US Watch

September FOMC quick reaction: No surprises

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Macro
United States

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

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

Alex Cohen
FX Strategist
BofAS
alex.cohen2@bofa.com

US Economics
BofAS

Global Economics Rates & FX
BofAS

See Team Page for List of Analysts

FOMC: Federal Open Market Committee

SEP: Summary of Economic Projections

BBDXY: Bloomberg dollar spot index

SOFR: Secured Overnight Financing Rate

Key takeaways

- The Fed maintained the target range for the fed funds rate at 5.25-5.50%, and the economic forecasts in the SEP were benign.
- 2024 median dot moved up 50bp to 5.125%, indicating just two cuts next year, while the longer-run dot was unchanged at 2.5%.
- Today's data leaves our Fed call unchanged: we expect one final hike in November, but it is a close call.

The decision: No surprises

As expected, the Fed stayed on hold at its September meeting, keeping the policy rate at 5.25-5.50%. There were no changes to the Fed's balance sheet policy either. Importantly, the forward guidance language was not altered, leaving the door open for additional hikes without making a firm commitment to raise rates further. This was very much in line with our expectations and leaves our Fed call unchanged: we expect one final hike in November, but it is a close call.

The revised "dot plot" was hawkish. The Fed is projecting one more hike in 2023, for a terminal rate of 5.5-5.75%. The median dot for 2024 moved up by 50bp to 5.125%, indicating just two cuts next year. The 2025 and 2026 medians were at 3.875% and 2.875%, respectively, in line with our expectations. Despite these relatively hawkish policy-rate projections, the economic forecasts in the SEP were remarkably benign. The SEP now shows a "no landing" forecast: there is essentially no price to pay in terms of growth or jobs for bringing inflation back down to target.

Chair Powell was generally non-committal in his press conference, stressing data dependence and elevated uncertainty. We think this makes sense around the end of the hiking cycle, as the Fed attempts to fine-tune the policy path.

Market reaction

The rates market interpreted the September FOMC meeting as hawkish. The summary of economic projections surprised, especially the 2024 median dot & 50bps of fewer cuts next year. The '24 dot contributed to higher rates at the front end of the Treasury curve including 2Y rates that rose by almost 10bps at the peak & led by a 7bps flattening in the '23-'24 SOFR futures curve. The SOFR futures curve & FOMC OIS now imply 85-88bps of rate cuts in '24 which is nearly 20bps higher vs early last week.

The BBDXY rallied about 0.3% on the release, appreciating broadly against other G10 currencies, though ended the day flat on net. There was some volatility during the press conference, though Powell's overall messaging did not seem to contain any material surprises. The USD's move was consistent with the removal of roughly 13bp of cuts to the OIS curve through 2024.

US Economics

Policy decision and statement: no surprises

As expected, the Fed stayed on hold at its September meeting, keeping the policy rate at 5.25-5.50%. There were no changes to the Fed's balance sheet policy either. The FOMC statement had minor changes to the first paragraph, upgrading the description of economic growth ("solid" rather than "moderate") but downgrading the description of job growth ("have slowed" rather than "have been robust"). Importantly, the forward guidance language was not altered. It still refers to "the extent of additional policy firming that may be appropriate to return inflation to 2 percent over time", leaving the door open for additional hikes without making a firm commitment to raise rates further. In other words, the Fed is highly data dependent. This was very much in line with our expectations and leaves our Fed call unchanged: we expect one final hike in November, but it is a close call.

Summary of Economic Projections (SEP): hawks get a free lunch

The revised "dot plot" was hawkish. The Fed is projecting one more hike in 2023, for a terminal rate of 5.5-5.75%. This is unchanged from the June forecasts. We have argued that it makes sense to leave the last hike in the dot plot for the sake of optionality, even if the Fed does not ultimately deliver that hike. We also took the view that the 2024 median was the most important forecast in the SEP. And that is where the Fed delivered a major surprise. The median dot for 2024 moved up by 50bp to 5.125%, indicating just two cuts next year. We had flagged this as a risk scenario, but we were expecting just a 25bp increase in the 2024 median. The 2025 and 2026 medians were at 3.875% and 2.875%, respectively, in line with our expectations. Contrary to our expectations, the longer-run dot did not increase. It remained at 2.5%.

