Liquid Insight

FOMC Preview: Watch your SEP

19 March 2024

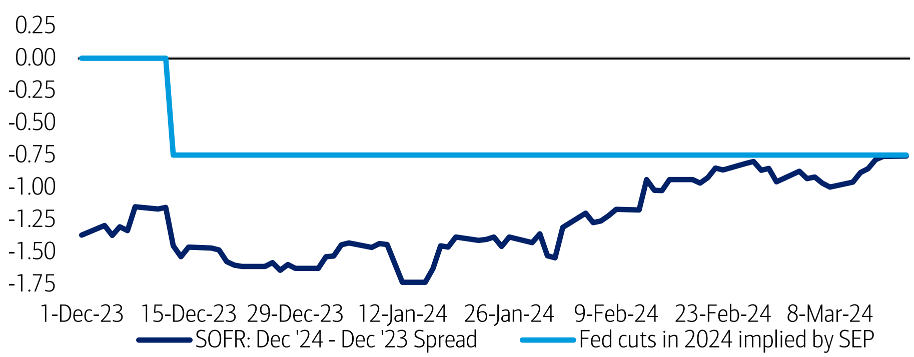
Rates and Currencies Research
Global

Key takeaways

- Fed should still have confidence in disinflation, despite recent stickiness. Expect an unch '24 dot, though its a close call
- Discussion about the balance sheet begins. The Fed will debate when and by how much to taper and what composition it prefers.
- Rates and FX to take signal from dots and Powell's Q&A. 2-way risk on potential for hawkish or dovish guidance

By Mark Cabana, Michael Gapen & Alex Cohen

Chart of the Day: Market pricing of total Fed cuts in 2024 & cuts implied by the March SEP
75bp in SEP implied cuts has served as a de facto "ceiling" for market pricing



Source: Bloomberg; BofA Global Research

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Dot plot is key risk, not giving up on disinflation just yet

We expect the Fed to leave the dot plot unchanged, revise higher '24 growth & inflation, and reiterate the broader disinflationary trend remains in place. The dot plot is a close call and risks skew to fewer cuts signaled.

The dot plot has served as a de facto "ceiling" for the pricing of rate cuts (See: Chart of the Day). The potential removal of an expected cut would be taken as hawkish by the market, putting upward pressure on rates and the USD, all else equal. Conversely, an unchanged dot amid an upgraded inflation forecast would likely be taken as dovish, as it would reflect less concern over recent inflation stickiness.

The meeting will also focus on the Fed balance sheet outlook. Our base case remains that the Fed slows QT at the May '24 FOMC and conclude QT at end '24. However, risks skew to a later slowdown & end of QT due to recent stable funding conditions. We expect no material signal for a Fed UST WAM shortening at this meeting.

Global Rates & Currencies Research
MLI (UK)

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

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

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

Adarsh Sinha
FX Strategist
Merrill Lynch (Hong Kong)
+852 3508 7155
adarsh.sinha@bofa.com

Janice Xue
Emerging Asia FI/FX Strategist
Merrill Lynch (Hong Kong)
+852 3508 8587
janice.xue@bofa.com

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Economics: Stay on hold, keep 3 cuts, but just barely
As noted in our preview (**Federal Reserve Watch: March FOMC preview: not giving up on the disinflation trend just yet 15 March 2024**) we expect the primary focus of Wednesday's FOMC to be on the Summary of Economic Projections (SEP) and Chair Powell's press conference, with the policy statement likely to remain little changed. In the SEP, the Fed is likely to revise its outlook in favor of stronger growth and firmer inflation while leaving unemployment near multi-decade lows. We think it still guides markets to a cutting cycle that begins in June, but the clear risk is it defers cuts. The Fed will also begin the discussion about its balance sheet plans, with a focus on when and how much to taper Treasury run-off caps.

