Federal Reserve Watch

January FOMC preview: Playing for time

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Economics
United States

US Economics
BofAS

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

US Rates Research
BofAS
+1 646 855 8846

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

See Team Page for List of Analysts

Progress has been made, but the Fed needs to buy time

Fed communication indicates the committee is pleased with the overall state of the economy and the progress made on reducing inflation. Growth in economic activity appears to have slowed, labor markets are coming into better balance, and inflation has moderated. The main questions for the Fed are: (1) how sustainable is this mix of data? and (2) is disinflation driven primarily by goods deflation sufficient to start a gradual easing cycle? We continue to expect the first rate cut in March, though we expect no strong signal in January. The Fed needs to buy time to see more data.

A shift to neutral policy rate guidance

We think the policy rate guidance needs to change again in January and believe the current upside bias in the statement remains untenable. If the Fed follows the evolution of guidance that it used during 2006-07, it could change the language in the statement to read, ""[i]n determining any future policy rate adjustments that may be appropriate to return inflation to 2 percent over time…". The literal reading of this guidance would suggest the Fed would be 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.

Press conference: Data dependence, methodical easing

In the press conference, we expect Chairman Powell will want to retain optionality around the timing of any easing in the policy rate. We expect data dependence to win out. That said, we do expect to hear emphasis on the anticipated pace of policy normalization and expect Powell to emphasize a gradual pace, or methodical and careful in the words of Governor Waller.

A robust discussion on balance sheet caps

We expect no decision on balance sheet policies at the January meeting, but we do expect the committee to engage in a discussion on balance sheet caps and tapering. Part of this discussion will involve what constitutes ample liquidity, a "low level" of balances in the ON RRP (President Logan) or zero balances in the ON RRP and a reserve-to-GDP ratio of about 10% (Governor Waller). We look for an announcement on tapering in March followed by an end to balance sheet runoff in June.

Voter rotation: A hawkish bent

With the January meeting comes a new rotation of voters on the committee. Rotating onto voting status are Cleveland Fed President Mester, Richmond Fed President Barkin, Atlanta Fed President Bostic, and San Francisco Fed President Daley. Our reading of their recent remarks suggest they are more cautious about the timing of policy rate cuts. That said, we don't put too much emphasis on the views of voters versus non-voters given the trend toward fewer dissents and preference for unanimous decisions.

Making progress, but is it enough (to start cuts)?

Fed communication during the intermeeting period indicates the committee is pleased with the overall state of the economy and the progress made on reducing inflation. Growth in economic activity appears to have slowed, labor markets are coming into better balance, and inflation has moderated. Most importantly in the eyes of the Fed, inflation has moderated without a significant rise in unemployment. As a result, the Fed's – and our – confidence on achieving the "soft landing" has increased.

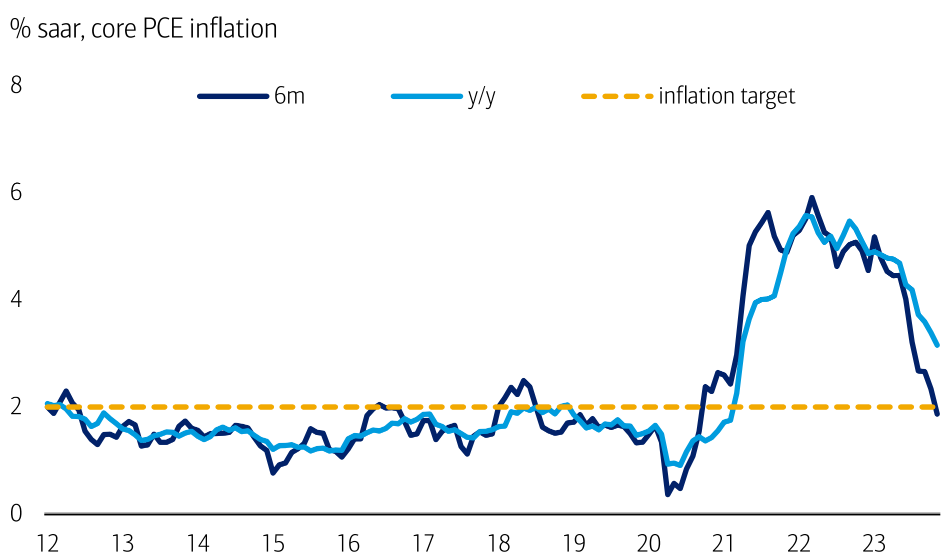
The main question, in our view, is how sustainable is this mix of data? In addition, when it comes to the degree of confidence expressed by individual FOMC participants about returning inflation to 2% - a key component in the decision to begin policy normalization - participants must take a stand on whether the good news on inflation should be discounted since it is mostly driven by falling goods prices, which may or may not continue.

