Liquid Insight

Nov FOMC preview: spooked by real rates

31 October 2023

Rates and Currencies Research
Global

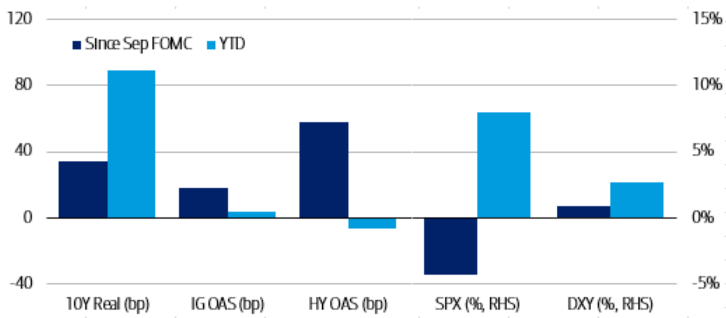
Key takeaways

- We expect the Fed to hold rates at 5.25-5.5% at the Nov FOMC. Chair Powell will likely continue to emphasize data dependence.
- Given ongoing economic resilience, we expect one more hike from the Fed, though it remains a close call.
- UST curves likely steeper & inflation BEs wider with dovish Fed despite strong data. Any removal of cuts should support USD

By Aditya Bhave, Mark Cabana, Alex Cohen, Michael Gapen

Chart of the Day: Select asset price changes YTD and since Sept FOMC

Broader financial conditions have tightened recently, but YTD changes reflect less impact & likely strong 2023 growth



Source: Bloomberg; BofA Global Research

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Fed seems spooked by rates despite very strong data

The Fed will likely hold rates steady despite accelerating GDP and employment. The Fed has adopted a more cautious tone due to the UST long-end rate rise, arguing rates markets have done some of its tightening.

At the press conference, Chair Powell will likely reiterate that the Fed is "proceeding carefully". Powell will likely be asked why 5.5% fed funds is restrictive despite 4.9% real GDP growth and the pickup in September payrolls. We think Powell will repeat his argument that more hikes could be warranted if there is "additional evidence" of above-trend growth or a tightening labor market. We still expect one more hike in December.

We believe the recent US rate rise is largely due to better growth and a reduction of future Fed cuts, though an acute supply / demand imbalance has supported the move (see US rate shock FAQ). The Fed attributes the rate rise to term premium; we disagree (see What is term premium telling us?). The rates curve is likely to steepen after the Nov FOMC communications with inflation breakevens wider. The USD is unlikely to materially break recent ranges on the back of our base-case FOMC expectations.

Global Rates & Currencies Research
MLI (UK)

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

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

Alex Cohen
FX Strategist
BofAS
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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BEs: breakevens

The Fed remains patient

We expect the Fed to maintain the target range for the federal funds rate at 5.25-5.5% at the November FOMC meeting. Several FOMC participants have adopted a more cautious tone in response to the large sell-off in long-end rates in recent weeks, arguing implicitly or explicitly that the rates market had done some of the Fed's financial tightening work for it, so additional hikes were less necessary. (Chart of the Day) Markets were pricing less than a 20% chance of a hike going into last week (just before the blackout period started), but Chair Powell, Governor Waller and New York Fed President Williams all chose not to make a strong case for a November hike. The committee clearly does not see an urgent need to hike again.

Last week Governor Waller and Chair Powell both laid out a similar framework for the policy outlook. Their base case seems to be that economic activity will soften in 4Q and beyond, after the 3Q surge. But they remain concerned about demand-driven re-acceleration in inflation. We also expect growth to slow in 4Q, but not significantly below trend. Powell's speech on October 19 suggested that the Fed could hike further in response to strong activity data. That is, it might not wait for inflation to increase again because it is aiming to pre-empt inflation. Given this, we think there is enough momentum in the economy to warrant one more hike. But it is a very close call, as the economy could slow meaningfully in 4Q for a variety of reasons, including a slowdown in business investment or inventory accumulation, the drag from student loan repayments, financial tightening and a potential government shutdown.

