Traders Move To The Fed: End-2023 Policy Rate Expectations Back At 5%

Higher for longer prospects are rising

June 1, 2023

This report does not constitute a rating action

Interest rate traders and the Fed have been in a tug of war this hiking cycle, including so far this year. Markets (traders) have consistently underpriced Fed rate moves perhaps believing that inflation would be less persistent or that Fed would cut rates at the first sign of market trouble: the much discussed "Fed put". Since the recent US data flow continues to generate positive surprises, we appear to be back in a world of rising rate hike expectations. Importantly, the prospect of higher for longer rates is rising.

To analyze this issue, we used data from the CME Fed Watch Tool, the source for all data in this blog. Specifically, we focus on interest rate traders' expectations of the Fed Funds rate at the December 13 FOMC meeting this year. We tell this story using two lenses.

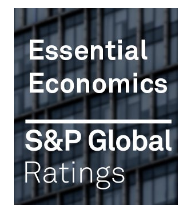
Weighted Average Rate Expectations Regain The 5% Threshold

2023 has been an up and down and up again year for Fed Funds rate expectations. The trend has been punctuated by the market turbulence around the collapse of Silicon Valley Bank in early March. We plotted the daily weighted average of traders' expectations for the outcome of the December 2023 FOMC meeting in Chart 1.

As of late May, interest rate traders now see the Fed Funds rate at 5% at end year. While this is less than the peak of 5.62% on March 9, it is up by over 100 basis points from a 2023 low of 3.88% just one week later. The narrative in mid-March in the midst of the SVB turbulence was that the Fed would need to pause its rate hikes – or even cut rates – in order to preserve financial stability. We wrote then that this was a false trade off. We argued that the Fed has the instruments to both support financial stability (for example through its discount window and ad hoc facilities such as the Bank Term Funding Program. In the event, the Fed raised its policy rate by 25 basis points following its March 22 and May 3 meetings.

Contacts

Paul F. Gruenwald
New York
paul.gruenwald
@spglobal.com

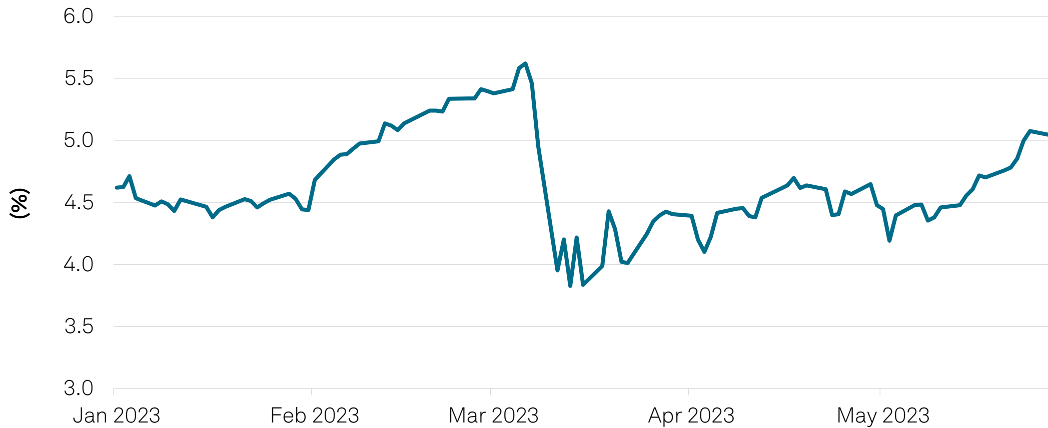


Follow us on LinkedIn and subscribe

Chart 1

Federal funds rate expectations for December 2023

Probability weighted daily average



Source: S&P Global Ratings.

The Fed has been clear in its view that rates may need to stay higher for longer to bring inflation back to the 2% target over the medium term. Indeed, core PCE inflation – its preferred measure – remains sticky and stands at 4.7% in April. This has been driven by developments in wages and services. Moreover, continued upside data surprises have resulted in rate cut expectations later in the year being taken off the table.