This "component arithmetic", as it has been described to us, is likely a differentiating factor behind the dispersion of participants' views about the appropriate timing of policy rate cuts. Some participants like Governor Waller have steered away from excessive focus on the behavior of inflation components in favor of the traditional headline and core inflation measures. After all, the inflation target is written in terms of changes in headline PCE inflation, not its components.

However, it is clear from other participants that their confidence in inflation returning to 2% on a sustainable inflation and their assessment of risks around any baseline forecast are related to the behavior of services prices relative to goods prices. Sticky shelter inflation and the expectation that declines in goods prices are likely to prove temporary could lead these participants to prefer a later, and slower easing cycle. These participants are more likely to ask the question of how much services inflation would need to slow to hit 2% if goods prices stop falling.

If we are right on our outlook for a rate cut in March, it is likely because a majority of participants focus on more aggregated measures of inflation than specific components. After all, if inflation continues along its recent trend, the committee will see y/y rates of core PCE inflation well below 3.0% by the March FOMC, along with 3m and 6m annualized rates at or below 2.0%. In addition, measures of long-run inflation

Exhibit 1: 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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expectations from the University of Michigan Survey of consumers, the Survey of Professional Forecasters, and market-implied breakevens each point to mandate-consistent outcomes. In our view, this should be enough to start a gradual normalization cycle beginning in March and we continue to expect 100bp of cuts in 2024 and an additional 100bp of cuts in 2025. Our forecast calls for quarterly 25bp rate cuts, with the Fed skipping meetings in between policy actions.

That said, if we are wrong on our outlook for a rate cut in March, it may be because FOMC members are reluctant to cut rates without evidence that services inflation is well behaved. In addition, even if participants are inclined to think disinflation trends are sustainable, they may prefer to take a risk management approach and cut later than earlier. We think this is inconsistent with the indicated change in the Fed's reaction function coming out of the December FOMC meeting where Chair Powell signaled that the committee does not believe a significant rise in the unemployment rate is needed to bring inflation down, but we are not on the committee and have no say in the matter. "Sustainability" and "confidence" are subjective measures left to the determination of each individual participant; we think the data will support action in March, but the data still have to deliver and Fed confidence needs to increase further.

Altogether, significant progress has been made, but its sustainability remains an open question for some on the committee. The Fed needs to buy time before taking actions on rates and the balance sheet to normalize its policy stance.

To signal or not signal?

The old adage is the Fed never surprises on hikes but is perfectly willing to surprise on cuts. If so, and given that we are likely coming into an easing cycle, it raises the question of whether markets should expect clear signaling from the Fed ahead of the start of any rate cutting cycle. If the Fed's historical behavior and proclivities hold, we should not expect clear guidance on when cuts will come. To be clear, we don't expect the Fed to signal strongly one way or the other about potential March rate cuts, but there will be plenty of opportunities for the Fed to signal during the intermeeting period prior to the blackout period ahead of the March meeting.

Given the uniqueness of the upcoming normalization cycle, where the Fed anticipates a gradual reduction in the nominal policy rate to preserve an appropriate amount of real policy rate tightening, we think it would make sense for the Fed to send clear signals. Surprising on cuts, in our view, is more appropriate when recession risk is high and the Fed can gain something by surprising markets. We do not believe that to be the case currently. Hence, we think the Fed will be messaging at the right time, but we do not believe that time is at hand; we think the Fed wants to see more inflation and labor market data before deciding on any action in March (or later).

Policy rate guidance: From upside bias to neutral

We think the policy rate guidance needs to change again in January and believe the current upside bias in the statement remains untenable. Please see the appendix to this report for our anticipated changes to the FOMC statement.

