Liquid Insight

FOMC Preview: A shift to neutral guidance

30 January 2024

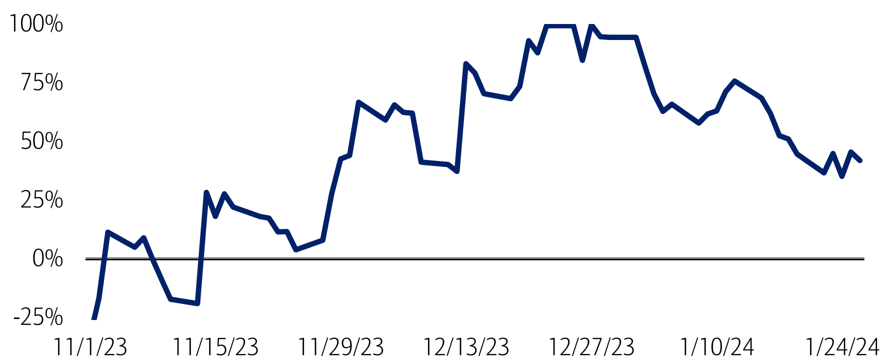
Rates and Currencies Research
Global

Key takeaways

- The Fed will likely remove the upside rate bias in the statement to go away in favor of neutral guidance.
- Rates markets will watch the FOMC closely for guidance on the policy path and discussion around balance sheet runoff.
- FX markets are likely to discount an incrementally dovish signal from the Fed given current expectations for March.

By Michael Gapen, Mark Cabana & Alex Cohen

Exhibit 1: Probability of a 25bps rate cut at the March FOMC
Market has reduced probability of a March cut meaningfully in '24



Source: Bloomberg

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A change to guidance typically comes first

Fed communication indicates the committee is pleased with the overall state of the economy and the progress made on reducing inflation. We continue to expect the firs rate cut in March, though we expect no strong signal in January. The Fed needs to buy time to see more data. We think the policy rate guidance needs to change again as we believe the current upside hiking bias in the statement remains untenable. The language is likely to become more neutral but the direction of travel of recent changes would signal some easing bias.

The rates market will watch the Jan FOMC closely for (1) updated guidance on policy path (2) discussion of QT slowing. On net we expect the January FOMC to be seen as marginally dovish and likely maintain March cut probability around 50% (Exhibit 1). We recommend clients continue to trade US rates tactically from the long side. As noted above, altering the statement language to a more neutral stance would still be interpreted as an incrementally dovish signal, but it is one that should be mostly discounted by the FX market at this point, given where expectations are for March.

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Economics: A de-facto easing bias

Next week the Fed will hold its first meeting of 2024. As we noted in our preview (see January FOMC preview: Playing for time), we expect it will be pleased with the progress made in returning inflation towards the 2% target without a significant rise in the unemployment rate. However, we think the Fed will remain coy about its intentions for the timing of policy normalization. We think the Fed prefers to see more data before making any decision on whether to start reducing rates in March, as we currently expect.

That said, there has been enough progress to warrant a change in forward guidance in the post-meeting statement. We think the current language referencing "the extent of any additional policy firming" can be replaced with "in determining any additional policy rate adjustments". The literal reading of this guidance would suggest the Fed is just as likely to raise rates as cut them, but the direction of travel in recent changes to policy rate guidance would signal some easing bias, particularly since most Fed communication has implicitly indicated the tightening cycle is over. While we continue to think the Fed can normalize its policy rate on inflation data alone, we acknowledge the upside surprise on 4Q GDP growth may be concerning to some committee members who believe bringing services inflation in line with the inflation target requires more softening in activity and labor markets.

Finally, we expect the committee will have an extensive discussion on how and under what conditions to reduce the pace of balance sheet runoff. In our view, Chair Powell will only provide a high-level synopsis of this discussion and we will look to subsequent speeches and the minutes of the January FOMC meeting for further details. We expect no decisions on the balance sheet policies at this meeting.

Rates: Jan FOMC likely to be seen as marginally dovish

The rates market will watch the Jan FOMC closely for (1) updated guidance on policy path (2) discussion of QT slowing. On net we expect the January FOMC to be seen as marginally dovish and likely maintain March cut probability around 50% (Exhibit 1). We recommend clients continue to trade US rates tactically from the long side. Detail below.

Policy path: our economists expect FOMC statement language to drop reference to an explicit hiking bias (current: "in determining the extent of any additional policy firming") and add more neutral outlook assessment (future: "in determining any future policy adjustments"). Such a language shift will be viewed as marginally dovish because it will be seen as moving in the direction of cuts. If the Fed does not change language, it will essentially remove the option to cut in March.

