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Liquid Insight

FOMC preview: A jittery 25bps hike

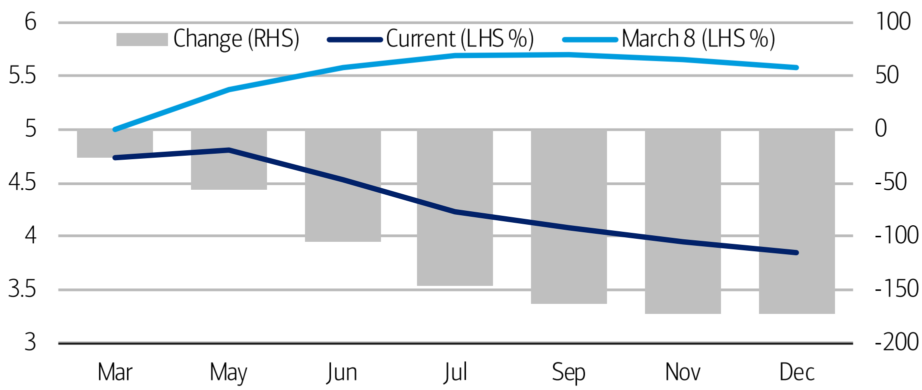
Key takeaways

- Fed expected to hike a dovish 25bps, barring no further financial system stress / contagion; pause might send "jitters"
- Fed's outlook will be conditional on banking system stress; we see risks to Fed's outlook as more balanced
- Front-end rates & USD may rise slightly with Fed hike, but banking system risk more important than monetary policy guidance

By Mark Cabana, Michael Gapen, & Alex Cohen

Exhibit 1: FOMC OIS pricing for each Fed meeting in 2023

Fed rate path has been sharply re-priced lower following banking system risks



Source: BofA Global Research, Bloomberg

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Dovish hike expected with bank stability risks in focus

We expect the Fed to hike by 25bps at this meeting, but the decision & outlook for any tightening depend on financial stability. Recent economic momentum & inflation have been overshadowed by banking system risks, sharply repricing the Fed's path (Exhibit 1).

We think the Fed's outlook has become two-sided. We retain our outlook for monetary policy, including a terminal target range of 5.25-5.5%, and a mild recession in the US beginning from Q3 of 2023. We now see a greater risk of Fed tightening and balance sheet reduction ending sooner; we saw risks that both would last longer previously.

Rates may sell-off at front-end with realization of hike, but market will likely be more focused on outlook for banking system risks. We continue to see lower rates by end '23. For USD, we expect some dollar appreciation on the back of a 25bps hike, but acknowledge that the range of USD outcomes is wide; it largely depends on the financial sector headlines.

20 March 2023

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US economics: Two tools, two problems

We see the emergence of financial stress presenting both near-term and medium-term issues for policymakers. The near-term issue is one involving addressing concerns of deposit flight, risk of asset sales, and loss of confidence following the revelation of failure of several regional banking institutions. The medium-term issue is to what degree the situation represents an adverse shock to banks' lending behavior, a tightening in credit standards, and a tightening in overall financial conditions.

We are already forecasting a mild recession in the economy beginning from the third quarter of this year, with a 1% peak-to-trough decline in GDP and roughly a 1.5pp backup in the unemployment rate. Our central thesis has been that a return to 2% inflation would likely require removing imbalances from labor markets in a way that would be consistent with prior business cycle recessions. We see recent events being broadly consistent with our forecast. A strong credit contraction could mean a harder landing for the economy and a quicker pivot to rate cuts from the Fed, but, for now, we retain our outlook for a mild recession and a return to 2% inflation by end-2024.

We think recent events, including the revelation of financial stress in a few regional banking institutions, have changed the debate on the policy outlook. The emergence of financial stress is likely to indicate to the committee that monetary policy is closer to being "sufficiently restrictive" than some may have thought previously. At the very least, stress in financial markets suggests that the Fed should proceed with caution.

Rate decision: We think the debate to be now between a 25bp rate hike in March, or none at all. More financial instability between now and next Wednesday could tip the balance in the direction of a pause in the rate hiking cycle – and perhaps a pause in balance sheet runoff – but our expectation is that the Fed will lift the target range for the federal funds rate by 25bp to 4.75-5.0% and maintain its current balance sheet policy.

Summary of Economic Projections (SEP) forecasts: Labor markets carried more momentum into 2023 than was previously known, and disinflationary pressures were not as strong. The SEPs will reflect this (Exhibit 2).