Most FOMC participants have implicitly or explicitly signaled that the rate hike cycle has likely ended and the decision for the committee is shifting toward when and how fast the policy rate should be reduced. Hence, the line, "[i]n determining ***the extent of any additional policy firming*** that may be appropriate to return inflation to 2 percent over time…" needs to be changed (bolded italics ours).

We think the Fed will move to fully neutral language, consistent with the view of most participants that risks around the outlook have become more balanced. If the Fed follows the evolution of guidance that it used during 2006-07, it could change the language in the statement to read, ""[i]n determining ***any future policy rate adjustments*** that may be appropriate to return inflation to 2 percent over time…" (bolded italics ours). The literal reading of this guidance would suggest the Fed would be 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.

A hawkish alternative: "Patience"

We would view unchanged guidance in the statement and the retention of upside bias to the policy rate path as decidedly hawkish, and it would likely come as a big surprise to financial markets. That said, there are other ways the Fed could change its guidance while still coming off as hawkish.

For example, the committee could change the statement to read, "[t]he committee ***intends to remain patient as it considers what additional policy rate adjustments*** may be appropriate to return inflation to 2 percent over time…" (bolded italics ours).

We would read this language as likely taking a March cut off the table and, as we note elsewhere in this report, we don't believe the Fed will communicate a specific view on the likelihood of action in March; we think it will continue to emphasize data dependence and desires optionality.

A dovish alternative: Signal increased confidence on inflation

In thinking of more dovish outcomes, we have a hard time thinking the committee would adjust its forward guidance to an outright easing bias. For example, the statement could refer to "future policy rate reductions", but we think this highly unlikely.

We think a dovish statement would send a signal of increased confidence about inflation returning to 2% and reduced inflation risks. The current language that says, "[i]nflation has eased over the past year but remains elevated" could be simplified to "[i]inflation has eased over the past year." The statement could also remove the language, "[t]he Committee remains highly attentive to inflation risks" or replaces it with language that says risks to inflation and the outlook are broadly balanced. Again, we think these changes are unlikely given that core PCE inflation is near 3.0% y/y currently.

Press conference: Data dependence, methodical easing, and discussion of reducing balance sheet caps

In the press conference, we expect Chairman Powell will want to retain optionality around the timing of any easing in the policy rate. We don't think the Fed wants to rule in or rule out a March cut for two main reasons. First, the Fed has emphasized data dependence and the incoming data has been quite favorable for the Fed's soft landing and disinflation forecast; a cut in March remains an option. Second, Powell has generally favored retaining optionality during a business cycle that has taken several unexpected twists and turns; taking a hard stand on March at this juncture would go against what has worked well for the Fed recently. We expect data dependence to win out.

That said, in the spirit of Governor Waller's recent remarks, we do expect to hear emphasis on the anticipated pace of policy normalization. With the Fed implicitly signaling that rate hikes are likely done, the next step is to provide additional communication on the easing cycle. As we argued above, this is unlikely to come in regard to the start of the easing cycle, but we see plenty of scope for communication about the anticipated pace and how the upcoming normalization cycle differs from Fed actions during prior business cycles.

Like Waller, we think Powell will emphasize a gradual pace of easing – methodical and careful were Waller's chosen descriptors – and the goal of reducing the nominal policy rate that keeps the real policy rate "at an appropriate level of tightness." In other words, recessions call for fast and large cuts while an economy in good shape with falling inflation require different action.

In our view, the Fed is only likely to deliver large cuts (50bp or more) if the outlook for activity and labor market deteriorates rapidly and recession risk materializes. Otherwise, we look for the Fed to move in 25 basis point increments. Under our current baseline, where shelter inflation falls slowly, we think this would imply 25bp reductions on a quarterly basis, timed in line with the release of updated projections. However, should inflation pressures diminish more rapidly than the Fed expects, we would not rule out 25bp cuts at consecutive meeting, particularly in the event that this outcome was driven by faster disinflation in services prices.