In the press conference, we expect Powell to retain the optionality around the timing of any easing in the policy rate. Powell will not signal a March cut and likely reiterate data dependence & desire for more confidence in lower inflation before easing. Risks skew to Powell sounding more dovish given his last public appearance. While front-end pricing has been volatile, there is still a historically large spread between the market YE '24 rate and '24 dot. We think there is room for the Fed to move to the market, this divergence remains vulnerable to more hawkish communication.

QT slowing: the Fed will likely start discussing technical considerations around when to slow QT. These discussions will narrow the gap in views between Logan (slow QT when ON RRP reaches a "low level") & Waller (slow QT with SRF use). We suspect Logan's arguments will win the day for technical reasons discussed in greater detail here: Logan & QT. We suspect Logan judges the ON RRP "low level" at $200-250b and see risks this level could be reached by the March FOMC meeting, if current ON RRP trends hold (Exhibit 3). For more detail see Fed considerations for slowing QT.

No QT decisions will be made at this meeting. Powell will likely share the nature of QT slowing discussions at the press conference but not announce any final decision. We expect more detail on QT slowing from Fed official speeches & the Jan FOMC minutes.

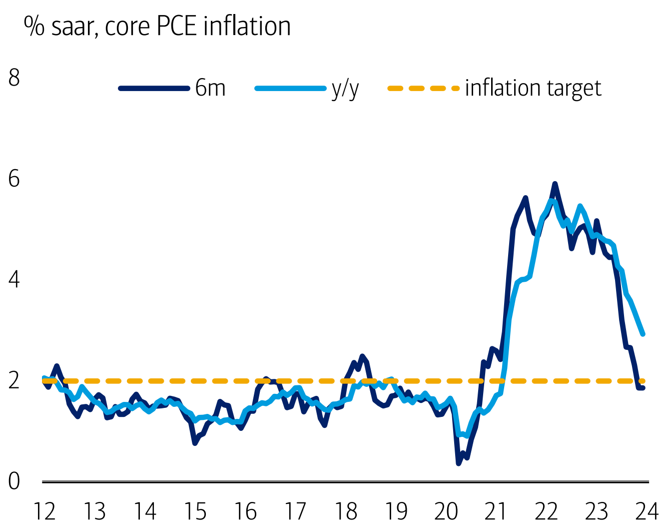
Overall, the Jan FOMC should be slightly dovish. It will set the stage for future cuts & QT slowing. We suspect the market will likely hold March pricing at ~50% for cuts & keep odds for a QT slowdown in 1H '24 (we hold our QT slowdown call for March).

FX: Awaiting the next signal

The FX market will similarly be attuned to how both the FOMC statement and Chair Powell articulate the policy bias as it relates to the near-term path and the likelihood of a move in March. As noted above, altering the statement language to a more neutral stance would still be interpreted as an incrementally dovish signal, but it is one that should be mostly discounted by the FX market at this point, given where expectations are for March. Any USD depreciation due solely to this would likely be short lived, unless the language was changed to something more overtly dovish related to a March cut. On the flip side, leaving this language as is, or adjusting it in a way that takes a March cut off the table would be an unexpectedly hawkish signal, causing the USD to rally. Separately, barring a major and unforeseen development related to balance sheet policy, this expected discussion should not in-and-of itself be a driver of the dollar.

Exhibit 2: Core PCE inflation (6m % saar and y/y % chg)

Over a six month horizon, annualized core PCE has already fallen below 2%



Source: BEA, Haver Analytics, BofA Global Research

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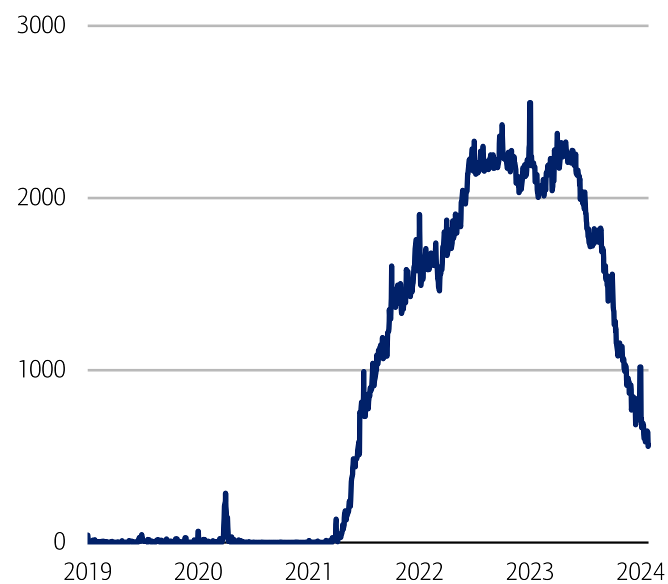
Exhibit 3: Fed overnight reverse repo facility use ($bn)

