THEMATIC

Will the Fed manage to restore price stability without a recession?

The Fed is determined to hike rates rapidly. In the short-term the US economy will be supported by the many cushions present in the economy, as a result of all the fiscal and monetary support provided during the Covid crisis. The Fed will be in a more difficult situation in 2023.

Valentine AINOUZ,
Deputy Head of Developed Markets Research

Delphine GEORGES,
Senior Fixed Income Research Strategist

The Fed signals that the inflation fight is going to get harder

The question now is what will be the pace of the slowdown in US economy

The Fed admits to being behind the curve. The Fed is determined to hike rates rapidly, as the labour market is extremely tight and inflation is stronger and more persistent than expected. Now, two questions for investors: (1) the pace of slowdown in US economic growth in a context of tighter financial conditions and (2) what trade-off would the Fed make in the case of a sharp slowdown in growth?

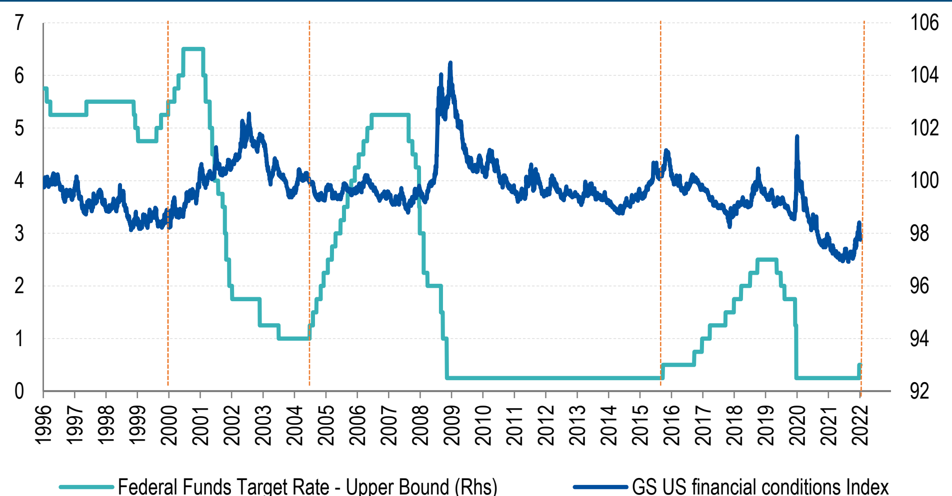
The Fed has far more reasons to act than the ECB. Inflation is a global phenomenon. Inflation is skyrocketing in the United States and the Eurozone. In February, it was close to 8% in the US and 6% in the Eurozone. The surge in prices of crude oil and other commodities will put additional upward pressure on near-term inflation. However, there are fundamental differences between the US and the Eurozone. In the Eurozone, inflation is driven mainly by energy prices. Wage growth even slowed to 1.9% year-on-year in the fourth quarter of 2021 from 2.3% in the previous period. In the United States, inflation is broader-based. Indeed, the US economy is running hot. American companies are increasing their margins, and prices are rising faster than their costs. The US labour market is extremely tight and pushing wages to grow at the fastest pace in decades.

Indeed, the March FOMC meeting was hawkish on many fronts. The Fed wants get to a neutral policy stance as rapidly as possible to move to more restrictive levels if that is what is required to restore price stability. Chair Powell was clear on its determination to do whatever it takes to bring inflation down when he said the FOMC would like to slow demand so that it is better aligned with supply and that they are aiming for less accommodative financial conditions. As a result, the Summary of Economic Projections is now showing a median terminal rate at 2.75%, above the neutral level of 2.5%. Furthermore, Powell recently reiterated his commitment to use all the tools available to achieve price stability, including 50bp moves during the coming meetings, which means that the neutral level of 2.5% could be reached in late 2022 or early 2023.

So far, demand has been supported by a strong labour market, accommodative financial conditions and the strong fiscal policy measures taken in response to the coronavirus crisis. Fed rate hikes will slow demand, the question now is what will be the pace of the slowdown in the US economy.

