US Watch

FOMC quick reaction- A holiday gift: the dovish pivot arrives

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Macro
United States

Michael Gapen
US Economist
BofAS
+1 646 855 3270
michael.gapen@bofa.com

Mark Cabana, CFA
Rates Strategist
BofAS
+1 646 743 7013
mark.cabana@bofa.com

Alex Cohen, CFA
FX Strategist
BofAS
+1 646 743 7015
alex.cohen2@bofa.com

US Economics
BofAS

Global Economics Rates & FX
BofAS

See Team Page for List of Analysts

Key takeaways

- The Fed maintained the target range for the Fed funds rate at 5.25-5.50%, and the statement was in line with our expectations
- The median member now foresees a 4.6% funds rate in 4Q 24 and 3.6% in 4Q 25
- We maintain our outlook for a cutting cycle that begins in June of 2024, but March is a close call

The dovish pivot arrives

The Fed delivered the dovish pivot that we expected heading into the December meeting. In our view, the bulk of the data flow since the Fed last met in November has been very favorable to their soft-landing outlook and growing confidence that inflation can return to 2% over time without sizeable demand destruction. While we did not expect the Fed to move to an outright easing bias, we did expect it to move to a more balanced reaction function and, in the event, we think it did just that.

The changes to the FOMC statement were in line with our expectation. The statement and Chair Powell's comment in the press conference implied the committee feels it is at (or very close) to the terminal means they are done hiking (in expectation) and are engaging in conversations about what is necessary to transition to cuts. In terms of the new set of projections, the median member now foresees a 4.6% funds rate in 4Q 24 and 3.6% in 4Q 25, in line with our pre-FOMC forecast. On net, the Fed simply wiped away its hawkish December move and returned to its prior June outlook.

We maintain our outlook for a cutting cycle that begins in June of 2024, though we note the incoming data and translation of CPI outturns into forecasts of PCE inflation pose risks to an earlier - or faster - cutting cycle than we currently project. We cannot rule out a March cut solely on inflation data, while any sharp deterioration in the macro data would make such a decision easier.

Market reaction

The rates market interpreted FOMC communications as dovish. The Dec FOMC communications validated our core view for lower rates led by the front end and belly of UST curve. We have recommended clients be long the 5Y part of curve and in 5s30s steepeners; these views were supported by FOMC communications today.

The USD sold off sharply and broadly on the clearly dovish menu of offerings from the FOMC, with the decline in the 2024 dot seemingly the biggest initial factor. A majority of the USD's move occurred on back of the statement/SEP release (DXY -0.7%), with Chair Powell's press conference prompting a further leg lower (-0.3%), as he reinforced a "soft landing" type economic outlook and neglected to push back on easier financial conditions.

FOMC: Federal Open Market Committee

CPI: Consumer Price Index

PCE: Personal Consumption Expenditures

SEP: Summary of Economic Projections

Refer to important disclosures on page 5 to 6.
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US Economics

The Fed delivered the dovish pivot that we expected heading into the December meeting. In our view, the bulk of the data flow since the Fed last met in November has been very favorable to their soft-landing outlook and growing confidence that inflation can return to 2% over time without sizeable demand destruction. While we did not expect the Fed to move to an outright easing bias, we did expect it to move to a more balanced reaction function and, in the event, we think it did just that.

The changes to the FOMC statement were in line with our expectation. We did expect them to acknowledge the slowdown in incoming data and thought the language around the need for additional policy rate firming would be removed. The committee did not fully remove this language, but the statement now refers to "any" additional policy rate firming that may be needed. This, plus the addition of the language that inflation has come down over the past year and Chair Powell's comment in the press conference that the use of "any" implied the committee feels it is at (or very close) to the terminal means they are done hiking (in expectation) and are engaging in conversations about what is necessary to transition to cuts. In our view, this constitutes a move to a more balanced reaction function even if the language outcome did not entirely meet our expectations.

In terms of the new set of projections, the median member now foresees a 4.6% funds rate in 4Q 24 and 3.6% in 4Q 25, in line with our pre-FOMC forecast. Revisions to growth, inflation, and unemployment were also as we projected after taking into account the November employment report. On net, the Fed simply wiped away its hawkish December move and returned to its prior June outlook. The SEPs now imply 75bp of cuts in 2024, though as Chair Powell notes this is not a plan and cuts will be dependent on the data flow.

Finally, Powell's remarks in the press conference reaffirmed the pivot to a balanced reaction function and first step toward dovish holds. We did not expect him to push back against market pricing of cuts and the easing in financial conditions since November and indeed he did not. He left open the possibility that the Fed could ease policy simply on inflation outcomes alone, depending on whether any pickup in growth was demand driven or supply induced. He continued to emphasize patience, caution, and a decision making process that would be dependent on the "totality of the data". We also took note that he said the committee was worried about staying at an elevated policy rate for too long, but did not balance that by saying they were overly worried about easing too soon. That may have simply been an omission of the moment and we do not read too much into any one press conference answer; we found it interesting as part of the balance of risk discussion.