Fed facility use has dropped sharply reducing extent of excess liquidity



Source: Federal Reserve Board

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Exhibit 4: Summary of Fed speak in previous weeks
Below is a summary of key quotes from Fed speakers in previous weeks

Speaker	Date	Quote
Waller (Governor)	16-Jan	"As long as inflation doesn't rebound and stay elevated, I believe the FOMC will be able to lower the target range for the federal funds rate this year." "When the time is right to begin lowering rates, I believe it can and should be lowered methodically and carefully."
Mester (Cleveland)	11-Jan	"I think March is probably too early in my estimation for a rate decline because I think we need to see some more evidence." "I think the December CPI report just shows there's more work to do, and that work is going to take restrictive monetary policy."
Williams (NY fed)	10-Jan	"My base case is that the current restrictive stance of monetary policy will continue to restore balance and bring inflation back to our 2% longer-run goal." "The timing of when [interest rates come down] that happens and the speed at which that happens will depend on how inflation evolves, how the economy evolves." "[FOMC] Intends to slow and then stop the decline in the size of the balance sheet when reserve balances are somewhat above the level it judges to be consistent with ample reserves. So far, we don't seem to be close to that point"
Barr (Vice Chair of Supervision)	9-Jan	Signals BTFP will end on March 11, when it expires
Bowman	8-Jan	"Should inflation continue to fall closer to our 2% goal over time, it will eventually become appropriate to begin the process of lowering our policy rate to prevent policy from becoming overly restrictive." "I will remain cautious in my approach to considering future changes in the stance of policy,"
Bostic (Atlanta)	8-Jan	"We are in a restrictive stance and I'm comfortable with that, and I just want to see the economy continue to evolve with us in that stance and hopefully see inflation continue to get to our 2% level Expects 2 rate cuts this year starting in 3Q "Open question" if and when the Fed should alter B/S reduction pace
Logan (Dallas)	7-Jan	"In my view, we should slow the pace of runoff as ON RRP balances approach a low level" "In light of the easing in financial conditions in recent months, we shouldn't take the possibility of another rate increase off the table just yet."

Source: Bloomberg

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Exhibit 5: Fed comments on Fed balance sheet
Views on QT taper timing and end are disparate

Fed speaker	Date	QT comment
Gov. Waller	1/16/2024	Roughly 10-11% reserves as share of GDP is endpoint for balance sheet; thinks that QT can taper as ON RRP approaches zero, more uncertainty around reserve levels; slow the pace of QT sometime this year (not for MBS); standing repo facility usage sign for understanding reserve scarcity
Mester (Cleveland)	1/11/2024	Slowdown of QT not imminent, Fed will discuss this year.
Williams (New York)	1/10/2024	Don't seem close to the point of slowing asset runoff. Hard to predict where ample reserves are.
Bostic (Atlanta)	1/8/2024	Open question on whether asset runoff pace should change.
Logan (Dallas)	1/6/2024	In my view, we should slow the pace of runoff as ON RRP balances approach a low level.
Minutes	Released (1/3/2024)	Several participants... suggested that it would be appropriate for the Committee to begin to discuss the technical factors that would guide a decision to slow the pace of runoff well before such a decision was reached in order to provide appropriate advance notice to the public.
Powell	12/13/2023	At a certain point there won't be any more to come out of ONRRP and then reserves will start to come down; intend to slow and then stop the decline in size of the balance sheet when reserve balances are somewhat above the level judged to be consistent with ample reserves; we're not at those levels

Source: BofA Global Research, Federal Reserve

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Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023 – Year Ahead 2023: Pivot ≠ Peak**, 20 Nov 2022
- After the storm, **Global FX Weekly**, 31 Mar 2023
- Budding stability **Global Rates Weekly**, 31 Mar 2023
- USD vs. complacency, **Liquid Cross Border Flows**, 22 Jan 2024

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: The thriller of 2024: March vs. June 26 January 2024

Global Rates Weekly: How you've grown 26 January 2024

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