US Watch

January FOMC: March is no longer the base case

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Key takeaways

- The Fed needs "greater confidence" in the outlook for inflation. It all but ruled out a March cut.
- We push out our first rate cut to June. Risks to a "later and faster" policy easing cycle are rising.
- We also push out the timing of our expected QT slowdown announcement from March to May.

The Fed needs “greater confidence” to cut

The Fed says it has confidence in the outlook but needs “greater confidence” before it starts normalizing its policy stance. What constitutes greater confidence? More progress in reducing services inflation – and shelter inflation in particular – and slower wage growth.

March is no longer the base case

Powell significantly raised the bar for a March cut by saying, “I don't think it is likely that the committee will reach a level of confidence by the time of the March meeting” (to reduce the policy rate). Based on the outcome of the January FOMC meeting, we now look for the rate cut cycle to begin in June and expect 25bp rate cuts in June, September, and December This would mean 75bp of rate cuts this year and we retain our view of 100bp of rate cuts in 2025.

We now push out the timing of our expected QT slowdown announcement from the March FOMC meeting to the May FOMC meeting. In addition to altering the timing of tapering, we also adjust the path of QT slowdown. We no longer expect a $15b/m taper in the US Treasury redemption cap at each FOMC meeting. Instead, we now expect a reduction in the Treasury redemption cap from $60b/m to $30b/m and for this to remain open-ended. Our view is that it can remain at this level until end ’24.

Market reaction

The rates market interpreted January FOMC communications as modestly hawkish. On balance, the Jan FOMC does not materially change our core rate market views. We still recommend clients trade duration tactically and with a bullish bias. Meanwhile, we now push out the timing of our expected QT slowdown announcement from the March FOMC meeting to the May FOMC meeting. This would see the first QT slowdown implemented in the month of May.

The FX market likewise took the Fed’s message as hawkish, with the USD appreciating broadly yet modestly on the statement release. The press conference saw more 2-way price action, until Chair Powell’s statement that they committee most likely won’t be confident enough to cut in March, which lifted rates and added another leg higher in the USD.

US Economics

The statement: A de facto easing bias with hawkish notes

Changes to the January FOMC statement came in broadly as we anticipated, with the main change being the removal of upside policy rate guidance in favor of language that referred to considerations of “any adjustments to the target range for the federal funds rate”. This neutral language is a de facto easing bias given the Fed’s forecasts and communication that 2024 should be the year policy normalization begins.

That said, the language change we expected was complemented by some generally hawkish language. The statement now reads, “[t]he committee does not expect it will be appropriate to reduce the target range until it has ***gained greater confidence*** that inflation is moving ***sustainably*** toward 2 percent” (all bolded italics ours). While we took this as slightly hawkish against our expectation for a March rate cut, we looked to the press conference for further guidance on what the committee had in mind with this language choice.

The statement now notes that “[t]he committee judges that the risks to achieving its employment and inflation goals are ***moving into better balance***.” Elsewhere, the statement retained the language that “the committee remains ***highly attentive to inflation risks***.” These language choices are somewhat hawkish, though not unexpected since we doubt the committee would be convinced it can cut rates until risks to the outlook are more balanced, and the Fed did not cut rates in January. Hence, we did not expect this language to be altered. Notwithstanding this view, they add to the policy rate guidance that gave the statement a more hawkish tone than we expected overall.

The press conference: March is not the base case

Going into the meeting, we anticipated the Fed would begin reducing its policy rate in March. The beginnings of the press conference were very much in line with this view, in our opinion. Powell was asked what would mean the Fed had gained “greater confidence” and he replied that the Fed was already confident inflation was returning to 2% and that more of the same data was needed to get the Fed moving (not better data, but just more of the same). He said they had already received six months of good data on inflation and they needed that to continue.

In addition, he said the Fed does not necessarily need to see weaker growth to begin normalizing the policy rate. Similar to his communication in December, he implied the Fed does not need to see a period of below trend growth or weaker demand was needed to achieve the inflation target. He continually pointed to the substantial rebound in labor force participation and return of immigration as bringing important supply side effects to the US economy, boosting activity while providing room for wages and inflation to come down.

