Liquid Insight

Sep FOMC preview: it's all about the SEP

18 September 2023

Rates and Currencies Research
Global

Key takeaways

- The Fed is likely to stay on hold at its Sep meeting. Chair Powell's message should be balanced, similar to Jackson Hole.
- November is a close call, but we retain our expectation for one last 25bp hike.
- Updates in the SEP dot plot should likely indicate fewer cuts in 2024 and a shift higher in the longer-run dot.

By: Michael Gapen, Mark Cabana & Alex Cohen

Exhibit 1: BofA forecast for updated Summary of Economic Projections: September versus June
We expect policy rate projections to be revised up for 2024 and beyond

	2023	2024	2025	2026	Longer Run
Change in real GDP (% 4Q/4Q)					
September SEP (forecast)	2.0	1.0	1.8	1.8	1.8
June SEP	1.0	1.1	1.8		1.8
Unemployment rate (%)					
September SEP (forecast)	3.8	.2	4.2	4.0	4.0
June SEP	4.1	4.5	4.5		4.0
PCE inflation (% 4Q/4Q)					
September SEP (forecast)	3.3	2.6	2.1	2.0	2.0
June SEP	3.2	2.5	2.1		2.0
Core PCE inflation (% 4Q/4Q)					
September SEP (forecast)	3.7	2.8	2.2	2.0	2.0
June SEP	3.9	2.6	2.2		
Federal funds target rate (midpoint)					
September SEP (forecast)	5.6	4.9	3.9	2.9	2.6
June SEP	5.6	4.6	3.4		2.5

Source: Federal Reserve, BofA Global Research

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Our expectation: one more hike in November

We expect the Fed to maintain the target range for the federal funds rate at 5.25-5.5% at the September FOMC meeting. This outcome would be consistent with both recent Fed communications and current market pricing. We expect no change to the Fed's balance sheet policies.

Investors will likely be focused on the Summary of Economic Projections (SEP), which will be released along with the FOMC statement. We expect the 2023 median policy rate forecast to show one more 25bp hike, for a terminal rate of 5.5-5.75%. Perhaps the most important forecast is the 2024 median, which in our view will shift up by 25bp to 4.875%, reflecting just 75bp of cuts next year.

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US Economics: One more hike in November

We expect the Fed to maintain the target range for the federal funds rate at 5.25-5.5% at the September FOMC meeting. This outcomewould be consistent with recent comments from a range of Fed speakers. Perhaps most tellingly, Governor Waller, who in our view has been the most reliable forecaster of policy moves in this cycle, said that the data do not suggest the Fed needs to do anything "imminent" in terms of policy. Markets are pricing only around 2.5bp or a 10% probability of a hike at the time of this writing. With the August CPI report out of the way, we do not see any major market-moving events before the September meeting.

November is a close call, but we retain our expectation for one last 25bp hike. While the Fed will be happy with progress on disinflation, the strength in economic activity leaves the door open for inflation to re-accelerate. Our base case is that it will not, but we think the Fed would prefer to err on the side of caution. The fact that the September dot plot is likely to reflect one more hike also lowers the bar, on the margin, for delivering that hike.

The Fed is in data-dependent mode and the data flow since the July meeting largely supports a wait-and-see approach. Most importantly, core PCE inflation slowed to 2.9% on a three-month annualized basis as of July. While the August CPI came in above expectations, the details of the report suggest that core PCE inflation should continue to moderate. Moreover, the labor market has cooled down. However, the activity data point to resilience or even acceleration. 2Q GDP growth stands at 2.1%, with risks of upward revisions, and 3Q growth is tracking at 3.1%. And the rates-sensitive sectors – housing and capex – are stabilizing.

A balanced message from Powell

Recent data should leave the Fed encouraged by ongoing disinflation but concerned about re-acceleration in inflation because of the strength in activity. We expect Chair Powell's message at the press conference to be balanced and very similar to his comments at Jackson Hole, since the outlook has not fundamentally changed since late-August. Powell is likely to note up front that the job is not done on inflation and the Fed will stay the course in order to get inflation back to 2%. We do not anticipate any forward guidance on potential additional hikes. Instead, we think Powell will continue to emphasize data dependence. The FOMC statement is likely to be nearly unchanged.