Time for discussion on balance sheet policies

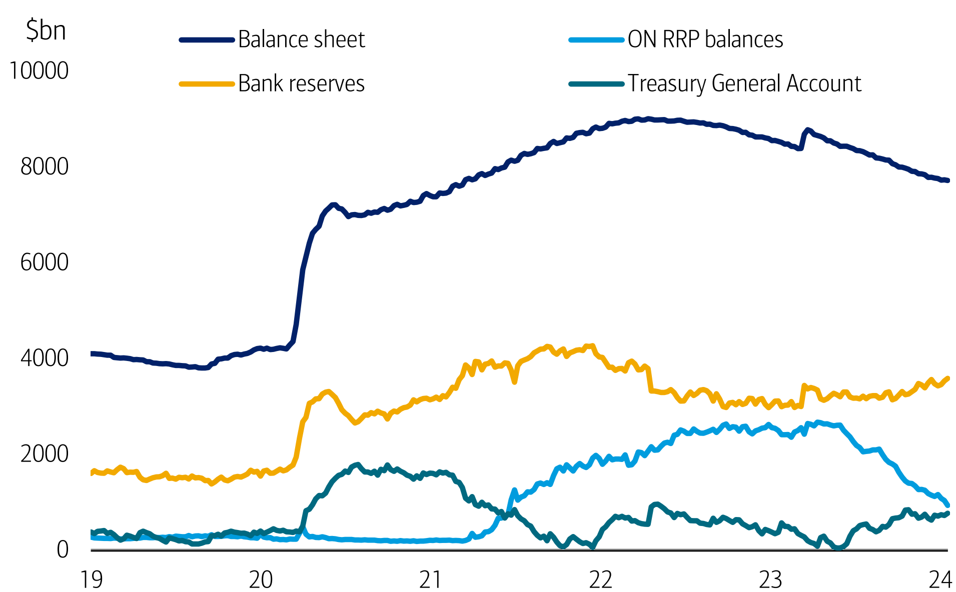
Finally, we expect the committee will have an extensive discussion on how and under what conditions the redemption caps on Treasuries will be lowered (eg. the tapering of quantitative tightening). In our view, Chair Powell will likely provide a high-level synopsis of this discussion at best and look to subsequent Fed speeches and the minutes for further details. We expect no decisions on the slowing of balance sheet runoff to be announced at this meeting.

About as far as we think Powell will go in the press conference is to explain why the Fed is considering tapering the pace of balance sheet runoff. At a macro level, the Fed uses its interest rate and balance sheet tools to target macro outcomes on inflation and employment. With employment likely above the Fed's estimate of maximum employment (eg. there is no shortfall in current employment from its maximum sustainable level) and inflation pressures moderating, less monetary restraint is required. This can be accomplished by rate cuts, slower runoff and an eventual end to quantitative tightening, or some of both.

Reductions in runoff also involve considerations to engineer a more orderly transition from an abundant to ample reserve regime. In other words, as liquidity scarcity is reached, some institutions will find themselves short of desired liquidity levels while others will have excess. Slowing the pace of runoff allows for a more efficient reallocation of liquidity while reducing the likelihood of hiccups in front-end funding markets that took place in 2019. While communication from Fed officials suggest they think liquidity is still abundant, this assessment appears to be shifting. Dallas Fed President Logan said in early January that month-end and quarterly-end jumps in repo rates imply "we're no longer in a regime where liquidity is super abundant and always in excess supply for everyone." In her view, the Fed "should slow the pace of runoff as ON RRP balances approach a low level."

Exhibit 2: Fed balance sheet ($bn)

ON RRP balances have fallen rapidly and are approaching "low levels"



Source: Federal Reserve, Haver Analytics, BofA Global Research

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We are not sure of her assessment of what a "low level" means, but believe it is likely $200-250bn. Should balances in the ON RRP continue to decline at their current pace, this range could be reached in March. Since runoff began in June 2022, securities held outright on the Fed's balance sheet have fallen by $1.322tn and balances in the ON RRP have fallen by $1.375tn (as of January 17). In 2023, ON RRP balances fell by an average of $122bn per month. In contrast, reserve balances have risen by $235bn since quantitative tightening began.

Others on the committee, including Governor Waller, have the view that balances in the ON RRP can be driven to zero before liquidity scarcity is reached. He believes the likely endpoint for balance sheet runoff and draining reserves out of the system is at a reserves-to-GDP ratio of 10-11%. He suggested that "a good signal" for reserve scarcity would be a surge in use of the Fed's standing repo facility. Narrowing the difference between these competing views on what constitutes reserve scarcity, in our view, will be an important goal of the discussion at the January meeting.

