Interest Rate Insights

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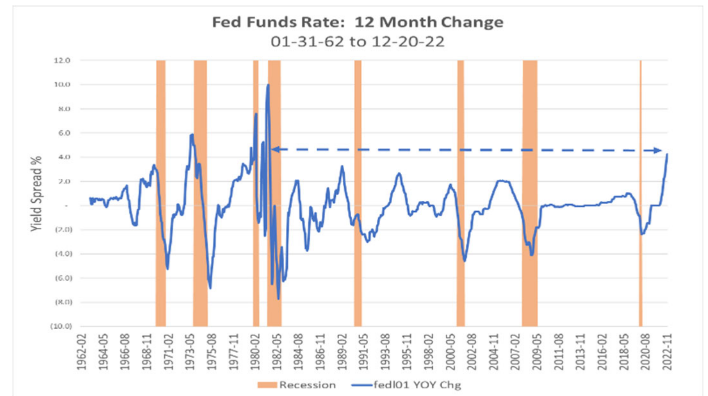
What are interest rates telling us about the prospects for a recession?

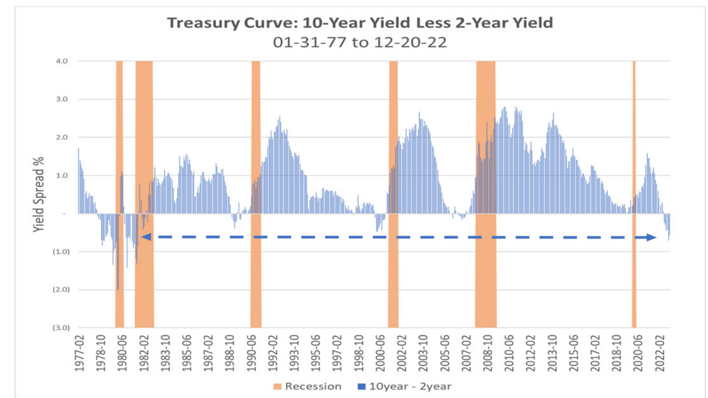
1. **The current pace of Fed tightening suggests a recession is imminent.**

   We have not seen a 12-month increase in the Fed Funds Rate of 4% or more in over 40 years. Each time the rate increased by at least 4% within the prior 12 months, we have had a recession. There were three such times. Other recessions have been precipitated with as little as a 2% 12-month increase in Fed Funds.



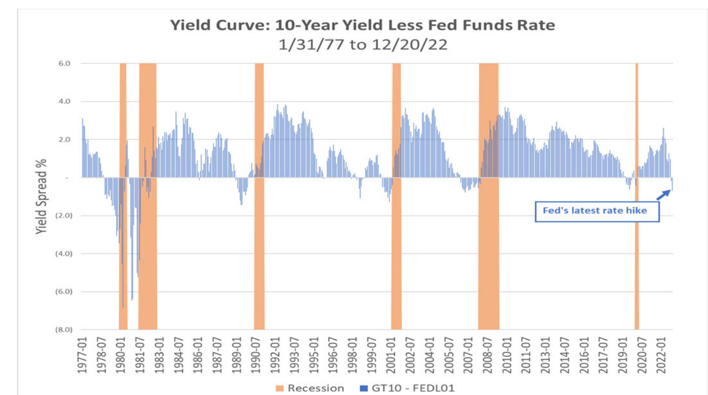
2. **The Treasury yield curve inversion also suggests a recession is likely next year.**

   Every previous Treasury yield curve inversion since 1977 has ultimately led to a recession. Generally, a recession occurs within 12 to 18 months of a sustained inversion. The severity of an inversion is tied to the severity of inflation, with the current inversion exceeded only by the inflationary seventies and early eighties.



3. **The 10-year less Fed Funds spread meaningfully inverted with the latest Fed rate hike, but this indicator needs time to mature.**

   The current level and duration of inversion of this spread has given false recession signals. However, assuming the Fed continues to tighten, it is likely the inversion of this spread will be sustained with the magnitude increasing, ultimately removing any argument for a false recession signal.



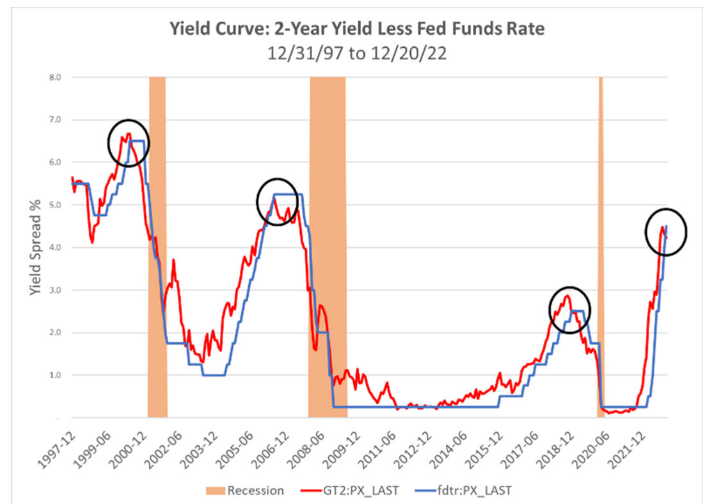
Will the Fed continue to tighten?

4. **The Federal Reserve Open Market Committee's so-called "dot plot" has the Fed Funds Rate peaking and remaining around 5.1% next year.** This is the median of the FOMC members' expectations. The market is pricing a lower peak rate of 4.9%, with small rate hikes getting us there by April/May. The Fed has said it will adjust its plan depending on how the data unfolds.

