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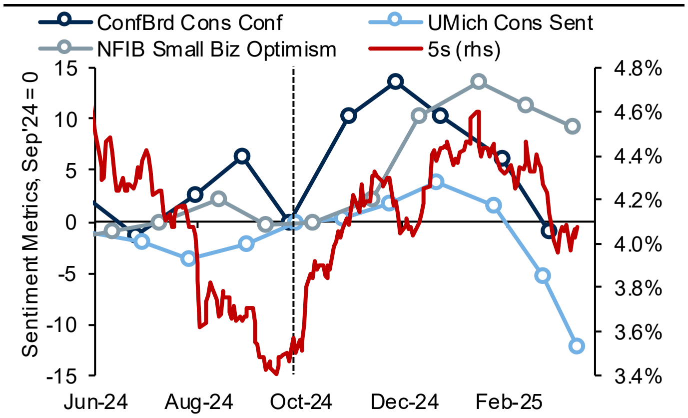
March 14, 2025

FOMC Preview: Watching, Waiting, Commiserating

The market narrative has done a near 180-degree turn since the January FOMC meeting, as policy chaos has injected a large dose of uncertainty into the psyche of consumers, businesses, and markets. This narrative shift has been readily apparent in soft data, with nearly every sentiment survey weighed down by tariff fears or concerns about cuts to government spending or services.

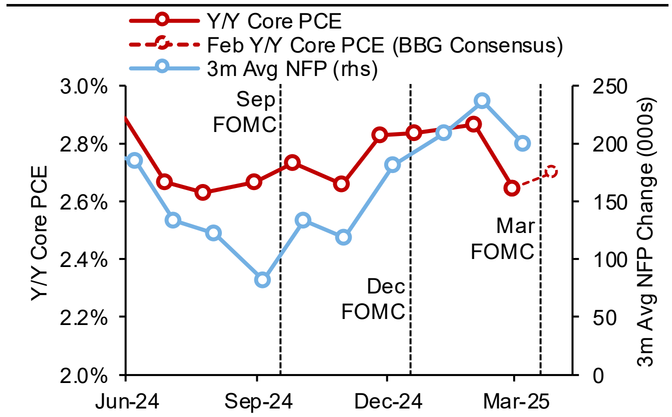
So far, the damage hasn't started to creep into the hard data – particularly those of most importance to the Fed. On the labor side of the mandate, UER prints have been low and stable over the last three months (4.1%, 4.0%, 4.1%), with NFP averaging a healthy +200k. Meanwhile, the inflation stickiness that prompted Powell to say their inflation outlook had "*kind of fallen apart*" in December hasn't shown any real signs of improvement. This week's CPI/PPI also suggest that core PCE for February (released after the meeting) is going to come in a bit higher than originally expected. Current Bloomberg consensus has y/y core rising from 2.6% to 2.7%, meaning inflation progress has basically been stalled out since hitting a low of 2.63% last June. And base effects are going to make it more difficult for y/y PCE to continue showing progress in the coming months. It's also worth noting that several FOMC participants (including Powell) flagged increases in inflation expectations heading into the blackout period. To that point, 1-year inflation expectations have spiked from 2.8% in December to 4.9% in March. (While one can certainly take shots at the UMich survey for partisan divide, sample size, online polling, etc., Williams did say it was still, "*something to watch closely*".)

Unwind of post-election sentiment boost shifted yields ↓



Source: Bloomberg, Conference Board, NFIB, UMich, RBCCM. Release dates.

