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Liquid Insight

Dec FOMC: dovish hold & financial easing

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Rates and Currencies Research
Global

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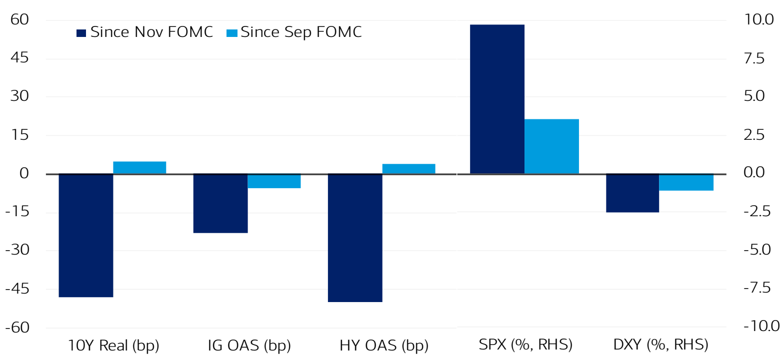
Key takeaways

- Fed expected to hold rates stable & deliver dovish hold at Dec FOMC, even with easier fin conditions
- Fed rate outlook to be more balanced; SEP = slightly higher U3, lower PCE, & more rate cuts in '24 (from 50 to 75bps of cuts)
- Rates to hold more cuts vs Fed, cutting trough may decline, & USD impact minimal

By FOMC: Mark Cabana, Michael Gapen & Alex Cohen

Exhibit 1: Financial conditions since the Nov & Sept FOMC meetings

Fed held in Nov b/c tight fin conditions; conditions have since eased but will still deliver dovish Dec hold



Source: Bloomberg

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Dovish hold despite meaningful easing of fin conditions

The Fed is expected to hold rates stable & deliver a dovish hold at the Dec FOMC. The Fed cited "tighter financial conditions" as a reason to remain on hold at the Nov FOMC. Since then, 10Y real rates are lower by nearly 50bps, equities +10%, credit spreads notably tighter, and USD weaker (Exhibit 1). Financial conditions have eased, even in relation to the Sept FOMC meeting, and underlying economic data has moderated.

Most data since the Nov FOMC has pointed to moderation in activity, disinflation, and cooling labor market. The Fed's confidence has likely grown that its current policy stance is appropriate & sufficiently restrictive. The next policy action will likely be a cut, in our view. The Fed will likely adjust statement language to make its policy rate outlook more balanced and revise its projections; SEP should show slightly higher unemployment, a bit more disinflation, and more rate cuts in '24 (from 50bps of cuts to 75bps).

A dovish hold should allow the rates market to sustain cuts in '24 and eventually lower the trough of the cutting cycle. A dovish hold is well priced by FX and should not elicit a meaningful USD response. Markets don't expect the Fed to deliver coal for the holidays.

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US economics: dovish hold + Fed SEP to show more ’24 cuts

At the Wednesday FOMC meeting, we expect the Fed to take the initial steps in changing its communication frm hawkish holds to dovish holds. At recent FOMC meetings, the Fed had chosen to remain on hold while signaling an upside bias to its policy rate path, emphasizing solid activity data, sticky inflation, and a median end-23 dot that was 25bp above the current target range. Since the November meeting, most FOMC participants have viewed incoming data as pointing to slower growth and greater evidence of disinflation. Hence, we think the Fed will likely remain on hold again in December and keep its balance sheet runoff policies in place, effectively ending the tightening cycle. We do not believe hawkish holds are very credible at this stage, although the committee will reserve the right to raise rates if necessary. One of the main questions for the committee in December is how strongly they want to signal that they have shifted to an easing bias.