2024 median dot in focus

Investors will be focused on the Summary of Economic Projections (SEP), which will be released along with the FOMC statement. We expect the 2023 median policy rate forecast to show one more 25bp hike, for a terminal rate of 5.5-5.75%. Perhaps the most important forecast is the 2024 median, which in our view will shift up by 25bp to 4.875%, reflecting just 75bp of cuts next year. This would be about 40bp above current market pricing. Risks are skewed toward an even larger upshift in the 2024 median, which would be a significantly hawkish outcome.

Has r* increased?

We also look for a small increase in the longer-run median. The 2026 and longer-run rate forecasts should reflect gradual recalibration of views on r* (neutral real rate), given the resilience of the economy despite 5%-plus policy rates.

Marking 2023 to market

In terms of the economic forecasts, we look for a big mark-to-market upward revision to 2023 growth and a modest downward revision to 2023 core PCE inflation. We think core inflation could shift up for 2024, consistent with a slower path of rate cuts.

US rates: cuts in '24 to remain under pressure

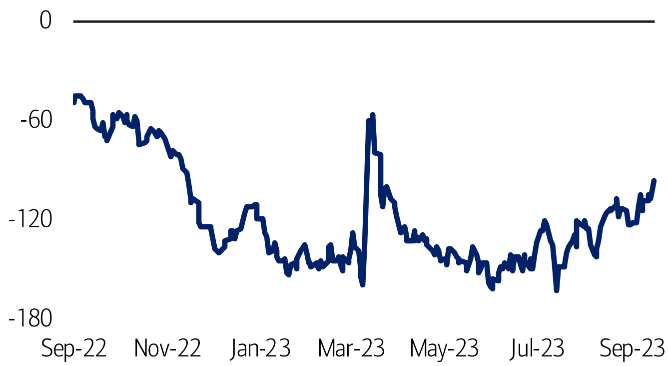
The Sept FOMC communications are likely to reinforce our view for clients to remain underweight the front end. Fed SEP dot plot will likely be seen as hawkish via: (1) '23 median dot to show 1 more hike in Q4 (2) '24 median dot to imply only 75bps of cuts next year (3) long run median dot to move higher from 2.5 to 2.625%.

The most notable of these changes to the market will likely be fewer cuts in '24 & the shift higher in the LR dot. Fewer cuts in '24 will stand in contrast to FOMC OIS pricing which still expects 100+bps of cuts in '24 (Exhibit 2). We see risks of a front-end sell-off & steepening in the '24 curve post SEP. The Fed's LR dot will still be well below the forwards but upward shift will imply Fed openness to a higher neutral / less restrictive policy stance today (Exhibit 3). Both changes should be seen as hawkish.

The Powell press conference should moderate the hawkish signals reflected through the SEP dot plot. Powell is expected to reiterate data dependence, downplay SEP dots, & reiterate mixed views from within the Committee (risks over over-tightening now closely balanced with risk of under-tightening). The press conference should soften some of the more hawkish SEP signals.

On balance, we expect the Sept FOMC to reiterate view to remain underweight the front end & continue to fade '24 cuts. We expect the market to pare back '24 cuts to around 75bps in coming months. Sept FOMC likely to challenge client narrative that Fed is done.

Exhibit 2: Slope between end '23 & '24 SOFR futures (bps)
Market has been paring back expected Fed cuts in '24



Source: Bloomberg

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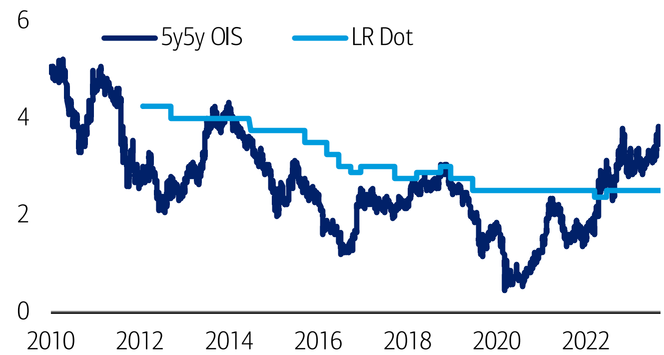
Exhibit 3: 5y5y OIS & Fed LR dot (%)
Fed LR dot has materially lagged market pricing in recent years