Regarding risks, he did note that a reacceleration in inflation was possible, but not likely in his opinion. He said the more likely risk is that inflation settles in at a level they view as inconsistent with their inflation mandate.

Then, Powell dropped a surprise on us and markets. When asked to respond to comments from some Regional Fed Presidents who have said it is premature to cut rates soon, Powell said, “[b]ased on the meeting today, I would tell you that I don't think it is likely that the committee will reach a level of confidence by the time of the March meeting to identify March at as the time to do that” (begin cutting rates).

We find this communication odd and against the spirit of the Fed’s reaction function. Ruling out a rate cut in March is inconsistent with the Fed’s emphasis on data dependence and a meeting-to-meeting decision process. Nonetheless, when the chair essentially rules out a March rate cut twice in the same answer, we have to take the signal on board. We now no longer expect the rate cut cycle to begin in March.

So what does constitute "greater confidence"?

We think two interrelated factors led the Fed to signal a later start to the tightening cycle than we anticipated. First is the composition of disinflation, which has been driven mainly by deflation in goods amid a slower decline in services inflation. Hence, while we see current inflationary trends as justifying action in March, there may be enough voices on the committee that remain concerned about services inflation – and shelter inflation in particular – and wage growth to keep the Fed on hold for longer. Hence, we think achieving "greater confidence" requires (1) more evidence that services inflation is consistent with 2% outcomes in the event that goods price declines stop, and (2) a further slowing in wage growth to 3.5%.

Second, Powell may have more confidence about the outlook than does the committee as a whole. Our reading of the wordsmithing in the statement – which leaned hawkish – and the explicit reference to the components of inflation as indicating others on the committee do not have the same level of confidence. We don't know for sure, of course, but it may be that regional Fed Presidents Barkin and Boskin, who rotated on as voters, remain unconvinced by the recent data flow.

…and no serious balance sheet discussion until March

What also came as a surprise to us was the lack of progress on balance sheet discussions. In response to a question on balance sheet policies, Powell said, "at this meeting we had some discussion of the balance sheet. We are planning to begin in-depth discussions of balance sheet issues at our next meeting in March. So, those questions are all coming into scope now, and we are focusing on them, but we are at the beginning of that process, I would say." In other words, move along, there is nothing to see here.

Updated Fed outlook: June start to rate cuts and May start of taper

Based on the outcome of the January FOMC meeting, we now look for the rate cut cycle to begin in June and expect 25bp rate cuts in June, September, and December This would mean 75bp of rate cuts this year and we retain our view of 100bp of rate cuts in 2025. In moving to this new baseline, we make the following comments:

- **A rate cut in March is not entirely off the table.** Should the labor market weaken abruptly, the Fed may be inclined to act in March. It just seems like more than inflation alone is now needed for a cut in March, despite Powell's comments in the press conference today and in December that strong growth was not an impediment to reducing rates. We would place the odds of a March cut at around 30-40%. After all, y/y core PCE inflation is on track for 2.4% in March at current trends, and the 3- and 6-month annualized rates could be at 2.0% or below. Maybe the Fed can get there in March, but the bar seems higher and we have to take Powell's statement at face value (though taking him at face value was what led us to put in the first rate cut in March after the December FOMC meeting).

- **May is on the table.** We did not move the first rate cut to May from March since there is only one inflation report between the two meetings and if the Fed has not seen enough by March, it is unlikely to see enough by May. That said, we think the committee prefers to take policy rate actions at meetings in which it provides new projections. Hence, we prefer leaning to June.

- **Risks are to "later and faster."** Financial markets, in our view, are pricing in a policy error. Risk assets suffered immediately after Powell said March is not the baseline and markets are now pricing in virtually 100% probability of a 25bp rate cut at each FOMC meeting this year beginning in May. If the Fed wanted to reduce market expectations for easing, it failed. And markets apparently don't agree with a gradual pace of rate cuts once the Fed starts. Markets may be saying the Fed needs to choose between "sooner and slower" and "later and faster." For now it's voting on the latter. We agree that risks to our new baseline tilt in this direction.

Powell's guidance suggests the FOMC is not ready to start slowing the pace of balance sheet runoff (quantitative tightening, or QT) as early as we previously thought, which would see the committee announce a QT slowdown at the March meeting.