In our view, the committee is not ready to shift from a tightening bias all the way to an outright easing bias. In the next three to four months, it is likely the case that many FOMC members would view a potential hike as slightly more likely than a cut. We think the committee can take the initial step of making its policy rate outlook more balanced by changing the existing language in the FOMC statement. The current statement refers to "the extent of additional policy rate firming that may be appropriate to return inflation to 2% over time". We think this could be altered to emphasize the committee's commitment to maintain a sufficiently restrictive stance of policy to return inflation to 2% over time. This language would be flexible enough to keep both cuts and hikes on the table, while opening the door more concretely to cuts as a first step in the direction of dovish holds.

Exhibit 2: Expected update to Fed summary of economic projections

More growth & unemployment, lower inflation, and faster cuts

	2023	2024	2025	2026	Longer Run
Change in real GDP (% 4Q/4Q)					
December	2.6	1.7	1.8	1.8	1.8
September	2.1	1.5	1.8	1.8	1.8
Unemployment rate (%)					
December	3.9	4.2	4.1	4.0	4.0
September	3.8	4.1	4.1	4.0	4.0
PCE inflation (% 4Q/4Q)					
December	3.1	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	3.5	2.5	2.2	2.0	2.0
September	3.7	2.6	2.3	2.0	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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In the updated Summary of Economic Projections (Exhibit 2), we look for growth in 2023 and 2024 to be revised higher to 2.6% and 1.6%, respectively. The unemployment rate path should be revised higher by 0.1% on a mark-to-market basis. On inflation, we see headline and core PCE falling to 3.1% and 3.5%, respectively, in 2023. For 2024 and 2025, we see the projected Q4/Q4 outturns falling to 2.4% and 2.5%, respectively. With revisions moving in the direction of slightly higher unemployment and slightly more disinflation, the appropriate policy path should call for fewer hikes (no December increase) and more rate cuts to normalize the policy stance beginning in 2024. We expect the median member to project a federal funds rate of 4.6% in 2024, versus 5.1% in September, 3.6% in 2025, and 2.9% in 2026. While the distribution of the longer-run neutral range has been drifting in the direction of a higher neutral rate, we do not believe the 2.5% median will move higher at this meeting.

US rates: Fed & market gap on cuts likely to remain after Dec FOMC

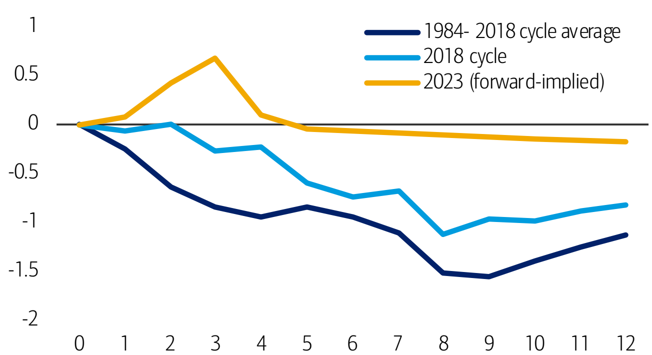
The rates market is pricing early & fast rate cuts, especially in relation to expected Fed SEP projections. The market is pricing over 110bps of '24 rate cuts and a trough of the cutting cycle near 3.5% by end '25. Powell won't endorse market pricing but the more balanced assessment of the policy outlook & faster pace of SEP-implied rate cuts should allow the market to retain more cuts vs the Fed. Weaker data should also push the cutting trough lower. On balance, we expect the market to hear a slightly dovish Fed at the Dec FOMC. We expect to retain our long 5Y (spot: 4.26%; risk to the trade: stronger than expected US growth data) & 5s30s steepeners (spot: 5bp; risk to the trade: Fed needs to hike more than priced) views after the Fed. The forwards appear easier to beat by being long 5Y at present (Exhibit 3).

