Fed Watch

# A larger 75 bps hike is now likely: markets have almost fully priced in that outcome[1]

Javier Amador / Iván Fernández

**June 14, 2022**

## We now expect more rate hike front-loading as the FOMC turns more hawkish following persistently high inflation

- **During the intermeeting period and before Fed officials began their blackout period on June 4, they continued to signal that a series of 50 bps hikes were coming and that it was unlikely that the Fed would be taking a break from its current rate hiking cycle anytime soon.** The forward guidance was clear: the Fed would hike the policy rate by 50 bps in June and July and a pause after that was unlikely. Hikes would continue until inflation showed clear signs of easing. Vice-Chair Brainard said in an interview that "[it was] very hard to see the case" for the Fed pausing rate hikes after implementing two more 50 bps hikes. The idea was that the Fed was going to be nimble and rates were going to increase "expeditiously" at least until they reached the neutral level. However, to anchor inflation expectations and keep some flexibility, Fed officials also signaled that the Fed was "prepared to do more" if inflation data came in worse than expected. Vice-Chair Brainard said that they were "certainly going to do what [was] necessary to bring inflation back down" while Chair Powell said that the Fed needed to see "clear and convincing evidence that inflation pressures [were] abating and inflation [was] coming down" and hinted that otherwise, larger hikes were possible, saying that "[if FOMC members don't see that], then we'll have to consider moving more aggressively" (Table 1).

- **What changed? Consumer prices surged in May.** Headline CPI was up 1.0% MoM, reaching 8.6% YoY, a fresh four-decade high (the highest since December 1981), while the annual core inflation rate eased less than expected (to 6.0% YoY) after also rising strongly in May (0.6% MoM sa). Both prints were above consensus expectations of 0.7 and 0.5%, respectively. Expectations of signals that inflation had peaked in March were not met, and while long-term inflation expectations remain anchored -some measures are somewhat below the level they were when the Fed hiked the fed funds rate by 50 bps on May 4[2]-, market-based expectations have steadily increased during 2022. Besides, survey-based short- and mid-term inflation expectations remain very high. The Fed might acknowledge that the longer inflation runs above their goal, the higher the risk that long-term inflation expectations will become unanchored, thereby making the return to price stability much more costly.

- **What else changed? A report from the WSJ (see) seems to hint that the Fed is ready to hike 75 bps tomorrow.** Even after the hot CPI reading, most analysts, us among them, still thought that the Fed would not surprise the markets with a larger-than-expected 75 bps interest rate increase. Moreover, although markets had priced in about ⅓ odds probability of a 75 bps increase (35% at yesterday's close, just before the WSJ was released), the odds seemed to be well below 50% until a report from the WSJ suggested that the Fed could surprise the markets with a larger 75 bps rate hike. Markets have almost fully priced in that outcome (Figure 1),

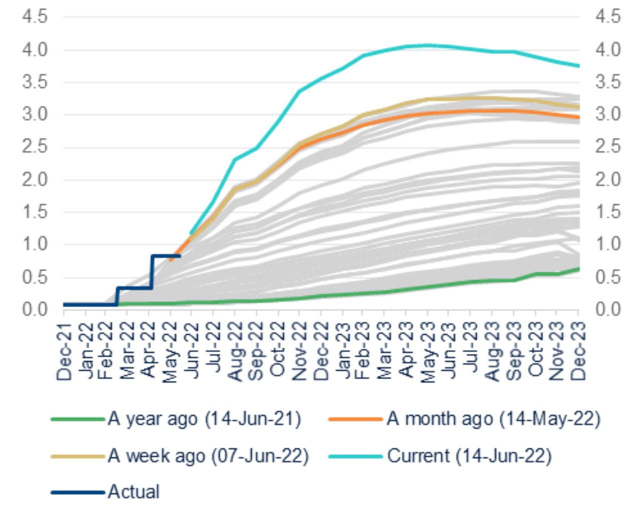
[1] At the time of writing this note, the federal funds rate futures market assigns an 95.8% probability of a 75 bps rate hike tomorrow.
[2] On May 4, the 5-10 years ahead TIPS inflation compensation was 2.48% and last Monday it stood at 2.39%.

and many analysts, among them some of the most prominent from Goldman Sachs and JP Morgan, changed their call as the WSJ article was read as a hint from the Fed that a larger hike was coming. Other economists are sticking with the half-percentage-point hike (see). The change was so abrupt that now a 50 bps hike would be the surprise. We now expect the Fed to take advantage of this sharp change in expectations to more aggressively front-load rate hikes until inflation starts to show clear signs of easing.