We now push out the timing of our expected QT slowdown announcement from the March FOMC meeting to the May FOMC meeting. This would see the first QT slowdown implemented in the month of May. We continue to believe the ON RRP level will be the single most important determinant for when the Fed slows QT. Positive ON RRP balances likely suggest to the Fed there is excess cash in the financial system; ON RRP balances near zero likely reduces confidence around the extent of excess liquidity in the system. We continue to believe the FOMC will judge ON RRP balances in the $200-250b level as low and likely warrant tapering. The recent pace of ON RRP reduction has moderated somewhat recently and we now expect ON RRP will reach near $250b by end April, reinforcing a QT slowdown announced at the May FOMC meeting.

In addition to altering the timing of tapering, we also adjust the path of QT slowdown. We no longer expect a $15b/m taper in the US Treasury redemption cap at each FOMC meeting. Instead, we now expect a reduction in the Treasury redemption cap from $60b/m to $30b/m and for this to remain open-ended. Our view is that it can remain at this level until end '24.

Overall, we have low confidence in how long the Fed will let securities roll off its balance sheet and acknowledge Fed QT will likely stop once either (1) fed funds & SOFR trade at or slightly above the interest on reserve balance (IOR) rate, or (2) macroeconomic data slows sharply to warrant Fed policy moving to an accommodative level. A QT slowdown may indeed allow for a longer period over which the Fed can reduce its balance sheet, in-line with recent comments from Dallas Fed President Logan.

US Rates: Market reaction

The rates market interpreted January FOMC communications as modestly hawkish. The initial hawkish interpretation was driven by an explicit signal on increased confidence required in inflation moving sustainable toward 2 percent before any rate cuts would be considered. The FOMC statement also removed the references to the US banking system being "sound & resilient" and tighter financial & credit conditions, which were seen as marginally hawkish. These statement changes initially caused interest rates to rise up to 6bps & curve to bear flatten.

In the FOMC press conference, the market was most focused on Chair Powell guidance that downplayed March rate cut odds. Specifically, Powell suggested "I don't think it is likely that the Committee will reach a level of confidence [on inflation returning sustainably to 2%] by the time of the March meeting". Following this comment market pricing for a March cut was reduced to <10bps or around 30-35%. The UST curve extended the bear flattening during the Powell press conference remarks.

On balance, the Jan FOMC does not materially change our core rate market views. We still recommend clients trade duration tactically and with a bullish bias. We remain comfortable recommending clients trade duration, using the 10Y as a proxy, between 3.75-4.25%. We continue to believe the US economy will moderate in coming months and that the Fed will be cutting by the June FOMC. We expect the trough of the rate cutting cycle to shift lower as the Fed nears their first cut. Re-emergence of banking sector concerns will further this tactically bullish rate bias.

FX: Market reaction

The FX market likewise took today's Fed statement as hawkish, with the USD appreciating broadly yet modestly on the statement release. The press conference saw more 2-way price action, until Chair Powell's statement that they committee most likely won't be confident enough to cut in March, which lifted rates and added another leg higher in the USD.

The USD, on net, was approximately 0.4%-0.7% higher vs. most G10 FX currencies consistent with the 4bp move in the 2yr UST and reduced pricing (OIS curve) of a March cut to about 30-35%. This followed some more notable swings in the USD earlier in the day as the market digested a below-consensus Employment Cost index and renewed small/regional bank concerns.

On the statement, the dollar found initial support from formal language that reflected a still upbeat view on the economy, suggested their policy goals (employment and inflation) were moving towards (but not fully in) better balance, and that they need greater confidence in the inflation outlook before cutting.

Stepping back from today's FOMC, we see FX markets, and the USD specifically, as most likely being driven by an eventual economic recoupling of the US lower towards the rest of the world, amid a soft-landing conditions. As such, while we see several G10 central banks (ex BOJ) also moving towards cuts in the coming months/quarters as inflation comes down, the eventual Fed cutting cycle should ultimately weigh on the USD through 2024 and into 2025. That said, this could take time to unfold, and the timing of this will still depend on the incoming growth/inflation data, as the Fed has stressed time and time again.

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