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Good Morning - Please find below a market flash update on the CPI data released this morning at 8:30 a.m. Please let us know if you would like additional market color or have any questions. We are also always happy to provide indications for Caps, Swaps or other derivative hedging products. Please feel free to reach out anytime! ***-RCA Hedging Desk***

RCA RATE MARKET UPDATE:

- **FOMC hiked 50 bps on Wednesday**
- **Rates lower week-on-week**
- **Fed maintained a hawkish tone; stated they "have more work to do"**
- **Powell dismissed the notion of rate cuts in 2023; stated more rate hikes "likely appropriate"**
- **FOMC members remain unanimous in supporting current monetary policy mandate**
- **Deepening recession fears lead to further yield curve inversion**

U.S. rates were lower week-on-week as market participants reacted to the Fed rate decision. Lower yields reflect the market clearing out any lingering expectations for a 75 bp hike that were priced into the curve. That said, the initial decline in rates was more pronounced immediately after the Fed announcement, but quickly reversed as Powell's press conference comments were interpreted as hawkish; they rekindled fears the Fed may have "more to go" than anticipated. As mentioned, the Fed policy statement immediately following the meeting remained hawkish; what is most notable about the policy statement is the continuity in wording from November. The phrase about the committee expecting "ongoing increases" to the fed funds rates was left unchanged. That should signal the FOMC's resolve to raise rates above 5%. One of the most striking takeaways from the meeting is the near-unanimous view among committee members that the appropriately restrictive level for rates exceeds 5%. It is now clear that the surprisingly soft November CPI report prior to the meeting did not materially change committee members' views. It certainly seems that the central bank is more concerned with avoiding the policy error of *under*-tightening than *over*-tightening. The market may also still be struggling with the notion that the Fed remains *adamant* that their primary concern is curbing inflation. Jobs matter; the dollar matters; consumer demand matters; housing matters – *but* the FOMC is *clearly* prepared to endure economic pain (as they have repeatedly stated) to stifle and *contain* inflation.

Unfortunately, the Fed created more questions than it answered, but one thing is clear: the FOMC is *determined* to get inflation down to the 2.00% target they have *steadfastly* maintained since the start of this tightening cycle. Powell was asked if the committee has or would consider an adjustment to the 2.00% inflation target – Powell defiantly answered that an adjustment to the inflation target was not under consideration and had not and would not even be discussed! They have done their best to communicate their dedication to this task, even in the face of weakening economic conditions or the prospect of a recession. (They all but acknowledged this fact by reducing their GDP forecast.) Chairman Powell, in response to a question at his press conference, flatly rejected speculation the FOMC may need to cut rates in the second half of 2023. That leads to the other major market considerations: how

long will the Fed hold rates once they achieve a rate they feel is satisfactorily restrictive? Will they cause a recession? What kind of lag effect will Fed actions to date have on inflation? Those are the *big* questions for 2023. Our view is to expect more rate hikes in the first half of 2023, moving toward a terminal rate of between 5.00% and 5.25% and prepare for that rate environment to hold for the foreseeable future. Stay tuned!

RCA CHARTS OF THE DAY:

Chart 1: The Bloomberg graph below shows the US Treasury yield curve today and 1 month ago. (Gold line = last month; Green line = current market). You can see from the graph that overall, rates are down across the curve over the prior 30 days. This reflects the market recalibrating forward FOMC expectations. What is more important to point out is the deepening of the yield curve inversion that has been present for the past several months. At the moment, revised FOMC expectations are priced into the short end of the curve – most market participants expect a 25 basis point hike at the Feb 2023 meeting (for now). The continued and worsening curve inversion indicates that the market is still *very* nervous about a Fed-caused recession; weaker than expected Retail Sales data earlier this week only intensified recession fears.