Source: Bloomberg

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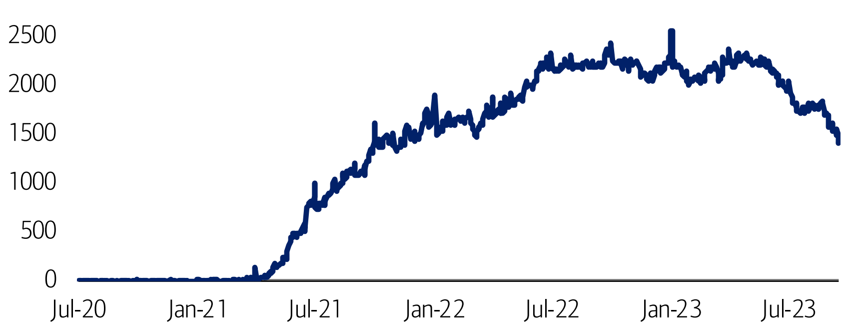
We expect no changes to Fed's policy implementation tools. The Fed is likely reassured by the swift decline in ON RRP use due to ongoing QT & Treasury cash balance increase. We expect the drain of cash & increase in collateral to place upward pressure on funding rates over time (see US funding: repo ripple). Recent repo ripples are likely to become more pronounced in 2H '23, turn into small waves in 1H '24, & become larger waves in 2H '24 as ON RRP reaches zero. The Fed & market should expect funding rates to more clearly evidence signs of tightening in coming quarters.

Exhibit 4: Fed overnight reverse repo use ($bn)
Fed O/N RRP has dropped sharply with QT & TGA rebuild



Source: Bloomberg

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FX: Resolute Fed = Resilient USD

The September FOMC will most likely impact the USD to the extent that the Fed makes material adjustments to the updated SEP (as discussed above). With the unchanged rate outcome all but universally expected, and recent Fed speaker guidance emphasizing more balanced risks surrounding possible future policy tightening, we would look to changes to the dot-plot to assess the USD's outlook. This is the case both for the final 2023 dot, as well as the 2024 projections.

With a cumulative 14 bp priced over the upcoming three meetings (Sep, Nov and Dec), an unchanged decision coupled while maintaining the median 2023 dot should be USD supportive. In that outcome, pricing for the Nov/Dec meeting would likely rise, bringing the dollar with it. The potentially dovish outcome of a removal of the 2023 hike, or an over emphasis on the downside risks to further hikes seems highly unlikely from the perspective of prudent Fed communication, as that decision will still ultimately be influenced by the upcoming data.

A possible removal of at least one of the four 25 bp cuts for 2024 implied by the current SEP could be even more impactful. Such a move would likely imply a later start to the cutting cycle, reinforcing the "higher for longer" policy approach. Stepping back, the USD has been driven towards the top of its range over the past few months by US relative growth outperformance, and associated favorable real rate dynamics. We have been long arguing that market's pricing of Fed cuts is excessive given growth resilience and stick inflation risks, even while accounting for the tail risks of a hard landing. A rise in the 2024 median dot would corroborate this view from the Fed's perspective and likely serve as a fresh tailwind to the USD, if realized. That said, given how far the USD has appreciated during this time, short-term positioning could limit the ultimate extent of USD appreciation on this outcome.

Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023 –** Year Ahead 2023: Pivot ≠ Peak, 20 Nov 2022
- The art of pausing **Global FX Weekly**, 15 Sep 2023
- Little Dipper **Global Rates Weekly**, 15 Sep 2023
- Ahead of the ECB & US CPI, **Liquid Cross Border Flows**, 11 Sep 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: The art of pausing 15 September 2023

Global Rates Weekly: Little Dipper 15 September 2023

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