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Wisdom of crowds and markets agree: Rate hike risks are rising

Matthew Luzzetti, Ph.D.
Chief US Economist
+1-212-250-6161

Brett Ryan
Senior US Economist
+1-212-250-6294

Justin Weidner
Economist
+1-212-469-1679

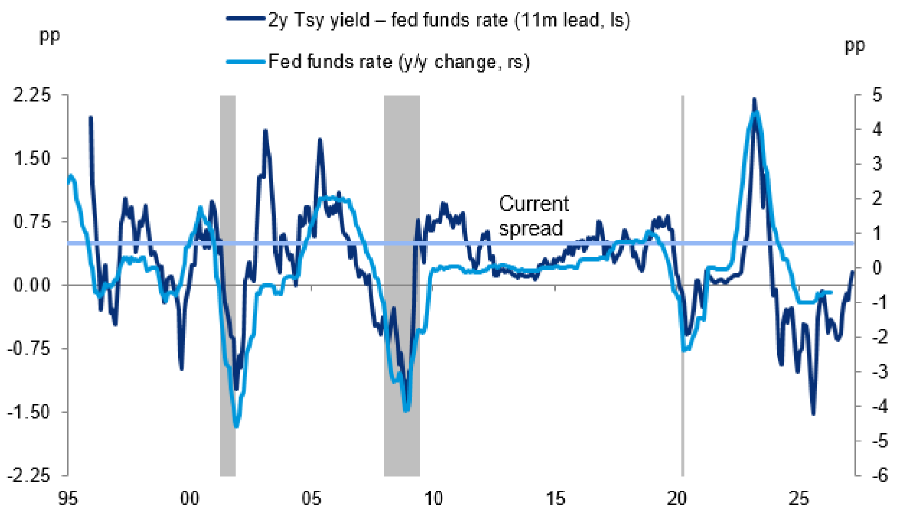
Amy Yang
Economist
+1-212-250-9959

Two weeks ago we highlighted how household interest rate expectations were sending a relatively strong signal that the Fed may hike rates over the coming year (see "Consumers think the Fed might hike rates"). Specifically, the net interest rate expectations indicator from the Conference Board clearly shifted in the direction of foreseeing higher rates over the next twelve months.

Treasury markets are now sending a similar signal. The easiest way to see this is through market pricing for the Fed rate path, which is pricing just shy of 20bps of rate increases this year.

We highlight another market metric that is now pointing to rate hikes. The current difference between the 2-year Treasury yield and the effective fed funds rate is ~45bps after briefly rising above 50bps yesterday. Historically, that spread has been a reasonably good leading indicator for future changes in the fed funds rate. For example, over the past three decades, the difference between the 2y yield and fed funds rate leads the year-over-year change in the latter by roughly eleven months with a peak correlation of +66%. (The correlation would likely be higher if not for the extended period where the fed funds rate was stuck at the zero lower bound after the GFC.)

Figure 1: Rising spread between 2y Treasury yield and fed funds rate pointing to rate hike risk



Source: FRB, Haver Analytics, Deutsche Bank Research

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If sustained near recent levels, the gap between the 2-year yield and fed funds rate would rise to the highest level since late 2022. A regression using this relationship implies an increase in the fed funds rate over the next year of roughly 30bps. As such, signals from households and markets are now broadly consistent, suggesting that risks are mounting the Fed could hike rates over the next year.

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David Folkerts-Landau
Group Chief Economist and Global Head of Research

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