Powell will probably not break new ground

Fed Chair Powell's remarks at the press conference should largely mirror his comments on October 19. We expect little forward guidance and an emphasis on data dependence. Powell is likely to state that the Fed is "proceeding carefully" and is mindful of financial tightening, which it does not view as a reflection of policy rate expectations. The only changes we expect to the FOMC statement are descriptions of current economic activity, which should be upgraded to reflect the robust recent data.

Rates: spooked now, scared later

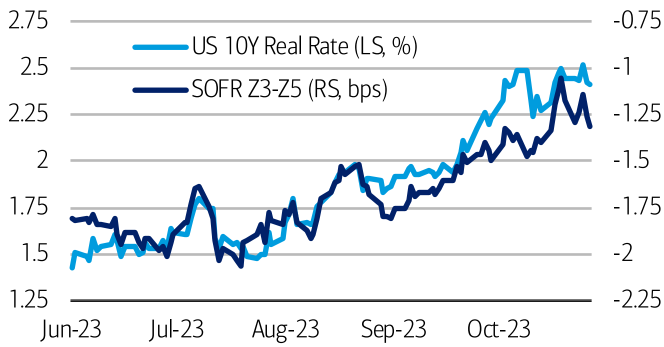
The Nov FOMC will likely support steeper nominal & real curves + wider long-dated inflation breakevens. In our view, a Fed hold is a given. Powell will likely struggle to explain why rates are restrictive at 5.5% fed funds and the Fed is holding with 8.5% Q3 nominal GDP growth, strong hiring, sticky core services, and strong retail spending. The rates market will likely hear an inexplicably dovish Fed that is concerned by higher real rates. Post FOMC we expect: Fed cut reduction (less inverted SFR Z3/Z5), steeper curves, wider breakevens.

The rates market likely believes the Fed has been spooked by higher real rates. We attribute the recent rate rise due to the 3 factors, in desceding order of priority (with a BIG gap between 1 & 2): (1) better US growth (2) supply / demand imbalance (3) offside asset manager long duration positions. These factors have been exacerbated by a Fed preference to proceed slowly on hikes. The market knows the Fed prefers not to hike; therefore, the market has removed future cuts. The relationship between rate cut removal and 10Y nominal and real rates is very high (Exhibit 2).

The more cautious Fed is likely driven by their interpretation of the real rate rise. We think the recent real rate rise is largely driven by better real growth expectations (Exhibit 3). The Fed seemingly believes it is driven by "term premium" (Exhibit 4). We think Fed term premium models do not accurately capture shifts in Fed policy beyond 1Y (i.e. pricing out of future rate cuts; see: [What is term premium in rates telling us?]).

We are concerned that the Fed is ignoring rate market signals at their own peril. The Fed seems to be dismissing away the real rate rise as a nefarious "unexplainable" factor. We think real rates are higher due to very strong US growth. If we are right, the Fed risks falling behind the real growth & inflation curve, unless the impact of higher rates becomes more pronounced in 2024. Inflation breakevens suggest the Fed is slipping (Exhibit 5). If we are wrong, then why is SPX still +8% YTD?

Exhibit 1: 10Y real rate & SOFR rate cut expectations
Market has increased real rates while rate cuts pared back



Source: Bloomberg

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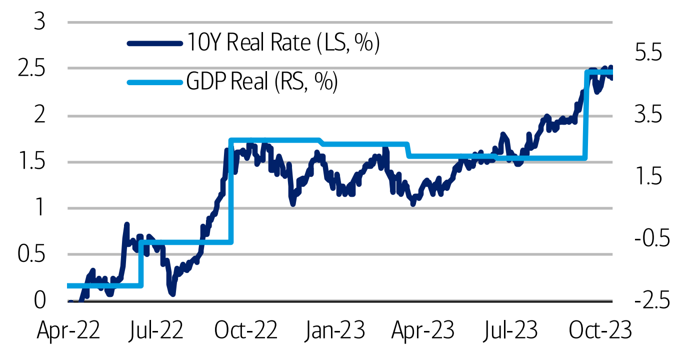
Exhibit 2: 10Y real rates & US real GDP
Real rates higher with US growth stronger



