market Is Now Pricing Over 6 Hikes, Financial Conditions Have Still Only Tightened Moderately


Source: Goldman Sachs Global Investment Research

Investors are debating the possibility of more aggressive responses, including a 50bp rate hike in March or even an intermeeting rate hike. The FOMC has not delivered an intermeeting hike since 1994, and it has not started a hiking cycle with a 50bp hike since the 1980s.

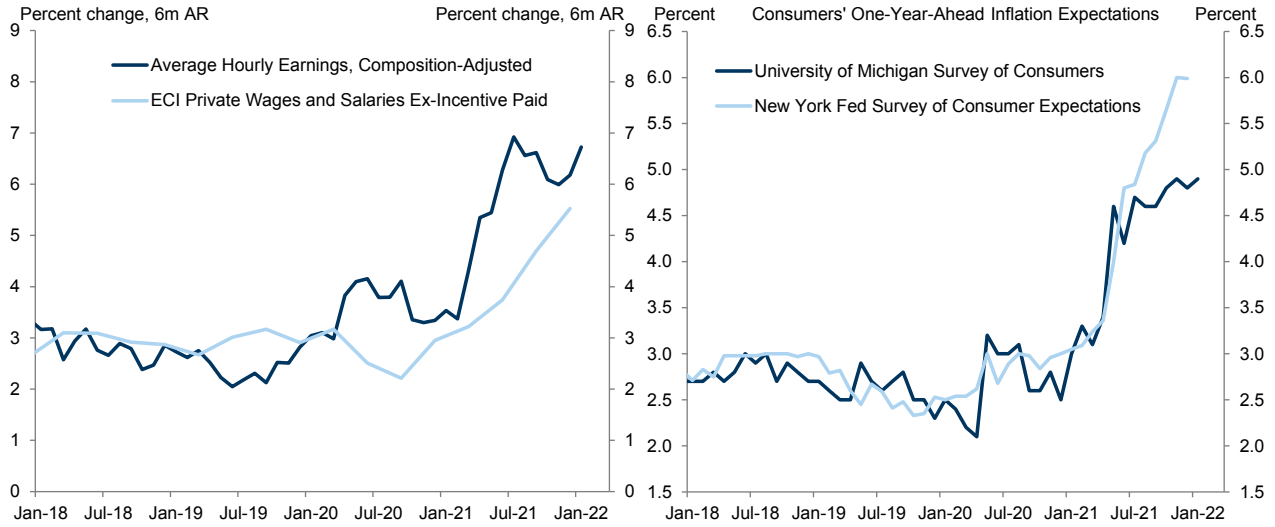
While it is not our base case, we do see the rationale for a 50bp rate hike in March. One argument is that the level of the funds rate looks inappropriately low, which might call for a quicker realignment.

Another argument is that the risk of a wage-price spiral deserves to be taken seriously. There are good reasons to think that wage and price pressures will calm down and the economy will avoid a wage-price spiral. But there is enough ambiguity to raise concern. Inflation should moderate this year as pandemic supply-demand imbalances fade and goods prices normalize, but the timing of that is uncertain, and the recent inflation trend is very firm. Employer surveys indicate that wage growth should slow to 4% this year, but the recent pace has been much higher at 6%. And long-term inflation expectations are well anchored on the 2% target, but short-term inflation expectations remain very high (Exhibit 3).

We could imagine the FOMC concluding that even a meaningful risk of an outcome as serious as a wage-price spiral requires a more aggressive and immediate response. In that case, we think a 50bp hike at the March meeting or some subsequent meeting would be more likely than an intermeeting hike.

While the risks to our forecast are tilted to the upside in the near term, we see the risks to our hiking path later in the year as tilted to the downside. This means that there are two-sided risks to the 175bp of total rate hikes that we now expect for the year as a whole.

Exhibit 3: Hot Wage Growth and High Short-Term Inflation Expectations Raise Concern About a Wage-Price Spiral



Source: US Bureau of Labor Statistics, University of Michigan, Federal Reserve, Goldman Sachs Global Investment Research

So far, most Fed officials who have commented have opposed a 50bp hike in March, including Cleveland Fed President Mester, who said yesterday, “I don’t think there’s any compelling case to start with a 50 basis point [hike]” (Exhibit 4). Our impression is therefore that most FOMC participants prefer to deliver more tightening with a longer series of 25bp hikes, rather than a 50bp move.

That said, St. Louis Fed President James Bullard became the first FOMC participant to call for a 50bp hike in March earlier today, and Governor Waller based his earlier opposition to a 50bp hike on concern about surprising the bond market, which is now pricing a 50bp hike as the base case. If other FOMC participants join Bullard and the market continues to price high odds of a larger move in March, we would consider changing our view.

Exhibit 4: So Far, Most Fed Officials Have Pushed Back Against a Possible 50bp Hike in March

Speaker	Date	Quote(s)
Barkin	10-Feb	Am I open to [a 50bps hike] conceptually? Sure, there will be times when we need to do that. Do I need there's a ... need to do it now? I think I'd have to be convinced on that.
Daly	10-Feb	[A half-point hike] is not my preference. ... Markets have already priced in the withdrawal of accommodation, and that is them hearing what the Fed is clearly communicating.
Bullard	10-Feb	I'd like to see 100 basis points in the bag by July 1. ... I was already more hawkish but I have pulled up dramatically what I think the Committee should do.
Mester	9-Feb	I don't think there's any compelling case to start with a 50 basis point [hike]. Again, we've got to be a little bit careful. Even though you can well telegraph what's coming, when you take that first action, there's going to be a reaction.
Harker	1-Feb	I would be supportive of a 25 basis point increase in March. ... Could we do 50 [basis points]? Should we? I'm a little less convinced of that right now, but we'll see how the data turns out in the next couple of weeks.
Bostic	31-Jan	For me, I'm thinking very much of a 25 basis point perspective. ... But ... we're really going to let the data show us to what extent a 50 basis point or 25 basis point move is appropriate.
Waller	13-Jan	I don't see a 50 basis point hike in March. We have not prepared markets for anything that dramatic. One of our key themes has been not to surprise markets. ... It would take a lot for us to move in that direction.

Source: Goldman Sachs Global Investment Research

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