We think the Fed will announce tapering of runoff in March and conclude its balance sheet reduction in June. We believe the most simple and straightforward indicator to assess the degree of liquidity abundance is the balance in the Fed's ON RRP. Meaningfully positive use of Fed ON RRP implies there is excess liquidity in the financial system (if banks found themselves short on liquidity, they could find ways to pull this cash out of Fed ON RRP via FHLB use, issuing directly to prime fund users of ON RRP, or competing more aggressively for deposits with MMF investors). Once ON RRP balances are near zero, it is no longer obvious to us that there is excess liquidity in the system. As a result, we have balance sheet runoff ending earlier than most.

We think the Fed will debate between a fixed monthly rate of reduction in Treasury redemption caps that would imply a fixed end date to quantitative tightening and reducing redemption caps without specifying an end date. For example, the Fed could announce in March that the current $60bn cap on maturing Treasury securities could decline by $15bn per month (to $45bn in April, $30bn in May, $15bn in June, and zero thereafter), which would imply a June end date. Conversely, it could cut the redemption cap in half to $30bn and then continue to assess liquidity conditions on a meeting-to-meeting basis to determine when reserves have moved from abundant to ample. We generally lean to the former guidance, but see both as viable options under discussion.

We continue to believe the Fed will not adjust redemption caps on MBS holdings given its preference for an all-Treasury portfolio in the long run. Once runoff ends, we expect the Fed to reinvest maturing MBS principal back into US Treasuries, as it has done in the past in similar situations.

Other topics: the December SEPs, FCIs, and ethics

Finally, without a new set of projections, we expect Powell will be asked whether the December Summary of Economic Projections (SEPs) are still relevant and operational in the context of the incoming data flow. We think "yes" based on recent Fed speeches.

On financial conditions indicators (FCIs), we expect Powell to repeat his broader message that any gap between market expectations and appropriate policy under the Fed's baseline are likely to be resolved in time and the Fed isn't overly concerned one way or another with fluctuations in financial conditions. We think much of the push-back from the Fed recently has been more about not getting boxed into a March cut so far in advance as opposed to views over which financial conditions have eased "too much" versus the Fed's desire.

Finally, though we take no view on the subject, we expect Powell to be asked about the conclusions put forth by the Office of Inspector General of the Board of Governors of the Federal Reserve System about the trading activity of Reserve Bank Presidents Kaplan and Rosengren, which can be found on the Fed's website.

Voter rotation: A more hawkish bent

With the January meeting comes a new rotation of voters on the committee. Rotating onto voting status are Cleveland Fed President Mester, Richmond Fed President Barkin, Atlanta Fed President Bostic, and San Francisco Fed President Daley. Rotating off voting status are Chicago Fed President Goolsbee, Philadelphia Fed President Harker, Minneapolis Fed President Kashkari, and Dallas Fed President Logan.

This rotation results in a slightly more hawkish group of FOMC voters given recent communication, including:

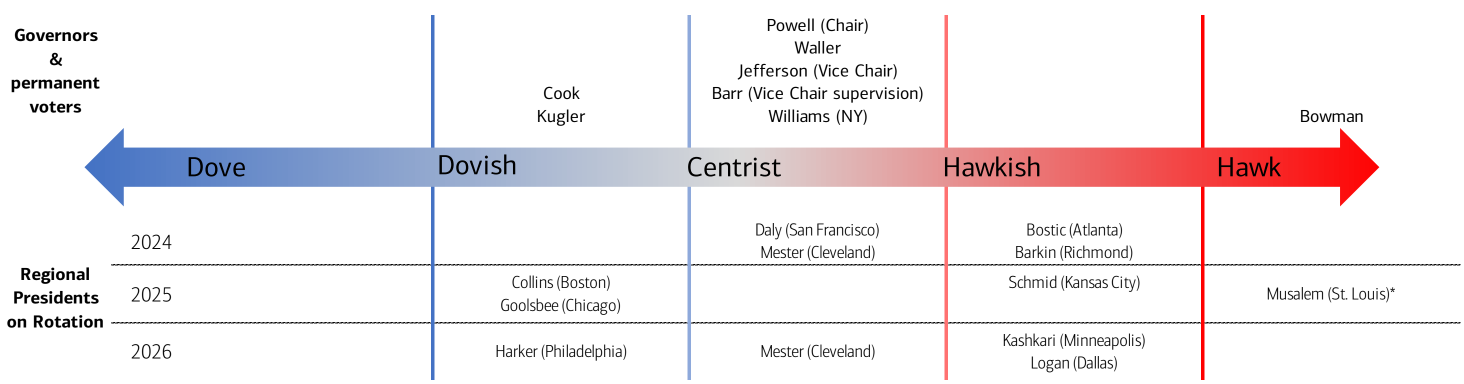
- Bostic (January 18): "In such an unpredictable environment, it would be unwise to lock in an emphatic approach to monetary policy. That is why I believe we should allow events to continue to unfold before beginning the process of normalizing policy." He favors cutting rates in 3Q, but would be open to cuts sooner if inflation falls "well faster" than he projects.