Exhibit 2: BofA forecast for updated Summary of Economic Projections: March versus December

We look for upward revisions to growth, inflation, and the policy rate path

	2022	2023	2024	2025	Longer Run
Change in real GDP (% 4Q/4Q)					
March SEP (forecast)	0.9	0.7	1.5	1.7	1.8
December SEP	0.5	0.5	1.6	1.8	1.8
Unemployment rate (%)					
March SEP (forecast)	3.6	4.4	4.6	4.5	4
December SEP	3.7	4.6	4.6	4.5	4
PCE inflation (% 4Q/4Q)					
March SEP (forecast)	5	3.2	2.6	2.1	2
December SEP	5.6	3.1	2.5	2.1	2
Core PCE inflation (% 4Q/4Q)					
March SEP (forecast)	3.5	3.5	2.5	2.1	
December SEP	4.8	3.5	2.5	2.1	
Federal funds target rate (midpoint)					
March SEP (forecast)	4.4	5.4	4.6	3.4	2.5
December SEP	4.4	5.1	4.1	3.1	2.5

Source: BofA Global Research

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For real GDP, we expect the March projections to show 4Q growth of 0.7% for 2023, 1.5% for 2024 and 1.7% for 2025. Growth in 2022 will be revised higher to reflect data received, including revisions. For the unemployment rate, we think the 2023 rate could come in at 4.4%, down two-tenths from the December forecasts, while we think 2024 and 2025 will likely remain unchanged. For headline PCE inflation, we think the 4Q/4Q forecast for 2023 and 2024 will rise by one-tenth to 3.2% and 2.6%. We would be surprised if the committee altered its outlook for PCE inflation in 2025. For core PCE, the committee's previous forecast generally ran higher than our and market-implied estimates. Here, we expect no change versus the December projection, though we would not be entirely surprised if the forecast was raised by one-tenth in 2023 and 2024.

In terms of the appropriate policy path, prior to the onset of financial stress, we would have been inclined to write down 5.6% since Chair Powell emphasized that the estimated terminal rate was likely to rise, and we doubt the Chair would have made such a statement for a smaller 25bp adjustment. That said, we do think there is scope for participants to limit the upward adjustment to the appropriate path for policy. Hence, we look for a new terminal rate of 5.4% for 2023, 4.6% for 2024, and 3.4% for 2025. These would be 25bp, 50bp, and 25bp higher than in December.

Statement: If the committee revises the SEPs in the direction that we expect, including lifting the appropriate terminal rate to 5.4%, then we think the statement needs to retain the language that "ongoing increases" in the target range for the federal funds rate are likely to remain appropriate. Elsewhere, we do think the statement needs to make some reference to the recent financial stress events.

Press conference: Chair Powell is likely to be balanced in his assessment of financial stability concerns, justifying why the declaration of "unusual and exigent circumstances" was warranted, while also projecting confidence that the Fed has the tools and commitment to use them to preserve financial stability. Without substantial evidence backing the financial stability concerns, Chair Powell will likely emphasize that the committee still views inflation as the primary concern and a modestly tighter monetary policy stance would be warranted to bring inflation down.

That said, when looking beyond this month's policy decision, we expect the Fed to back away from the explicit projections in the SEPs. After all, uncertainty around the baseline has risen in a way that will make it difficult for Chair Powell to pre-commit to any course of action beyond a general commitment to data dependence, which will now include financial stability risks.

For details on US economic views, see March FOMC preview: Two tools, two problems.

US rates: Market thinks Fed's dovish hike may be the last

The rates market is expecting a dovish hike. Rates may sell-off at front end with realization of hike, but market will be more focused on the outlook for banking system risk. We continue to see lower rates by end '23, especially at the UST back-end.

The rates market will likely be most interested in how the Fed characterizes the impact of recent banking instability in the monetary policy. Focus will be on the press conference for what the next move could be and how they are thinking about what would justify a cut. The market will likely discount the SEP & any rate forward guidance, which may be seen as stale given banking system risks.

The rates market is pricing 16bps of hikes at the March meeting (as of Fri close), which could see the front-end sell-off modestly & curve flatten with any hike. However, the rates market seems to believe the Fed will hike for similar reasons as the ECB; in case of an unexpected pause, the market may question "what does Fed know that we don't?". This could drive further jitters about underlying banking system risks.

The rates market increasingly believes a hike at the March meeting may be the last of the tightening cycle. Between the March & May meetings, the Fed is priced for <25bps in total with an early 60bps of cuts priced in the two meetings thereafter (Exhibit 3). The whole Fed policy path has also been sharply re-priced lower & the market now sees a lower trough to the cutting cycle of around 3-3.25% (Exhibit 4).

We have long expected US rates to decline with an economic slowdown & realize well below the forwards a few weeks ago. We did not expect the rate re-pricing to occur so rapidly and to be driven by banking stability concerns. We maintain a constructive duration bias out the curve & still favor longer-dated receivers.

Our curve bias has recently shifted. We recently favored flatteners but are now more neutral/ leaning towards steepeners. The Fed will likely be on hold & in data-dependent mode in the near-term. We see growing logic for steepeners with a Fed that might need to ease/ pause for financial stability reasons but has not yet vanquished inflation.