We maintain our outlook for a cutting cycle that begins in June of 2024, though we note the incoming data and translation of CPI outturns into forecasts of PCE inflation pose risks to an earlier - or faster - cutting cycle than we currently project. We cannot rule out a March cut solely on inflation data, while any sharp deterioration in the macro data would make such a decision easier.

Exhibit 1: Summary of Economic Projections (Dec vs Sep)

The SEPs now imply 75bp of cuts in 2024

	2023	2024	2025	2026	Longer Run
Change in real GDP (% 4Q/4Q)					
December	2.6	1.4	1.8	1.9	1.8
September	2.1	1.5	1.8	1.8	1.8
Unemployment rate (%)					
December	3.8	4.1	4.1	4.1	4.1
September	3.8	4.1	4.1	4.0	4.0
PCE inflation (% 4Q/4Q)					
December	2.8	2.4	2.1	2.0	2.0
September	3.3	2.5	2.2	2.0	2.0
Core PCE inflation (% 4Q/4Q)					
December	3.2	2.4	2.2	2.0	

Exhibit 1: Summary of Economic Projections (Dec vs Sep)
The SEPs now imply 75bp of cuts in 2024

	2023	2024	2025	2026	Longer Run
September	3.7	2.6	2.3	2.0	
Federal funds (midpoint)					
December	5.4	4.6	3.6	2.9	2.5
September	5.6	5.1	3.9	2.9	2.5

Source: Federal Reserve, BofA Global Research

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US Rates

The rates market interpreted FOMC communications as dovish. The dovish interpretation stemmed from (1) FOMC statement language stating "inflation has eased over the past year" (2) SEP '24 cutting projections for 75bps vs 50bps in Sept (3) Powell's comments that the Committee discussed the timing of rate cuts today. The Dec SEP also suggested an assessment of risks to the inflation outlook as broadly balanced, which was a change from the higher inflation risk in September; the market believes this confidence in the inflation outlook is key for the Fed to start cutting rates. The market now prices nearly 20bps of cuts at the March FOMC meeting, 140+bps total cuts over '24, and trough in the cutting cycle at around 3.3%.

The Dec FOMC communications validated our core view for lower rates led by the front end and belly of UST curve. We have recommended clients be long the 5Y part of curve and in 5s30s steepeners; these views were supported by FOMC communications today. Today's communications also supported our other views to expect a steepening of the real rate curve and volatility surface. Our core justification for these views has been that the trough of the cutting cycle would be priced lower the market as the Fed moved towards cutting rates. That process was accelerated today.

The Fed kept their administered rates unchanged at the meeting, as expected. Chair Powell suggested the Fed is not talking about altering the pace of QT right now. He also suggested that the reason for Fed cuts matters when considering if QT could continue while rates are lowered. These comments suggest a relatively high bar to alter QT which could continue to see money market pressures build in coming months.

FX

The USD sold off sharply and broadly on the clearly dovish menu of offerings from the FOMC, with the decline in the 2024 dot seemingly the biggest initial factor. A majority of the USD's move occurred on back of the statement/SEP release (DXY -0.7%), with Chair Powell's press conference prompting a further leg lower (-0.3%), as he reinforced a "soft landing" type economic outlook and neglected to push back on easier financial conditions.

The post-FOMC move essentially brought the dollar back towards levels reached in late November, prior to the recent upside prints employment and CPI data, amid softening data in Europe, and the pricing of further cuts elsewhere in the G10. The USD's decline occurred amid a notable re-repricing of Fed expectations, with March showing about 75% chance of a cut (from ~45% prior), and pricing of total cuts in 2024 shifting from 115 bp to 140 bp.

While we had suggested that the market pricing of the Fed that had contributed to the USD's November decline seemed excessive, today's FOMC clearly did not attempt to push back on that. That said, our base case outlook for next year remains broadly intact. We see FX markets, and the USD specifically, as most likely being driven by an economic recoupling of the US lower to the rest of the world, after a year of relative outperformance. As such, while we see several G10 central banks (ex BOJ) eventually shifting into easing cycles as inflation comes down, the eventual Fed rate cuts should ultimately weigh on the USD through 2024 and 2025. The timing of this will still be beholden to the data (and a still data-dependent Fed), but for now the signal from the Fed seems clear. Currency markets will get further policy signals tomorrow, as the ECB, BOE, SNB, and Norges bank all meet.

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Research Analysts

US Economics

Michael Gapen
US Economist
BofAS
+1 646 855 3270
michael.gapen@bofa.com

Aditya Bhave
US and Global Economist
BofAS
+1 646 855 9929
aditya.bhave@bofa.com

Stephen Juneau
US Economist
BofAS
+1 646 855 7254
stephen.juneau@bofa.com

Shruti Mishra
US and Global Economist
BofAS
+1 646 855 1040
smishra44@bofa.com

Jeseo Park
US and Global Economist
BofAS
+1 646 855 8688
jeseo.park@bofa.com