5. **The 2-year less Fed Funds spread suggests Fed tightening is over, or almost over.**

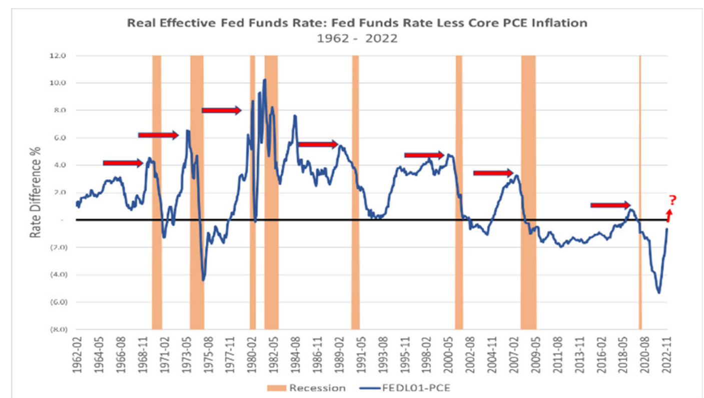
   The 2-year Treasury yield fell below the Fed Funds Rate with the last rate hike. Every tightening cycle of the past 25 years ended with 2-year yield falling below Fed Funds. So, this spread is signaling an end to Fed tightening either now, or after the next 0.5% increase, they have telegraphed. Then, the rate plateaus for a while.

   We must go back to the inflationary late 70s/early 80s to observe Fed raising Fed Funds meaningfully above 2-year Treasury yields.



6. **But… the real Fed Funds Rate is far too low.**

   - Except for the COVID era, *we have never had a recession without "peak positive" real rates well above 3%.* We are currently at a negative 0.35%.
   - The Fed's median projection is for this spread to reach 1.6% in 2023 and to stay there in 2024. This is also the average real rate over the past 60 years.
   - The Fed's expected 1.6% real rate depends on its median forecast for core PCE inflation falling to 3.5% by Q4 2023, 1.1% below the level reported today.



7. **And… for now, growth is not a concern nor an impediment to further rate hikes.**

   - Yesterday, the third revision to 3rd quarter GDP growth was reported at 3.2% annualized, and personal consumption was reported at 2.3%, both well above expectations.
   - Our Private Sector Output Index grew at more than 3% annualized for the three months ending November
   - The Atlanta Fed's "nowcast" of GDP growth estimates GDP growth at 3.7% as of today

So, for now, growth concerns are not a factor for the Fed with respect to the path for interest rates; only inflation is. While the Fed is expected to tighten by at least another 50 basis points based on their own projections, those projections depend on the core PCE inflation rate falling to 3.5% in 2023. If PCE inflation comes in hotter than the Fed expects, we should also expect the FOMC to take rates for higher and/or hold rates at a high level for longer than their current projection of 5.1% for 2023.

What are inflation expectations?

8. **The inflation data:**

▪ University of Michigan 1-year inflation expectation:	4.4%
▪ University of Michigan 5-to-10-year inflation expectation:	2.9%
▪ FOMC median 2023 core PCE inflation expectation:	3.5%
▪ FOMC median 2024 core PCE inflation expectation:	2.5%
▪ FOMC core PCE inflation target:	2.0%
▪ TIPS based 10-year average annual CPI inflation expectation:	2.2%
▪ TIPS based 5-year average annual CPI inflation expectation:	2.3%
▪ Current CPI inflation (Nov)	7.1%
▪ Current core CPI inflation (Nov)	6.1%
▪ Current PCE inflation (Nov)	5.5%
▪ Current core PCE inflation (Nov)	4.7%

9. **The inflation theories (two camps):**

- The Delayed Transitory Theory: Jerome Powell now famously used the word “transitory” to describe inflation in 2021. He has since been castigated for it and jettisoned that idea. Yet, so it seems, the market has not. Consider that the TIPS based 5-year annual inflation expectation of just 2.3% is far below the current CPI inflation rate of over 7%. If that does not say transitory, I do not know what does. Whether it is right is another question. The implication is that we will experience inflation rates below the Fed’s target of 2%. The Fed spent the past pre-COVID decade trying to sustain inflation at 2% or higher. There is a bit of cognitive dissonance here.

- The Post-COVID, Post-Putin New World Theory: The essence of this theory is demand outstripping supply, particularly with regard to labor. As the thinking goes, COVID brought forward an inevitable demographically based labor shortage that was compounded by Putin’s war. Putin’s war plus COVID caused a global rethink of supply chains leading to near-shoring and reshoring. Both words, “near-shoring” and “reshoring,” can be viewed as code for higher labor costs. Add to this structural change the massive fiscal and monetary stimulus to offset the lockdowns, and you have demand far outstripping supply. While there are nuances to debate, it is clear that the post-COVID, post-Putin new world is biased toward a higher inflation experience than the prior pre-COVID decade.

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Some Final Thoughts:

1. The markets are pricing a return to a pre-COVID low inflation regime that is unlikely to occur.
2. There is a disconnect between the Fed’s expected rate path and market pricing. The Fed’s median forecast is a 5.1% rate that will hold through the end of next year. The market is pricing a peak rate of 4.9% by June, followed by rate cuts with the Fed Funds ending the year lower than it started. Someone is going to be sorely disappointed.
3. The economy has demonstrated resilience in the face of Fed rate hikes
4. While we may be past peak inflation, we are a long way away from the Fed’s target
5. The Fed will likely cause a recession next year as it seeks to establish mastery over inflation.
6. Since a recession will be Fed induced, it can also be Fed offset. There is a belief that the Fed will recoil at rising unemployment and reverse itself. As such, the recession will be mild.
7. The Fed is not Mr. Scrooge yet. Happy Holidays to All!

Sources include Bloomberg, The Federal Reserve, and Wealthcare.

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