Hard data story hasn't changed much since last SEP



Source: BEA, Bloomberg, BLS, RBCCM. *Release dates.*

Perhaps in a world where inflation had been progressing as the Fed hoped the last six months, they would have had more flexibility to take some "insurance" out against the deterioration in sentiment. But as it stands, we think they are unlikely to make a dovish pivot until this deterioration crosses over into hard data (particularly business investment, hiring/layoffs, and consumption), <u>or</u> inflation gets back on track (which likely takes 2-3 months of meaningful disinflation). Notice that we didn't mention further equity declines here. A Powell "put" on risk assets may exist, but it is probably more tied to financial stability than any particular degree of say, equity decline – i.e., they likely aren't moved by the S&P 500 going down by another 15%...unless it happens in just a few sessions. Corporate credit spreads are likely a more important trigger for any Fed "put" than equities, and those remain near multi-decade tights (despite some recent widening). Potential wealth effects from risk asset declines are a downside risk, but unlikely to have a major impact on their policy stance until the effects are realized.

Overall, we don't expect any large shifts in tone at the March meeting. They will remain patient and watchful, but perhaps now with a tad more caution given the recent sentiment shift. As Powell said just last week, "*We do not need to be in a hurry, and are well positioned to wait for greater clarity*."

SEP: 2025 dot unlikely to change

The March SEP may provide some fuel to the "stagflation" fire. It seems highly unlikely that the 2025 median dot will shift away from the two cuts shown in December. Meanwhile, GDP is likely to be marked down (mechanically, based on data received so far) and PCE is likely to be marked up given the lack of improvement since December – it's also possible that more participants are now incorporating tariff impacts into their submissions. Unemployment rate forecasts seem unlikely to change, with a decent buffer between December's median of 4.3% and the current 4.1%, and significant uncertainty around how labor supply and demand will evolve. With growth marked down, inflation marked up, and no changes to the rates dot, the overall medians are likely to paint a picture of a Fed forced to accept weaker growth amid upside inflation pressures.

- **Beyond 2025, the median dot path may imply a quicker return to "neutral."** The December SEP showed a shallow path of cuts, with the longer-run median of 3.0% not reached until after 2027. But with the growth picture potentially weaker down the road and tariff-related inflation seen as truly "transitory", then that could mean caution up front, but more cuts later on as the tariff impacts roll out of inflation/inflation expectations. The 2027 dot could drop to 3.0%, and/or implied cuts in 2026 could increase from 50bp to 75bp. This could also be an attempt to "soften the blow" from the unchanged 2025 dot. Given the degree of near-term uncertainty though, we doubt markets will put that much weight on modest changes to out years. On the longer-run dot, we do think the year-long upward slide is likely to pause this quarter.

Powell's presser

While many may want Powell to hew more closely towards the shift in market narrative, we doubt his tone will be noticeably different from the patient chord he struck just ahead of the blackout period. Federal policies will almost certainly be the focus of the Q&A, but Powell has been reticent to discuss the potential ramifications of Trump's policies. This is what he had to say on that topic in his remarks last week: *"Looking ahead, the new Administration is in the process of implementing significant policy changes in four distinct areas: trade, immigration, fiscal policy, and regulation. It is the net effect of these policy changes that will matter for the economy and for the path of monetary policy. While there have been recent developments in some of these areas, especially trade policy, uncertainty around the changes and their likely effects remains high. As we parse the incoming information, we are focused on separating the signal from the noise as the outlook evolves."* We can't imagine the signal-to-noise ratio has shifted that much over the last seven days.

That being said, one of the things we will be watching for most closely is any evolution in Powell's characterization of the impacts of policy uncertainty itself. There are the actual economic impacts of Trump's policies, if enacted. But then there is also the impact of the *uncertainty* around future policies, even if never enacted. While Powell may rightfully not want to speculate on the former, the latter is getting harder to ignore. Powell did float this topic at the January FOMC, stating that *"large and persistent"* uncertainties were a drag on business investment during the first trade war, and noted that they were something the Fed would be on the lookout for. Clearly, those uncertainties have risen since then. Evidence of that was plainly obvious in the February Beige Book – the word "uncertainty" appeared 45 times. But it didn't seem like those uncertainties have yet had a major cooling effect on business activity.