Despite these relatively hawkish policy-rate projections, the economic forecasts in the SEP were remarkably benign. The 2023 figures were marked to market based on the latest data, with GDP growth moved up from 1.0% to 2.1%, core PCE inflation marked down two tenths to 3.7%, headline inflation revised up a tenth to 3.3% because of the surge in energy prices and the unemployment rate down from 4.1% to 3.8%. None of this was particularly surprising. What caught our eye was that growth in 2024 was marked up from 1.1% to 1.5%. This means the average growth rate for 2023-24 is now 1.8%, exactly in line with the Fed's median estimate of potential growth. Yet inflation was unchanged in 2024 and marked up just a tenth for 2025, and the unemployment rate was taken down four tenths to 4.1% for both years. So the SEP now shows a "no landing" forecast: there is essentially no price to pay in terms of growth or jobs for bringing inflation back down to target.

In our view, the only internally consistent narrative here is that the neutral rate has gone up. While this is not reflected in the longer-run dot, there is evidence of a recalibration of views around r* in the 2026 policy rate forecasts. The median 2026 forecast is 37.5bp above the longer-run rate, even though the economy is shown to be in equilibrium in 2026.

Press conference: "proceed carefully" in the face of uncertainty

Chair Powell was generally non-committal in his press conference, stressing data dependence and elevated uncertainty. We think this makes sense around the end of the hiking cycle, as the Fed attempts to fine-tune the policy path. Powell was open-minded about the last hike, noting that there was a balance of views in the dot plot (12 for and seven against), and stating that the data would guide the ultimate decision. Interestingly, when pressed on the Goldilocks nature of the SEP, Powell declined from validating it. He instead stated that forecasting is very difficult and the Fed is not committing to a policy path. It will be guided by the data. He said the Fed was aiming for a soft landing but noted that it was not a done deal. And he essentially argued that the Fed would look through the spike in energy prices because it is a supply shock that is not reflective of the state of underlying demand, except to the extent that it affects inflation expectations. On balance we did not learn a lot from Powell's press conference and the market response was correspondingly muted.

US Rates

The rates market interpreted the September FOMC meeting as hawkish. The summary of economic projections surprised, especially the 2024 median dot & 50bps of fewer cuts next year. The '24 dot contributed to higher rates at the front end of the Treasury curve including 2Y rates that rose by almost 10bps at the peak & led by a 7bps flattening in the '23-'24 SOFR futures curve. The SOFR futures curve & FOMC OIS now imply 85-88bps of rate cuts in '24 which is nearly 20bps higher vs early last week.

The rates market heard a more balanced outlook for the Fed in the press conference. Chair Powell reiterated Fed data dependence & that it will proceed carefully on any further rate increases. Chair Powell also reflected limited confidence that rate levels are yet sufficiently restrictive and the majority of Fed officials still think further tightening is appropriate. On balance, the press conference appeared less hawkish vs the SEP but still left rates higher & curve flatter during FOMC communications.

Overall the September FOMC was similar to our expectation written in our preview: "we expect the Sept FOMC to reiterate view to remain underweight the front end & continue to fade '24 cuts." We remain underweight the front end, neutral the back end, & expect Treasuries to cheapen amidst elevated supply + weak demand. 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. Path of least resistance still remains for higher rates.

There were no changes in the Fed's setting of administered rates or to their policy implementation tools, as expected. The pace of Fed QT also remained unchanged. Fed QT will continue to slowly drain cash from the system & add collateral to be funded by the private sector. This will place increased upward pressure on SOFR & money market rates over time. The Fed & market should expect funding rates to more clearly evidenced signs of tightening in coming quarters.

FX

Going into the FOMC, we saw scope for a "hawkish pause" to be dollar supportive to the extent that SEP dot forecasts a) confirmed median expectations for an additional hike this year, and b) conveyed Fed expectations for a slower/shallower path of rate cuts in 2024, potentially to a higher long-term equilibrium policy rate than previously thought. The Fed broadly delivered on this and exceeded to the hawkish side with the removal of 2 cuts in the 2024 dot, which shifted up from 4.625 to 5.125.

The BBDXY rallied about 0.3 percent on the release, appreciating broadly against other G10 currencies, though ended the day flat on net. There was some volatility during the press conference, though Powell's overall messaging did not seem to contain any material surprises. The USD's move was consistent with the removal of roughly 13bp of cuts to the OIS curve through 2024.

After a notable rally since mid-July, the USD has been mostly rangebound over the past few weeks. Key drivers during this time have been broadly resilient US growth against a global backdrop of weaker economic conditions, particularly in Europe and China. This has lifted real rate differentials in the dollar's favor and brought the dollar index towards the top of the year's range. Looking ahead, we see scope for the dollar's resilience to continue this year, but most likely not at the same pace as seen over the past two months. That said, looming risks going into Q4 include the potential growth impacts of the UAW strike and a possible government shutdown, a change in consumption behavior, and possible but not widely expected major China stimulus.

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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