Distribution Of End-Year Fed Funds Expectations Shifting Outward

An alternative lens on rising rate Fed Funds rate expectations for December 2023 is the distribution of outcomes expected by traders. This is shown in Chart 2, which uses the latest available data point (May 26) and the corresponding trading day for each previous month this year.

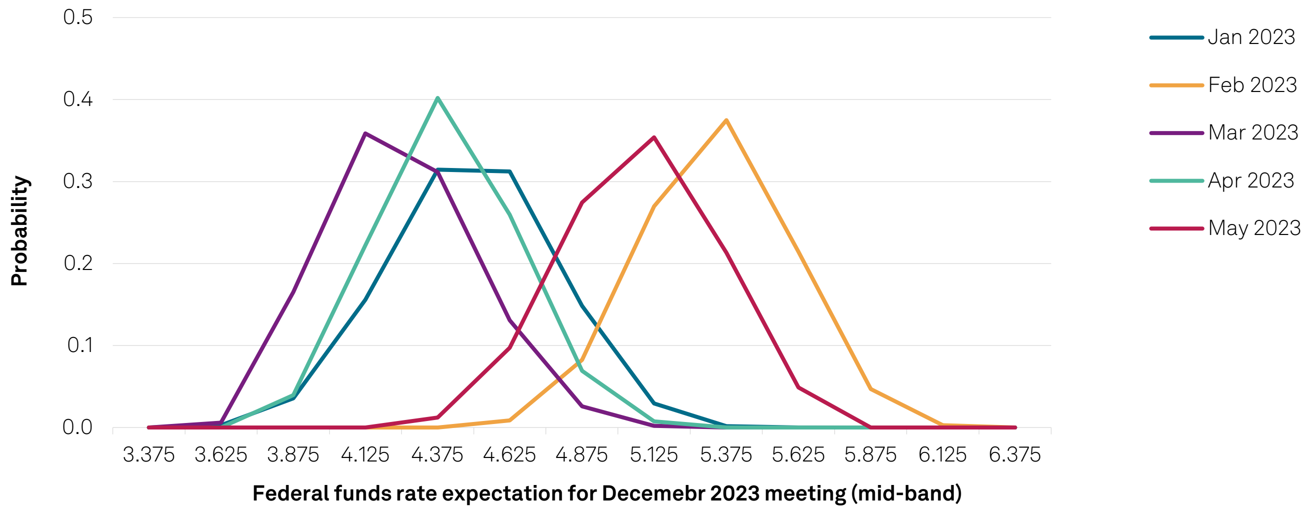
The distributions add a dimension to the weighted average line plotted in Chart 1. First, the shift from April to May is roughly equivalent to the shift from January to February, albeit with differing starting positions. Second, the leftward shift from February to March by roughly 150 basis points is striking.

The fact that current rate expectations are not back to February's levels warrants investigation. The difference stems from the notion that, following the SVB fallout, the Fed can do less tightening because the banks, through more stringent lending standards, will do more. This was particularly seen to be true for smaller and more regional banks, where lending to labor-intensive firms and commercial real estate is more prevalent. While there was some evidence of this in the Fed's latest Senior Load Officer Survey, the case was not a slam dunk. To the extent that banks do less tightening than expected, the Fed will need to do more. That is, policy rates will need to go higher.

Chart 2

Federal funds rate expectations for December 2023

Distributions on 26th/27th of each month of this year



Source: S&P Global Ratings.

Risk Of Higher For Longer Is Rising

What's the bottom line? Our view is that the Fed has been making progress in convincing the market that it is serious about keeping rates higher for longer in order to bring inflation back to target. The (inter-related) combination of successive upside surprises to output, a robust labor market and sticky inflation have bolstered the view that inflation may not come down as quickly as previously thought.