- Mester (January 11): "I think March is probably too early in my estimate 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." Mester favors a rate cutting cycle consistent with the median forecast in the dot plot (75bp in cuts this year).

- Daly (January 19): "We don't want to loosen policy too quickly, only to find that inflation gets stuck at way above target. That would be a miss. That would be a very scarring miss." She said it is "premature" to say rate cuts are around the corner, saying she needs to see more evidence that inflation is on a consistent trajectory back to 2% before easing.

That said, we don't put too much emphasis on the views of voters versus non-voters given the trend toward fewer dissents and preference for unanimous decisions. Hence, while the mix of FOMC voters may skew more hawkish in 2023 versus 2024, we think all voices on the committee matter and can influence the policy decision at any given meeting.

Exhibit 3: BofA Dove-Hawk chart
With the turn of the calendar to 2024 comes a new set of FOMC voters



Source: Federal Reserve, BofA Global Research. * Until we know more information about his views on monetary policy, we have left President Musalem's position in our dove-hawk chart in the same place as former St. Louis Fed President Jim Bullard.

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Appendix: Projected changes in the FOMC Statement

Below we show our projected changes to the December FOMC statement which will appear in January. Strikethrough text indicates deletions from the December statement while underlined text indicates new language that we expect to appear.

Recent indicators suggest that growth of economic activity has slowed from its strong pace in the third quarter. Job gains have moderated ~~since earlier in the year~~ but remain strong, and the unemployment rate has remained low. Inflation has eased over the past year but remains elevated.

The U.S. banking system is sound and resilient. Tighter financial and credit conditions for households and businesses are likely to weigh on economic activity, hiring, and inflation. The extent of these effects remains uncertain. The Committee remains highly attentive to inflation risks.

The Committee seeks to achieve maximum employment and inflation at the rate of 2 percent over the longer run. In support of these goals, the Committee decided to maintain the target range for the federal funds rate at 5-1/4 to 5-1/2 percent. The Committee will continue to assess additional information and its implications for monetary policy. In determining any future policy rate adjustments ~~the extent of any additional policy firming~~ that may be appropriate to return inflation to 2 percent over time, the Committee will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, and economic and financial developments. In addition, the Committee will continue reducing its holdings of Treasury securities and agency debt and agency mortgage-backed securities, as described in its previously announced plans. The Committee is strongly committed to returning inflation to its 2 percent objective.

In assessing the appropriate stance of monetary policy, the Committee will continue to monitor the implications of incoming information for the economic outlook. The Committee would be prepared to adjust the stance of monetary policy as appropriate if risks emerge that could impede the attainment of the Committee's goals. The Committee's assessments will take into account a wide range of information, including readings on labor market conditions, inflation pressures and inflation expectations, and financial and international developments.

Voting for the monetary policy action were Jerome H. Powell, Chair; John C. Williams, Vice Chair; Thomas I. Barkin; Michael S. Barr; Raphael W. Bostic; Michelle W. Bowman; Lisa D. Cook; Mary C. Daley; ~~Austan D. Goolsbee~~; ~~Patrick Harker~~; Philip N. Jefferson; ~~Neel Kashkari~~; Adriana D. Kugler; ~~Lorie K. Logan~~; Loretta Mester; and Christopher J. Waller.

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Research Analysts

US Economics

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

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

Stephen Juneau
US Economist
BofAS
+1 202 442 7429
stephen.juneau@bofa.com

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

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