On the SEP more specifically, we look for the median member to project growth of 1.8% this year (from 1.4% in December), with unchanged values for 2025 and 2026 at 1.8% and 1.9%, respectively. We expect headline and core PCE in 2024 will be revised higher to 2.5% and 2.6%, respectively, from 2.4% and 2.4%, previously. We look for headline and core PCE to be one-tenth higher in 2025, and for the committee to continue to project inflation reaches 2.0% by 2026. Despite these expected upward revisions to growth and inflation forecasts, we still foresee the median member to continue to forecast three cuts in 2024, four in 2025, a terminal of 2.9%, and no change in the median long-run dot. This may be fanciful thinking on our part, but there are several inflation reports and plenty of time between now and June to change course if needed. The clear risk is less confidence on inflation reduces the number of cuts in 2024, if not 2025.

In the press conference, Powell is likely to say the committee is less confident about the outlook for inflation in March than it was in January considering recent inflation prints. We expect him to balance this by underscoring the confidence in the outlook expressed through the updated projections. We think the message will be that the January and February CPI reports have marginally reduced confidence and challenge the prospect of a June cut, but that the broader disinflationary trend remains in place. The timing of cuts is one thing. Whether there are cuts is another.

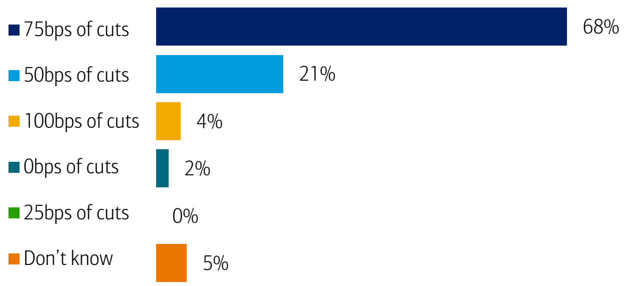
Finally, the Fed made wholesale changes to its statement in January and it does not need much editing. The statement can still describe growth as "solid" despite evidence of deceleration. And despite the uptick in U3-unemployment to 3.9%, it can be described as having "remained low". We do think the statement needs to acknowledge that the pace of job creation has picked up. Otherwise, the message from the statement is that cuts will come if and when the Fed gains confidence on inflation. That has not changed.

US rates: '24 cut anchor at risk
The rates market will be most focused on the dot plot & balance sheet guidance. Our economist's base case for the March FOMC meeting will likely be seen as dovish given no change to the dot plot but higher '24 growth & inflation. Fed balance sheet guidance risks to slowing QT later than we expect. Detail below.

Dot plot risks:
Rate market risks around the March FOMC largely center on the dot plot. Most expect SEP economic expectations to show upward GDP and inflation revisions; the key question is if the Fed shows 2 or 3 cuts for the median '24 dot. Thoughts on dots:

Fed 3 '24 cuts with higher PCE revisions will be seen as a dovish inflation reaction function; we would expect curve bull steepening (2Y yield likely -5bps), declines in front end real rates, and risk on. Our clients expect median '24 dot to show 75bps (Exhibit 2).

Exhibit 1: Client expectations for March SEP '24 median dot
Most expect an unchanged 2024 Fed median dot



Source: BofA Global Research FX and Rates Sentiment Survey
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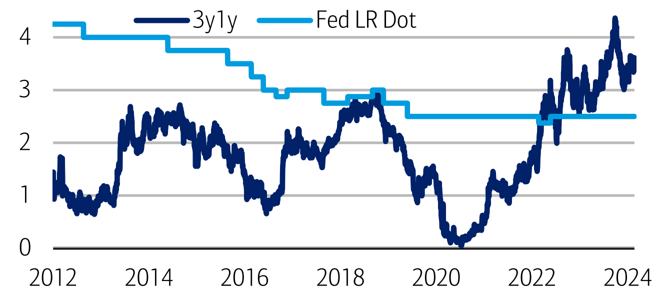
Exhibit 2: 3y1y OIS & Fed LR dot (%)
Market has moved well above Fed LR dot



Source: Bloomberg
BofA GLOBAL RESEARCH

Fed 2 '24 cuts risk a hawkish rate response, bear flattener (2Y yield likely +10bps), & risk off. The rate market will lose a key anchor that has prevented the market from pricing <75bps of '24 rate cuts. If the Fed only shows 50bps of cuts the market will increasingly question when those cuts will be delivered. Fed cut "jump risk" applies not only due to the Nov election but unfavorable PCE base effects in 2H '24. Market pricing for '24 cuts could quickly move from 75bps to ~37.5bps if the 3 cut anchor is lost.