The S&P Global Ratings economics team along with our credit research colleagues intends to explore the implications of higher for longer in our upcoming Credit Conditions forecast round. We aim to publish those reports in the final week of June.

Copyright © 2023 by Standard & Poor’s Financial Services LLC. All rights reserved.

No content (including ratings, credit-related analyses and data, valuations, model, software or other application or output therefrom) or any part thereof (Content) may be modified, reverse engineered, reproduced or distributed in any form by any means, or stored in a database or retrieval system, without the prior written permission of Standard & Poor's Financial Services LLC or its affiliates (collectively, S&P). The Content shall not be used for any unlawful or unauthorized purposes. S&P and any third-party providers, as well as their directors, officers, shareholders, employees or agents (collectively S&P Parties) do not guarantee the accuracy, completeness, timeliness or availability of the Content. S&P Parties are not responsible for any errors or omissions (negligent or otherwise), regardless of the cause, for the results obtained from the use of the Content, or for the security or maintenance of any data input by the user. The Content is provided on an "as is" basis. S&P PARTIES DISCLAIM ANY AND ALL EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE, FREEDOM FROM BUGS, SOFTWARE ERRORS OR DEFECTS, THAT THE CONTENT'S FUNCTIONING WILL BE UNINTERRUPTED, OR THAT THE CONTENT WILL OPERATE WITH ANY SOFTWARE OR HARDWARE CONFIGURATION. In no event shall S&P Parties be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs or losses caused by negligence) in connection with any use of the Content even if advised of the possibility of such damages.

Credit-related and other analyses, including ratings, and statements in the Content are statements of opinion as of the date they are expressed and not statements of fact. S&P's opinions, analyses, and rating acknowledgment decisions (described below) are not recommendations to purchase, hold, or sell any securities or to make any investment decisions, and do not address the suitability of any security. S&P assumes no obligation to update the Content following publication in any form or format. The Content should not be relied on and is not a substitute for the skill, judgment and experience of the user, its management, employees, advisors and/or clients when making investment and other business decisions. S&P does not act as a fiduciary or an investment advisor except where registered as such. While S&P has obtained information from sources it believes to be reliable, S&P does not perform an audit and undertakes no duty of due diligence or independent verification of any information it receives. Rating-related publications may be published for a variety of reasons that are not necessarily dependent on action by rating committees, including, but not limited to, the publication of a periodic update on a credit rating and related analyses.

To the extent that regulatory authorities allow a rating agency to acknowledge in one jurisdiction a rating issued in another jurisdiction for certain regulatory purposes, S&P reserves the right to assign, withdraw, or suspend such acknowledgement at any time and in its sole discretion. S&P Parties disclaim any duty whatsoever arising out of the assignment, withdrawal, or suspension of an acknowledgment as well as any liability for any damage alleged to have been suffered on account thereof.

S&P keeps certain activities of its business units separate from each other in order to preserve the independence and objectivity of their respective activities. As a result, certain business units of S&P may have information that is not available to other S&P business units. S&P has established policies and procedures to maintain the confidentiality of certain nonpublic information received in connection with each analytical process.

S&P may receive compensation for its ratings and certain analyses, normally from issuers or underwriters of securities or from obligors. S&P reserves the right to disseminate its opinions and analyses. S&P's public ratings and analyses are made available on its Web sites, www.standardandpoors.com (free of charge), and www.spcapitaliq.com (subscription) and may be distributed through other means, including via S&P publications and third-party redistributors. Additional information about our ratings fees is available at www.standardandpoors.com/usratingsfees.

Australia: S&P Global Ratings Australia Pty Ltd holds Australian financial services license number 337565 under the Corporations Act 2001. S&P Global Ratings' credit ratings and related research are not intended for and must not be distributed to any person in Australia other than a wholesale client (as defined in Chapter 7 of the Corporations Act).

STANDARD & POOR'S, S&P and RATINGSDIRECT are registered trademarks of Standard & Poor's Financial Services LLC.