US TREASURY YIELD CURVE – 1 MONTH CHANGE

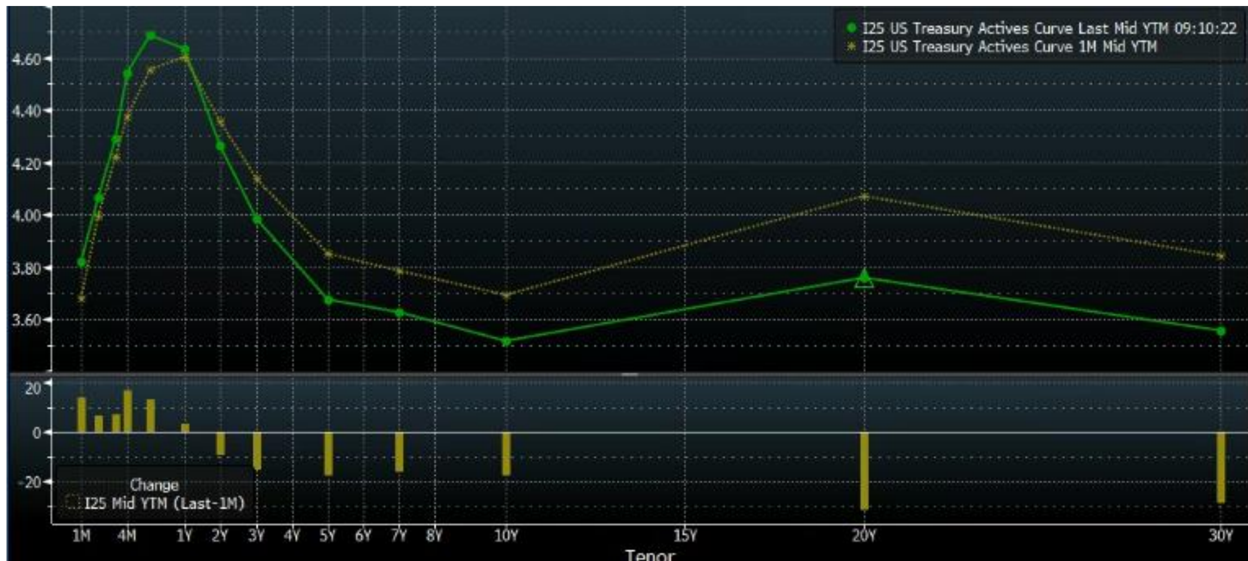

Chart 2: The Bloomberg table below shows projections for the next three FOMC meetings by leading Wall Street bank economists and the survey of Bloomberg economists. You can see that terminal rate expectations have increased in line with the Fed narrative and the revised dot plot that we saw after the meeting. You can also see that there is definitely uncertainty in the market concerning the magnitude of future rate hikes – some are calling for up to 100 basis points of additional tightening in the first half of next year, whereas some have dialed-back expectation and are only anticipating an additional 50 basis points in rate hikes. This is partly due to the fact that the next FOMC meeting is not until early February

2023 and we will see a ton of data prior to the next meeting. We could definitely see additional rate volatility and sudden rate swings as the market sorts out Fed expectations for 2023. Of note, the dot plot in the updated SEP peaks significantly higher — 5.1% at end-2023 — compared to 4.6% in the Fed's September forecast. There was remarkable consensus among committee members to raise rates to that peak, with 17 of 19 participants seeing a terminal rate of at least 5.1%, and seven seeing at least 5.4%. The majority of market participants have adjusted expectations to reflect a higher terminal rate (far right column of table).

Wall Street Banks: FOMC Forecasts / First Half, 2023

Fed Rate Forecasts (bp)	Feb. 1	March 22	May 3	Terminal Rate
Bank of America	50	25	0	5.25
Barclays	50	25	0	5.25
Citigroup	50	25	25	5.50
Deutsche Bank	25	50	0	5.25
Goldman Sachs	25	25	25	5.25
JPMorgan Chase	25	25	0	5.00
Morgan Stanley	25	0	0	4.75
Wells Fargo	50	25	0	5.25
Bloomberg Economics	25	25	0	5.00

CURRENT U.S. TREASURY & SOFR SWAP RATES (10:00 AM):

- **U.S. Treasury and SOFR swap rates lower from one week ago**
- ***Yield curve inversion deepens; signals increasing market concern FOMC may be accelerating a recession***

Term:	U.S. Treasury Rates	1 Week Change
2-Year	4.252%	-9.5 bps
3-Year	3.969%	-13.4 bps
10-Year	3.519%	-6.3 bps

Term	SOFR Swap Rates	1 Week Change
2-Year	4.279%	-11.2 bps
3-Year	3.837%	-9.8 bps
10-Year	3.222%	-6.7 bps

WHAT TO WATCH THIS WEEK AND NEXT:

Key economic data released this week and next week includes:

- TUE 12/20 Housing Starts at 8:30 a.m.

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- WED 12/21 Existing Home Sales at 10:00 a.m.
- THU 12/22 GDP at 8:30 a.m.
- FRI 12/23 Durable Goods Orders at 8:30 a.m.
- FRI 12/23 Personal Income, Personal Spending at 8:30 a.m.

Upcoming FOMC meeting schedule:

- ***2/1/2023 Next FOMC Meeting***
- *3/22/2023*
- *5/3/2023*

Best Regards and Happy Holidays!

Best regards,

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