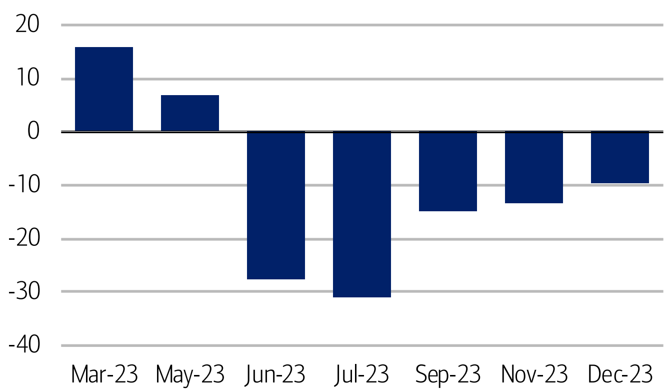
Administered rates: We expect no change in the Fed's setting of administered rates or ON RRP (Overnight Reverse Repo facility) terms at the March FOMC meeting. Clients have speculated the Fed lowering the ON RRP rate or cap to make this facility less attractive so as to slow banking system deposit outflows or flight to safety flows.

Dropping the ON RRP rate also risks dragging EFFR (Effective Fed Funds Rate) lower, which prior to the recent episode was printing lower in the range. Lowering ON RRP could risk EFFR printing uncomfortably close to the bottom of the target range. At the same time, raising IORB (Interest on Reserve Balances) could risk EFFR printing too close to the top of the range if funding pressures continue.

We expect the Fed to find it unnecessary to adjust the administered rates now. Assuming that this bank stress is contained, the Fed would still want to encourage banks to compete for deposits by bidding up for funding. The Fed may also not want to signal support for one market participant type (banks) while hurting another with lower ON RRP (MMF).

Exhibit 3: Fed hikes/ cuts priced by meeting (bps)

Market looking for Fed cuts by June meeting, with some risk of 50bp cut



Source: Bloomberg

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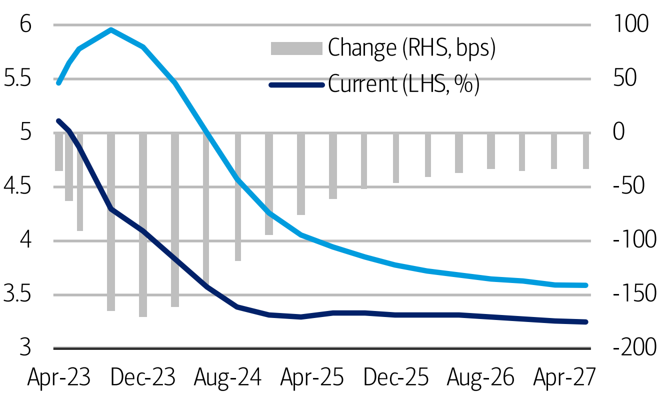
Exhibit 4: Euro dollar path today, 1.5 weeks ago, & change

Policy path has been sharply re-priced lower with bank risk



Source: BofA Global Research, Bloomberg

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FX: A range of possibilities for the USD

We see a relatively wide range of potential outcomes for the dollar coming out of the FOMC, and acknowledge the risks that any new and material financial sector headlines can significantly cloud the outlook. It has been less than 2 weeks since Chair Powell's testimony indicated that the pace of Fed hikes could accelerate, which essentially brought the broad USD to the highs of the year. Since that time, financial sector turmoil has resulted in elevated interest rate volatility and re-pricing of Fed's policy expectations. This has subsequently weighed on the dollar, though the partial off-set of broader safe-haven support has kept the net dollar move relatively contained. The BBDXY is less than 1 % lower since 9 March, despite an over 100 bp decline in the 2y Treasury yield. Despite the relatively limited FX price action, uncertainty is high.

Since our call for a 25 bp hike by the Fed is not fully priced into the market, we would expect some dollar appreciation on the back of the rate decision if our call is realized, all else remaining equal. The Fed's statement guidance, press conference message from Chair Powell, and the SEP adjustments will also play a part. Another precondition for a dollar rally will be the Fed's ability to communicate that financial stability risks can be addressed with more targeted measures, leaving monetary policy to continue to address inflation.

As inflation is the main policy challenge for most central banks this year, we have argued that any signs of wavering commitment to the 2% target will result in currency depreciation. While not our baseline, should the Fed pause or come out with assertively dovish messages in light of the tightening of financial/credit conditions, we would expect the USD's near-term downtrend to re-emerge. This scenario would also be viewed as a contrast to last week's 50 bp hike by the ECB, and the pricing in of additional hikes through June. The BOE, SNB and Norges Bank meetings on Thursday will also be informative and should provide further directional signals for associated currencies vs. the dollar.

Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023 – Year Ahead 2023: Pivot ≠ Peak**, 20 Nov 2022
- Central bank policy dilemmas begin, but focus on inflation prevails for now, **Global FX Weekly**, 17 Mar 2023
- Rate stress test **Global Rates Weekly**, 17 Mar 2023
- USD roller coaster, **Liquid Cross Border Flows**, 13 Mar 2023

Rates, FX & EM trades for 2023

For a complete list of our open trade recommendations, as well as our trade recommendations closed over the past 12 months, see the reports below:

Global FX weekly: Central bank policy dilemmas begin, but focus on inflation prevails for now 17 March 2023

Global Rates Weekly: Rate stress test 17 March 2023

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