- The Fed is feeling comfortable in moving forward with its tightening process without putting the US economy in a recessionary-type environment. At the press conference, Powell repeated that the number of job openings far exceeds that of unemployed workers, creating the potential that the economy could cool without putting anyone out of work. The board, meanwhile, projects sub-4% unemployment through 2024, despite lots of rate increases and balance sheet runoff.
- In addition to the strength of the US labour market, the US economy will be in the short-term supported by the many cushions present in the economy, mainly as a result

1/ **Fed starts hiking as financial conditions begin to tighten**



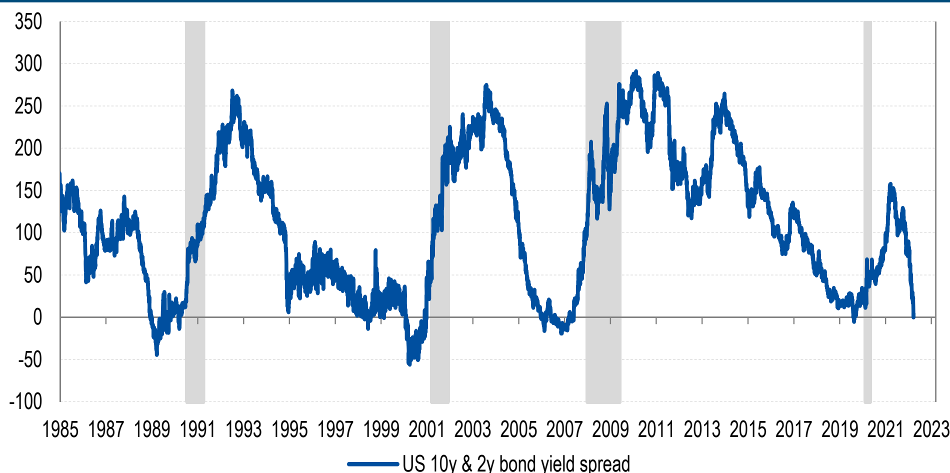
Source: Bloomberg, Amundi Institute - Data as of 15 March 2022

THEMATIC

The risk is that the Fed pushes the US economy into recession as it tries to bring inflation down

The Inversion of the curve is driven by the strong inversion of the inflation breakeven curve

2/ **2S/10S touches inversion has been good recession indicator, albeit with long lead time**



Source: Bloomberg, Amundi Institute - Data as of 1 April 2022

of all the fiscal and monetary support provided during the Covid crisis:

- for the corporate sector: higher cash holdings, higher debt duration and lower effective cost of debt than before the Covid crisis.
- for households: healthy balance sheets, large stacks of accumulated savings, and a constructive wealth effect, as housing prices and shares rose sharply from pre-pandemic levels.
- increased borrowing costs could weaken demand for homes, but with the inventory of homes for sale at a record lows, it could take time before that shift affects home prices.

• As a result, the terminal rate could rise to around 2.75%-3% above the neutral ratio, due to short-term buffers to absorb rate hikes.

• However, in the longer run, the economy's vulnerability to rising rates has increased significantly compared to past decades due to record debt levels and tight asset valuations. We will monitor closely the impact of the Fed's monetary policy tightening on financial conditions. This time is different. The Fed is starting to raise rates as financial conditions have already started to tighten.

• **The Fed will be in a more difficult situation in 2023. The trade-off between growth and inflation may be a story of H2 2023.**

• Inflation may continue to surprise on the upside in 2023, pushed up by costs. In a context of still-high inflation and a sharp slowdown in economic activity.

• Indeed, central banks have few "tools" to fight cost-driven inflation without hurting growth. Higher energy costs are already a tax on the economy. **This is where the ECB stands today.**

• The Fed could be obliged to support growth, in particular in a context of heavy indebtedness and strong investments necessary for the green transition.

Towards an inversion of the yield curve…

• A policy rate meaningfully above estimates of neutral this cycle is unlikely without long-run inflation expectations becoming meaningfully unanchored. Nevertheless, the probability that the Fed might have to deliver more hikes to bring inflation back to target remains significant and will put upward pressure on the front end of the curve. At the same time, the upside at long end of the curve will be capped by the continued strong demand and the expected slowdown in growth in 2023. In that context, the yield curve is likely to curve.

