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RESEARCH NOTE

Hoping For the Best, Preparing For the Worst

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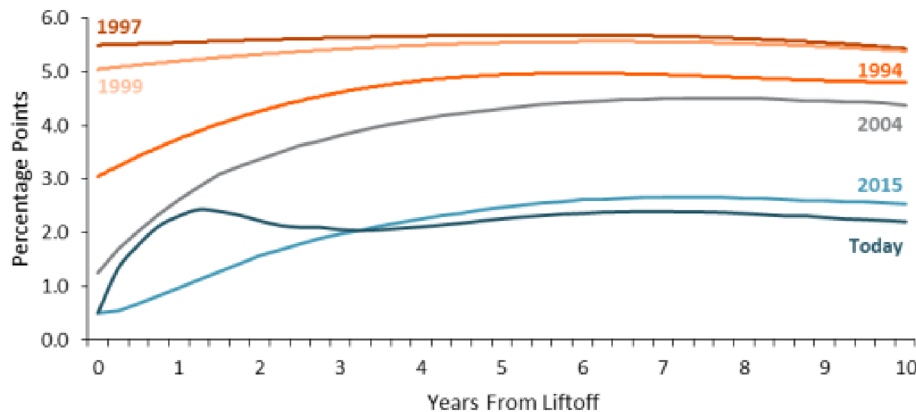
We've officially embarked on a very peculiar tightening cycle—one in which inflation is at levels more associated with the peak of the hiking cycle, and not the start. It is driven by two historical shocks affecting both supply and demand, with little precedent, if any. If markets are to be believed, this hiking cycle is setting up to be much faster than the previous ones and presents a challenging environment for market participants and policymakers alike.

The strength of both household and corporate balance sheets suggest a soft landing is still possible for the Fed, but for now, bond markets appear to be signaling a more risk-adverse scenario is in store.

MARKET EXPECTATIONS FOR THE FEDERAL FUNDS RATE IMMEDIATELY AFTER LIFTOFF



Source: As of March 22, 2022.

Bond markets normally price in a smooth path higher for the policy rate, gradually approaching the neutral rate. Market participants expect an aggressive but short hiking cycle, with rate cuts expected about a year after hiking begins.

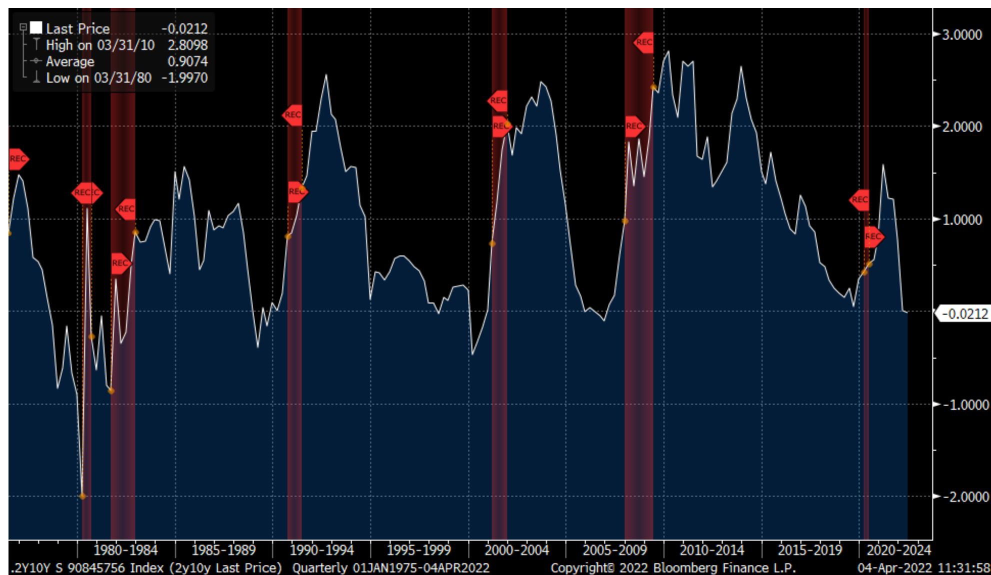
Two interpretations come to mind.

First, investors may consider that inflationary forces from the accumulated effects of the pandemic and Russia's war in Ukraine will abate over the next year, rendering tighter policy conditions unnecessary. This optimistic outcome—a monetary policy recalibration—is consistent with the Fed's belief that inflation will decline by next year. If the latest bout of inflation is mostly a supply-side phenomenon, then the Fed's rate hikes would help ensure inflation expectations remain well-anchored, adjusted to prevailing conditions, while waiting for the storm to pass.

On the other hand, it could also imply expectations for a recession sometime in 2023 or 2024. This more pessimistic scenario is one in which the Fed will need to be more aggressive and potentially overtighten, either because its credibility is put to test amid runaway inflation, or perhaps due to a policy error. Coupled with the flattening yield curve, markets could be signaling that caution is warranted as the current tightening path is bound to break something—whether it's an economic slowdown, a fall in risk assets that triggers a negative wealth event, or a loss of liquidity event, possibly associated with quantitative tightening, leading to jammed-up financial plumbing.

There is some merit to this second interpretation, as the Fed has a difficult task ahead. Wages are rising amid a tight labor market, and underlying inflationary pressures are now increasingly strong and broad-based. Importantly, this is bleeding into expectations, with longer-term consumer inflation expectations now edging higher. With the growth momentum also in the midst of downshifting as accommodative fiscal policy is unwound, risks of a hard-landing scenario are on the rise. Moreover, if constraints on the supply side take much longer to normalize, slowing demand—which risks accidentally inducing a recession—could be the only way the Fed can tame inflation.

Of course, none of this is guaranteed. With consumer spending staying firm and consumer balance sheets in decent shape, perhaps the pain threshold until demand destruction seeps in is much higher. Even this scenario is associated with some risk, however. While this could keep growth buoyant, it would also keep inflation elevated, possibly necessitating an even more aggressive hiking cycle.



Source: Bloomberg. As of April 4, 2022.

For now, the latest telltale sign from markets has been an inversion of the 2-to-10-year yield spread. On average, a sustained inversion typically precedes a recession 18 months later, albeit with great variability. However, the outlook need not be too gloomy as a soft landing remains a possibility, and current circumstances do not need to be the harbinger of a recession, necessarily. History also suggests that risk assets, like credit and equities, tend to perform in the lead up to a downturn anyway. So, depending on when a recession finally transpires, investors will be remiss to overlook whatever upside is left on the table.

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