- **Along with its monetary policy decision, the Fed will also release updated economic projections by meeting participants, including their assessment for the appropriate fed funds rate for each year from 2022 to 2024 and over the long run.** Last March, the Fed penciled in a fed funds rate in the 1.75-2.00% range by the end of this year, followed by a 2.75% terminal rate by 2023 and 2024 before returning to a 2.5% longer-run level. With a 75 bps hike now likely this month, the Fed will be very close to the 1.75-2.00% range. This implies that the median participant will likely signal a much tighter policy path for this year and for 2023. While the March dot plot showed significant dispersion on the terminal fed funds rate reached by 2023, ranging from a minimum of 2.1% to a maximum of 3.6%, our view is that this month's dot plot will show more consensus among meeting participants which will likely be reflected in several "dots" coming together in the 3.00%-4.00% range, which would be close with the sharp moves seen recently in futures market. That is, the dot plot will likely signal more rate hike front-loading and a higher terminal rate.

**A report from the WSJ seems to hint that the Fed is ready to hike 75 bps tomorrow**

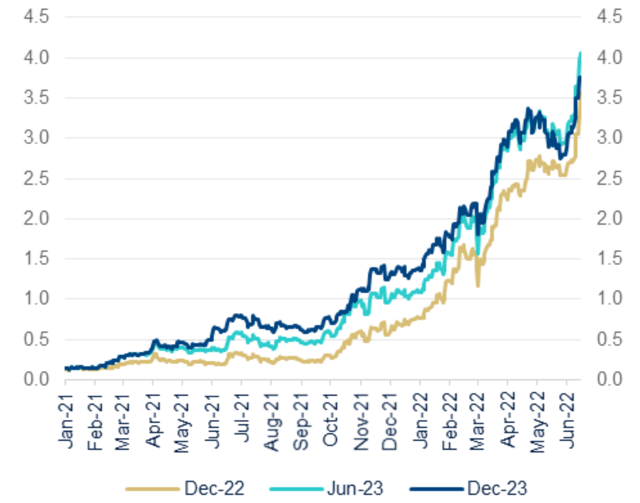
Figure 1. **IMPLIED RATE IN 30-DAY FED FUNDS FUTURES** (DAILY DATA, %)




The gray lines indicate weekly implied rate paths from a year ago.
Source: BBVA Research based on data by Bloomberg.

**Markets have almost fully priced in that outcome; now a 50 bps hike would be the surprise**

Figure 2. **IMPLIED RATE IN 30-DAY FED FUNDS FUTURES** (DAILY DATA, %)




Source: BBVA Research based on data by Bloomberg.

## The forward guidance was clear: the Fed would hike the policy rate by 50 bps in June and July and a pause after that was unlikely; hikes would continue until inflation showed clear signs of easing

