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MACRO STRATEGY

A Cutting History: 2023 in Context

Key Takeaways

We continue to expect **Fed Funds rate cuts in 2023**, despite markets lowering their rate cuts expectations.

We believe it relatively unlikely that the Fed will be able to maintain high rates for a long time. Moreover, the higher they hike over the next few quarters, the more likely they will have to cut in 2023.

The Volcker Fed Also Cut Rates

Historically, the average length the Fed has held monetary policy at a high and constant rate has been approximately **half a year**, with some hiking episodes reversed nearly immediately.

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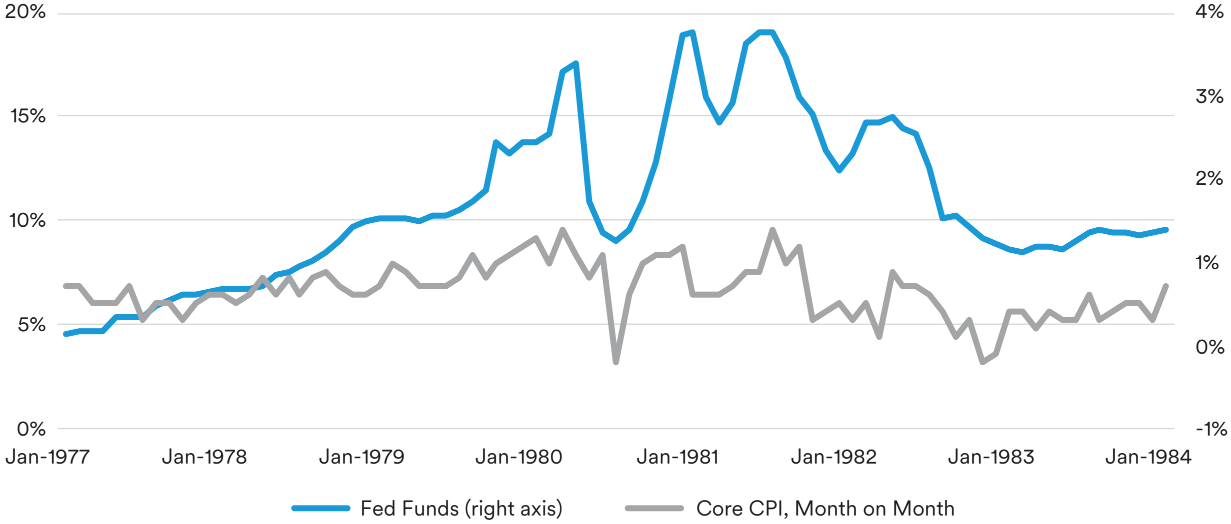
Figure 1 | Fed Funds and Inflation During the Volcker Fed



Source: Federal Reserve, Bureau of Labor Statistics, Hover, MIM

The starkest example was the much-vaunted Volcker Fed, which crushed the stagflation episode with sharp increases to the target federal funds rate range. From Paul Volcker's first month as Federal Reserve Chairman in August 1979 through April 1980, Chair Volcker presided over eight percentage points of tightening, to 17.61%. After that, there was a substantial period of policy volatility. **The Fed began easing monetary policy in earnest when month-on-month inflation was still at the extraordinarily high rate of 0.9% month over month (11% annualized)** in June 1981. Ultimately, the Volcker Fed never maintained high rates but switched almost immediately from hiking to cutting.

Markets Expect the Fed to be Able to Hold the Line

After the Federal Open Market Committee (FOMC) meeting, the markets effectively expected no net change in the Fed Funds rate between year-end 2022 and year-end 2023. This includes about 29 bps of hikes in Q1 2023 and a 25 bp cut sometime during the last three quarters of 2023.

Figure 2 | Fed Funds Forecast Based on Fed Funds Futures

Date	Dec 2022	Dec 2023	Change	Peak (date)	Cuts from peak
Pre-FOMC (Sep 19)	4.218	4.045	-0.173	4.454 (5/3/2023)	0.409
Post-FOMC (Sep 30)	4.238	4.326	+0.088	4.528 (3/22/2023)	0.202
MIM	4.125	3.625	-0.500	-	-

Qualitatively, we agree with market expectations: the Fed will continue to hike aggressively in the near term but will spend time in a holding pattern before cutting rates later in the year.

However, we think the market is headed in the wrong direction. The market has reduced its expected number of cuts in 2023 and lengthened the time the Fed maintains level (and high) rates. These changes were likely in response to the hawkish statement by the FOMC, the Summary of Economic Projections (SEP), and Chair Powell's press conference, which reiterated the Fed's commitment to maintaining high rates until inflation is back to 2%. This lengthened the hold time of peak Fed Funds to approximately nine months (from February until the November meeting).

We, instead, expect the Fed to struggle to maintain high rates as economic conditions deteriorate due to tightened monetary policy. **We continue to think that the Fed will capitulate earlier to the pressure to cut rates, and that the number of rate cuts will be greater than markets currently anticipate.**

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