• It is worth though noting that the nature of the recent **2s10s flattening** may provide less information about future growth expectations, as it is also **driven by two factors:**

- an **inverted breakeven curve** as result of the inflation shock; the breakeven curve is pricing in a return to pre-pandemic inflation regime in the beyond-three-year range.
- an **inverted term premium curve,** as yields at the long end of the curve have been under pressure from strong demand by US banks and the Fed.

Finalised on 25 March 2022

Amundi ASSET MANAGEMENT | Institute

CROSS ASSET INVESTMENT STRATEGY

April 2022 #04

Find out more about Amundi publications

research-center.amundi.com

Emerging Private Equity Money Markets Find Monetary Policies Foreign Top-down Bottom-up Exchange Corporate Equities Forecasts Sovereign Bonds High Fixed Income Yield Real Estate ESG Quant Investment Strategies Asset Allocation

DISCLAIMER

This document is solely for informational purposes.

This document does not constitute an offer to sell, a solicitation of an offer to buy, or a recommendation of any security or any other product or service. Any securities, products, or services referenced may not be registered for sale with the relevant authority in your jurisdiction and may not be regulated or supervised by any governmental or similar authority in your jurisdiction.

Any information contained in this document may only be used for your internal use, may not be reproduced or redisseminated in any form and may not be used as a basis for or a component of any financial instruments or products or indices.

Furthermore, nothing in this document is intended to provide tax, legal, or investment advice.

Unless otherwise stated, all information contained in this document is from Amundi Asset Management SAS and is as of 31 March 2022. Diversification does not guarantee a profit or protect against a loss. This document is provided on an "as is" basis and the user of this information assumes the entire risk of any use made of this information. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The views expressed regarding market and economic trends are those of the author and not necessarily Amundi Asset Management SAS and are subject to change at any time based on market and other conditions, and there can be no assurance that countries, markets or sectors will perform as expected. These views should not be relied upon as investment advice, a security recommendation, or as an indication of trading for any Amundi product. Investment involves risks, including market, political, liquidity and currency risks.

Furthermore, in no event shall any person involved in the production of this document have any liability for any direct, indirect, special, incidental, punitive, consequential (including, without limitation, lost profits) or any other damages.

Date of first use: 1 April 2022.

Document issued by Amundi Asset Management, "société par actions simplifiée"- SAS with a capital of €1,143,615,555 - Portfolio manager regulated by the AMF under number GP04000036 – Head office: 90-93 boulevard Pasteur – 75015 Paris – France – 437 574 452 RCS Paris – www.amundi.com

Photo credit: ©MDelporte - iStock/Getty Images Plus-Ozgur Donmaz

Chief editor

BLANQUÉ Pascal, *Chairman of Amundi Institute*

Editor

DEFEND Monica, *Head of Amundi Institute*

Deputy-Editors

BLANCHET Pierre, *Head of Investment Intelligence*
BOROWSKI Didier, *Head of Global Views*

Amundi Institute contributors

AINOUZ Valentine, *Deputy Head of Developed Markets Strategy Research, CFA*
BELLAICHE Mickael, *Fixed Income and Credit Research Strategist*
BERARDI Alessia, *Head of Emerging Macro and Strategy Research*
BERTONCINI Sergio, *Senior Fixed Income Research Strategist*
BLANCHET Pierre, *Head of Investment Intelligence*
BOROWSKI Didier, *Head of Global Views*
CESARINI Federico, *Head of DM FX, Cross Asset Research Strategist*
DROZDZIK Patryk, *Senior EM Macro Strategist*
GEORGES Delphine, *Senior Fixed Income Research Strategist*
HUANG Claire, *Senior EM Macro Strategist*
MIJOT Éric, *Head of Developed Markets Strategy Research*
PORTELLI Lorenzo, *Head of Cross Asset Research*
PERRIER Tristan, *Global Views*
USARDI Annalisa, *Cross Asset Research Senior Macro Strategist*
VARTANESYAN Sosi, *Senior Sovereign Analyst*

With Amundi Investment Insights contribution

BERTINO Claudia, *Head of Amundi Investment Insights*
CARULLA Pol, *Amundi Investment Insights*
FIOROT Laura, *Deputy Head of Amundi Investment Insights*
DHINGRA Ujjwal, *Amundi Investment Insights*
PANELLI Francesca, *Amundi Investment Insights*

Conception & production

BERGER Pia
PONCET Benoit