However, commentary in the Beige Book only spanned through February 24th, and the sentiment/narrative slide didn't really kick off until just after that. We wouldn't be surprised to learn that anecdotal evidence gathered from business contacts in the weeks between the Beige Book reference period and the FOMC meeting skew more negative. We hope someone in the press will follow up on this comment from January to gauge how Powell's view has evolved. If so, we would expect him to echo the Beige Book: uncertainty has definitely risen, but they haven't yet seen clear evidence that it is translating into a drag on activity. (Very in line with the soft data, hard data divide discussed above).

QT: pause time?

Since the January minutes release, there have been three main topics of discussion on the QT front:

- **Will the Fed pause QT, and if so, when?** We fully expect the Fed to pause QT until several months after the debt limit episode is resolved and the TGA is rebuilt, given that their view into reserve "ampleness" will be clouded (This assumes that it goes all the way down to the x-date – an earlier resolution could lessen the time needed for a TGA rebuild). As to when that pause gets underway, we lean slightly towards an announcement at next week's meeting, with the pause going into effect in April. Waiting until May is also possible, but June is likely too late as the TGA will already be very low. But overall, there is no reason not to get the process underway in March. It has already been well socialized and like December's RRP cut, the Fed is likely looking at this decision as mostly technical in nature, i.e. no big deal and no need to dally.
- **Does a QT pause mean QT is over?** We fully expect the Fed to resume QT once the debt limit is resolved and the TGA rebuild is complete. We think markets are overthinking how difficult restarting QT would be. A preprepared paragraph from Powell and a simple line or two of text in an updated implementation note could communicate their intention to resume down the road. There is certainly a debate that could be had on whether it would be easier to just leave reserves in "abundant" territory after the pause, but the Fed seems pretty intent on bringing reserves down to a point where funding markets start to

show some small signs of tightness. If so, there is no reason not to restart the QT process after the debt limit-related uncertainty has passed. The caveat here is if the economic outlook deteriorates in a major way during a pause, the chances of the Fed resuming QT seem much lower.

- **What will the long run composition of the SOMA portfolio look like?** On a very near-term basis, if details around a pause are announced, then the ~$15bn/mo of MBS runoff reinvestment will likely be skewed towards bill supply. In fact, the Fed could kill two birds with one stone by buying bills with maturity dates around the x-date, which are usually eschewed by markets. But as to the longer-run composition of SOMA post-QT, we don't expect any decisions to have been made. We do expect that they will lean towards a shorter-dated portfolio (as has been suggested by multiple Fed speakers), but as we wrote previously, the market impact of such a decision may be quite limited. The maturity distribution of reinvestments of maturing UST securities have almost no bearing on market supply given that they are all purchased as add-ons at auctions – meaning the maturity distribution of privately-held UST supply is unchanged. As for MBS reinvestments into UST, which have to be conducted in the open market, the amounts will likely be ~$15bn per month. Even if those are skewed entirely to bills, the market impact may be limited, especially if the Treasury responds by increasing bill issuance. As noted by SOMA Manager Roberto Perli the shift towards more bills will be done *"at a gradual pace, calibrated to avoid having too large of an impact on the market–in practice, that would likely take a number of years."* In other words, the Fed is going to do it's best to make sure this isn't a tradable market theme.

Market overview

We think directional risks into this meeting are going to be light. Consensus seems to be for a relatively quiet meeting. Still, we would expect some hedging of a dovish outcome (i.e., 3 cuts in 2025 median dot or a spooked Powell). So, if everything comes in as we expect, we could still see some modest bear-flattening as those risks are unwound. While the probability seems very small, there is some hawkish tail risk that the Fed keys in more on inflation stickiness/expectations/tariff-risks (i.e., a shift towards *fewer* cuts in the dots) and Powell sounds too dismissive of downside risks. That would drive a much bigger price response, with the front-end pushing back above 2x2025 cuts and a sharp bull flattening on policy error expectations. But again, that is a very tail risk. Overall, we think the forward-looking nature of the recent economic concerns (trouble possibly coming, but not here yet) and a wait-and-see Fed should dampen any price response to next week's meeting, which will likely be very backward looking.

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