The '26 & longer-run (LR) dots are also important to the market. We think the '26 dot is more important than the LR dot because it represents the trough of the Fed cutting cycle. If the Fed cutting cycle trough rises we suspect the market estimate of neutral will also rise; the Fed cutting trough is most important for rates >2Y. The LR dot is relevant for the market but we believe it is a less tradeable signal. The market has been very comfortable pricing a higher neutral vs Fed (3y1y = 3.6%, LR dot = 2.5%, Exhibit 3).

Overall, we continue to recommend clients be patient on adding duration given recent US data flow & risks around the March FOMC. At end Feb we suggested clients "add if 10Y back at or above 4.25%" (see: Double WAMmy). The market quickly re-priced and clients should be looking to tactically add duration around current levels. If rates continue to rise towards 4.5% we will likely shift from a neutral to long duration stance. We see near term risks to higher rates (Q1 10Y forecast = 4.4%). Paul Ciana, our FICC technical strategist agrees and states "new YTD yield highs likely a buying opportunity, such as 10y 4.35-4.55%" (see: confident chart for Q2).

Balance sheet guidance:

The Fed is expected to engage in the first robust discussion on the outlook for their balance sheet at the March FOMC meeting. Our base case remains that the Fed slows QT at the May '24 FOMC by lowering the UST redemption cap from $60 to $30b/m while keeping the MBS redemption cap unchanged at $35b. The Fed would then conclude QT at end '24.

Risks to our base case skew to a later slow down of QT & longer QT period. We have overweighted Dallas Fed President Logan's guidance that the Fed would slow QT when ON RRP balances reach a "low level". We have assumed "low" means $200-250b which could be reached in April, especially following the tax date. However, since Logan's comments, money market rates have shown greater signs of stability vs late '23 which risk a later QT slowdown (see stable repo).

If the Fed signals a later QT slowdown than we expect it will contribute to modest upward pressure on money market rates & result in higher bill supply vs our base case (see: bill supply: higher w/ QT shift & refunding). Bill supply would be $30b higher per month of existing QT vs our prior estimates. Short-dated swap spreads would also likely tighten modestly if the Fed signals a later QT timeline.

Finally, we do not expect any announcements on the Fed's UST portfolio composition at this meeting. We expect any discussion of the Fed UST weighted average maturity (WAM) will be delayed until May or later. Indeed, Chair Powell said at his recent Senate testimony "I don't think we will deal with [UST WAM discussion] at this meeting". We think recent short-dated swap spread widening following Waller comments or shortening Fed UST WAM are overdone because (1) any Fed SOMA UST WAM shift will be slow (2) market impact is likely largest only if Fed purchases in the secondary market. Our best guess is that Fed UST WAM shortening is likely more of a story for 2025, not 2024. For more detail see: Fed UST WAM shift: a slow aspiration.

FX: A range of possibilities

With a policy move and material change to the statement virtually off the table, the USD will most likely take its initial direction from the SEP. OIS markets are currently priced at around -13bp of cumulative cuts by June, and -70bp by YE. With 3 cuts currently penciled into the SEP, the scope for any initial USD rally will likely come from a potential shift in the median dot to 2 cuts, as discussed above. Conversely, an unchanged dot plot, along with an upgrade to the inflation outlook would likely be taken as dovish by the FX market, likely prompting a reversal of the USD's rally over the past week.

The USD will then take its cue from Powell's Q&A, and any possible guidance on whether the Committee has gained any more or less "confidence" in the inflation picture to steer the market in the direction of potential June action or inaction.