Clients have asked about the very wide gap between the Fed SEP dots & market pricing (Exhibit 4). The market has a historically large negative spread to the 1y ahead dot, consistent spread to the 2y ahead dot, and historically positive spread to the 3y dot. Assuming the average spread between the 1y ahead dot and the market, the implied 2024 dot would be around 4.15%, suggesting over 100bps of cuts next year. This seems unlikely to us near term. The gap between the Fed and market will need to close somehow and the Dec FOMC will be the first test (see Dot disconnect). If the Fed dots in '24 show a stable 50bps of cuts, it will be seen as hawkish; if 75bps of cuts, this will be neutral / slightly dovish; and 100bps of cuts will be clearly dovish. For clients looking to fade the extent of rate cuts, we recommend 3m1y payer spreads (current: 7bp) with limited downside (see Too many CB cuts priced?). The risk to the trade is the pricing of even more rapid cuts.

We think the Fed is likely to keep their administered rates & balance sheet policy unchanged at the Dec FOMC. Powell may be asked questions about the recent jump in money market rates & implications for QT. The Fed is unlikely ready to adjust QT plans but we think recent money market volatility may pull forward a timing of this discussion.

Exhibit 3: Change in 5y following end of hiking cycle (PPTS)

Implied change in forwards reflects smaller rally than historically observed in prior cycles



Source: BofA Global Research, Bloomberg; Note: x-axis shows months after final hike, 2023 line assumes final hike in July '23 and uses realized vs forward-implied change in 5y yield

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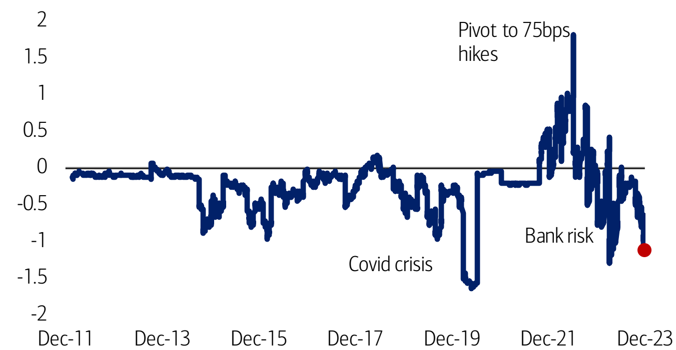
Exhibit 4: Spread between market pricing and 1y ahead median dot (PPTS)

Market is historically below the 1y ahead latest dot plot ahead of new projections



Source: BofA Global Research, Bloomberg, Federal Reserve

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FX: Seeking direction post sell-off

The DXY has declined ~2.8% since last month's FOMC, with November's move representing the largest decline in a year. Soft labor and inflation data prints last month, and perceived dovish communication from Fed officials combined to bring the USD down from YTD highs, amid notable market re-pricing for earlier and deeper cuts.

As for Wednesday's FOMC, barring any unexpected surprises, a more balanced/neutral Fed should not elicit a material move in the USD, all else equal. As noted, rate-cut pricing has already moved aggressively, and the market should be well priced for a reasonable update of the SEP dots based on recent Fed commentary and US data. For the dollar to sell-off meaningfully, we would likely need to see Fed guidance (either SEP, the statement, or Chair Powell's commentary) tilt even more towards an endorsement of current market pricing, which is not our expectation (see above). With the "soft landing" outlook becoming increasingly entrenched, the evolution of data should likely be a bigger near-term driver, given the Fed's still "data dependent" approach. Beyond the Fed, Thursday sees central bank meetings by the ECB, BOE, SNB and Norges bank, which collectively could provide further direction for currency markets.

Longer term, we still expect the USD to eventually depreciate next year on US growth "recoupling" with the rest of the world. However, as we saw in the wake of Friday's employment report, the path will likely not be straightforward.

Bottom line: Fed to deliver a dovish hold at the Dec FOMC. Fed policy guidance will likely sound more balanced & SEP projections will show higher U3, lower PCE, and more '24 rate cuts. A dovish hold should allow the rates market to sustain cuts in '24 and eventually lower the trough of the cutting cycle. A dovish hold is well priced by FX and should not elicit a meaningful USD response.

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
- USD selloff defying corporates & officials, **Liquid Cross Border Flows**, 04 Dec 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: Don’t expect early rate cuts 08 December 2023

Global Rates Weekly: Doves of a feather 08 December 2023

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