Table 1. **RELEVANT REMARKS FROM FOMC VOTING MEMBERS**

| Relevant remarks on the path of monetary policy |
| --- |
| **Jerome Powell (Board, Chair).** In a radio interview (see), Powell noted that the ongoing process of getting inflation down to its target rate will "include some pain", as the main goal is to avoid inflation becoming entrenched at high levels. He reiterated the Fed's challenging goal is still to achieve a soft landing, which won't be easy. Similar to what Powell said in May's meeting press conference, he signaled the likely scenario of two additional 50 bps hikes for June and July meetings, highlighting that if inflation comes in worse than expected, the Fed is "prepared to do more". At that time, he noted that a 75 basis point increase was not something the Committee was actively considering. During his virtual participation in an event hosted by the Wall Street Journal (see), Powell further highlighted the optimistic chances of the economy being well-positioned to withstand less accommodative monetary policy. Yet, importantly, he noted that the Fed needed to see "clear and convincing evidence that inflation pressures are abating and inflation is coming down" and hinted that otherwise, larger hikes were possible, saying that "[if FOMC members don't see that], then we'll have to consider moving more aggressively". |
| **John Williams (New York, Vice Chair).** During a speech delivered at a NABE symposium in Germany (see), Williams offered three reasons for the high inflation environment: 1) the pandemic-related recomposition of spending towards durable goods and housing, 2) the imbalance in the labor market, where overall demand far exceeds supply, and 3) the constrained global supply of goods and commodities due to the war in Ukraine and lockdowns in China. He pointed out that while the Fed's monetary policy actions will only cool the demand side of the equation, some of the rebalancing will also be accomplished through eventual supply-side relief. Williams stressed his view on the need for the FOMC to move expeditiously the fed funds rate back to more normal levels as financial conditions keep tightening through effective communication. |
| **Lael Brainard (Board).** Brainard offered some remarks at Johns Hopkins University (see), where she noted that high inflation was the Fed's most pressing challenge, and that strong actions were being taken to bring it back down. Brainard later commented to the media (see) that it was "very hard to see the case" for the Fed pausing rate hikes and that they were "certainly going to do what [was] necessary to bring inflation back down". |
| **Christopher Waller (Board).** Waller offered a speech at the Hoover Institution (see), where he stressed the fact that financial conditions have been tightening since late-2021. During a speech delivered at the Goethe University in Germany (see), Waller explained that both bottlenecks and a shortage of workers are currently the main drivers of high inflation. He emphasized that the FOMC is committed to doing "what it takes" to bring inflation down to avoid inflation expectations becoming unanchored. Waller noted that he won't take 50 bps hikes off the table until signs are that inflation is coming down and that he is "prepared to do more" if the data suggest that inflation is stubbornly high. He noted his optimism that policy tightening can tame inflation without causing a sharp increase in unemployment based on the current relationship between vacancies and unemployment. |
| **Loretta Mester (Cleveland, 2022 voter).** In a video interview (see), Mester pointed out to be comfortable with 50 bps hikes at the Fed's next two meetings, and that she did not favor larger increments. Mester also offered a speech at an event hosted by the Federal Reserve Bank of Atlanta (see), where she addressed issues related to the balance sheet runoff, pointing out that MBS sales would eventually be considered. She also noted that the appropriate level of reserves remains uncertain. Then during a panel discussion hosted by the ECB (see), Mester recognized that it will likely take some time for the "unacceptably high inflation" to reach the Fed's longer-run goal as several of its drivers are supply-side factors. She stressed that she will need to see several months of sustained downward monthly readings of inflation before concluding it has peaked. Similar remarks were offered in a panel discussion hosted by the Philadelphia Council for Business Economics (see), where she reiterated her expectations to raise the policy rate another 50 bps at each of the next two meetings. |
| **James Bullard (St. Louis, 2022 voter).** Noting that inflation is "exceptionally high", Bullard delivered his well known "Is the Fed behind the curve?" presentation at Stanford University (see). Bullard later commented to the media (see, see, see) that, in his opinion, the probability of a recession is not particularly elevated at this time, and that while a 75 bps move was not his base case, he noted that he has been advocating a policy rate of 3.5% by the end of the year. During a panel discussion hosted by the Energy Infrastructure Council (see), Bullard pointed out that the balance sheet reduction should put upward pressure on the longer end of the yield curve, adding that some of that has already occurred as the 10-year Treasury yield and 30-year mortgage rate are up substantially. Finally, Bullard offered a presentation during a virtual event hosted by the Economic Club of Memphis (see), where he added that US inflation expectations could become unmoored without credible Fed action, possibly leading to a new regime of high inflation and volatile real economic performance. |
| **Esther George (Kansas City, 2022 voter).** During a video interview (see), George commented she didn't see the need for bigger rate hikes, such as a 75 bps increase that some have suggested. Later at an event hosted by the Federal Reserve Bank of Kansas City (see), George argued that a possibility for the recent inflation environment is that the pandemic has resulted in persistent damage to the productive capacity of the economy, which could be manifested along a number of dimensions: 1) persistent damage to global supply chains, 2) the quick destruction of capacity in the services sector, and 3) long-lasting damage to workforce engagement and labor force participation. On the path of monetary policy, she expected further rate increases could put the federal funds rate in the neighborhood of 2 percent by August. |
| **Patrick Harker (Philadelphia, 2022 alternate voter for Boston and 2023 voter).** Highlighting that inflation is an "urgent problem", Harker offered a speech at the Mid-Size Bank Coalition of America (see), where he explained that inflation is currently driven by supply (COVID-19 lockdowns, shortages, bottlenecks, Government policies on global trade tariffs, sanctions, and immigration) and demand factors (fiscal and monetary policy). He noted that the current tightening process began last September before the Fed started to move the federal funds rate or taper its asset purchases. Harker also expected two additional 50 bps hikes in June and July. |

Source: BBVA Research.

## DISCLAIMER

The present document does not constitute an “Investment Recommendation”, as defined in Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse (“MAR”). In particular, this document does not constitute “Investment Research” nor “Marketing Material”, for the purposes of article 36 of the Regulation (EU) 2017/565 of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive (MIFID II).

Readers should be aware that under no circumstances should they base their investment decisions on the information contained in this document. Those persons or entities offering investment products to these potential investors are legally required to provide the information needed for them to take an appropriate investment decision.

This document has been prepared by BBVA Research Department. It is provided for information purposes only and expresses data or opinions regarding the date of issue of the report, prepared by BBVA or obtained from or based on sources we consider to be reliable, and have not been independently verified by BBVA. Therefore, BBVA offers no warranty, either express or implicit, regarding its accuracy, integrity or correctness.

This document and its contents are subject to changes without prior notice depending on variables such as the economic context or market fluctuations. BBVA is not responsible for updating these contents or for giving notice of such changes.

BBVA accepts no liability for any loss, direct or indirect, that may result from the use of this document or its contents.

This document and its contents do not constitute an offer, invitation or solicitation to purchase, divest or enter into any interest in financial assets or instruments. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.