While the Fed is still data dependent and likely not ready to overly commit to specific guidance, Powell has been known to surprise the market recently. The scope for a another one cannot be overlooked. Recall, recent official communication by Chair Powell/the FOMC was interpreted as:

- Dovish at the December FOMC both in terms of the SEP (added cuts), and Q&A (talk of cuts, inflation optimism, no pushback on easy financial conditions). (DXY -0.95% during FOMC)
- Hawkish at the January FOMC, when he surprised the market with more specific guidance away from a potential March cut during Q&A. (DXY +0.3% during FOMC)
- Dovish in last week's congressional testimony, when he suggested the Fed was "close" to having the confidence to ease and didn't assertively express concern on recent upside inflation prints. (DXY -0.5% over both days)

Given his most recent comments were directed to a Congress more interested in discussing jobs, housing affordability and bank regulation, its perhaps not surprising that he elected to shade in the dovish direction. While upping the dovish language in light of the February CPI and PPI reports feels unlikely, an unchanged dot plot could be enough for the FX market to resume USD selling. Nonetheless, there appears to be a range of plausible outcomes for FX markets to brace for.

Notable Rates and FX Research

- **Global Macro Year Ahead 2024 -** Hope for the best, prepare for the worst, 19 Nov 2023
- **Global Rates Year Ahead 2024 –** Cloudy with a chance of landing, 19 Nov 2023
- **G10 FX Year Ahead -** The year of the landing, 20 Nov 2023
- Fade it until you make it, **Liquid Cross Border Flows**, 11 Mar 2024

Rates, FX & EM trades for 2024

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 punch bowl 15 March 2024

Global Rates Weekly: Stop being negative 15 March 2024

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Research Analysts

US

Ralph Axel
Rates Strategist
BofAS
+1 646 855 6226
ralph.axel@bofa.com

Paul Ciana, CMT
Technical Strategist
BofAS
+1 646 855 6007
paul.ciana@bofa.com

John Shin
FX Strategist
BofAS
+1 646 855 9342
joong.s.shin@bofa.com

Vadim Iaralov
FX Strategist
BofAS
+1 646 855 8732
vadim.iaralov@bofa.com

Mark Cabana, CFA
Rates Strategist
BofAS
+1 646 855 9591
mark.cabana@bofa.com

Bruno Braizinha, CFA
Rates Strategist
BofAS
+1 646 855 8949
bruno.braizinha@bofa.com

Meghan Swiber, CFA
Rates Strategist
BofAS
+1 646 855 9877
meghan.swiber@bofa.com

Europe

Ralf Preusser, CFA
Rates Strategist
MLI (UK)
+44 20 7995 7331
ralf.preusser@bofa.com

Ruben Segura-Cayuela
Europe Economist
BofA Europe (Madrid)
+34 91 514 3053
ruben.segura-cayuela@bofa.com

Mark Capleton
Rates Strategist
MLI (UK)
+44 20 7995 6118
mark.capleton@bofa.com

Athanasios Vamvakidis
FX Strategist
MLI (UK)
+44 020 7995 0279
athanasios.vamvakidis@bofa.com

Sphia Salim
Rates Strategist
MLI (UK)
+44 20 7996 2227
sphia.salim@bofa.com

Kamal Sharma
FX Strategist
MLI (UK)
+44 20 7996 4855
ksharma32@bofa.com

Ronald Man
Rates Strategist
MLI (UK)
+44 20 7995 1143
ronald.man@bofa.com

Michalis Rousakis
FX Strategist
MLI (UK)
+44 20 7995 0336
michalis.rousakis@bofa.com

Pac Rim

Adarsh Sinha
FX Strategist
Merrill Lynch (Hong Kong)
+852 3508 7155
adarsh.sinha@bofa.com

Janice Xue
Rates Strategist
Merrill Lynch (Hong Kong)
+852 3508 8587
janice.xue@bofa.com

Shusuke Yamada, CFA
FX/Rates Strategist
BofAS Japan
+81 3 6225 8515
shusuke.yamada@bofa.com