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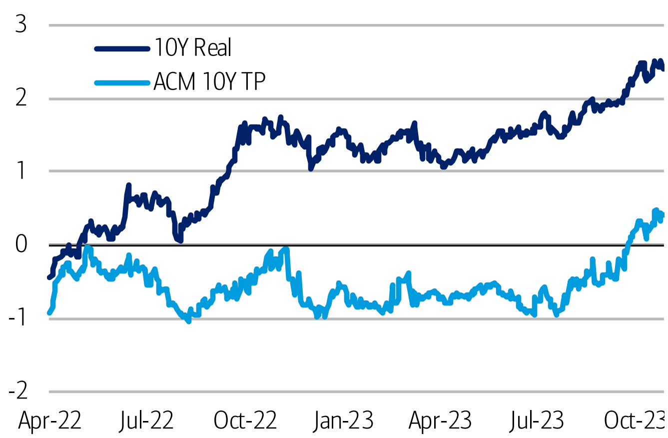
The rates market shouldn't expect the Fed to catch up at the Nov FOMC. UST curves should go steeper (both nominal & real) and inflation breakevens should widen. Risk assets are also vulnerable. We don't think Dec FOMC OIS will price much risk of an additional Fed hike b/c possible gov't shutdown. The rates market will likely reflect a behind the curve Fed through steeper curves and higher long-end nominal & real rates.

A Fed spooked by higher long-end rates today may be downright scared post Nov FOMC.

Exhibit 3: UST 10Y real rate & ACM term premium measure (%)
Fed believes real rates higher due to term premium, we are skeptical



Source: Bloomberg

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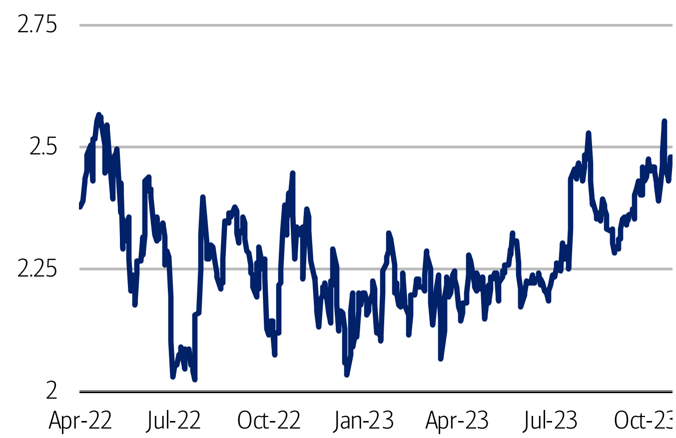
Exhibit 4: US 5y5y inflation breakeven (%)
Dovish Fed in face of strong data = wider inflation breakeven inflation



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FX: Awaiting a fresh catalyst

Fed commentary this month has prompted the USD to consolidate around the YTD highs. The seemingly concerted effort by FOMC members to highlight the broader tightening of financial conditions has served to reduce expectations for a higher terminal fed funds rate this year, which in turn slowed the USD's ascent. That said, US relative growth outperformance remains an ongoing theme in the FX market, as the data flow has continued to print to the upside. This, coupled with rising geopolitical uncertainty and broader G10 central banks similarly demonstrating a desire to pause the hiking cycle (for example, BOC and ECB last week), has served as a counter-balance to the Fed's recent commentary.

With expectations for the November FOMC fully entrenched, the FX market will likely be looking to parse out nuances of Chair Powell's assessment of the balance of risks and potentially a further elaboration on how the Fed sees broader financial conditions as a complement/substitute to further tightening. That said, it seems unlikely he will intentionally break from the standard guidance of "data dependent"/"high for long" language that has been in place for some time. Barring a material and unforeseen shift in tone, a significant Fed-induced impact on the USD appears unlikely, though to the extent that 2024/25 cuts are priced out, the USD should find support. Friday's employment report looms as a potentially bigger driver of the USD near-term.

Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023 –** Year Ahead 2023: Pivot ≠ Peak, 20 Nov 2022
- The needle could easily move**, Global FX Weekly**, 27 Oct 2023
- Haunted fiscal house, **Global Rates Weekly**, 27 Oct 2023
- Yielding to official pressure, **Liquid Cross Border Flows**, 23 Oct 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 needle could easily move 27 October 2023

Global Rates Weekly: Haunted fiscal house 27 October 2023

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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