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Fed Watch

# Fed set to shift gears down to a 25bp hike but to signal that the job is not yet done

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## Chair Powell will likely insist that rates are still not yet "sufficiently restrictive" in an attempt to reverse market expectations

- **The Fed's base case continues to assume that continued tightening of monetary policy is needed to make sure inflation returns to 2% on a sustained basis.** The Fed is widely expected to shift down to a 25bp hike at its first meeting of the year to take the fed funds rate to a 4.50-4.75% target range. Yet, to avoid an unwelcome further downshift in the yield curve (Figure 1) and an unjustified easing of broad financial conditions (Figure 2), it is set to signal that it will press ahead with additional hikes -i.e., it will likely keep the "ongoing increases in the target range will be appropriate" reference in its policy statement to signal the likelihood of more than one additional hike. It will also insist that it will keep policy "sufficiently restrictive for some time" in an attempt to change market's perception that rate cuts might start soon after the peak fed funds rate is reached.

- **The Fed will attempt to prevent any small change from being interpreted as dovish and will convey a message that the job is not yet finished.** Since their last meeting in December, several FOMC voting members said the Fed is determined to stay the course on their fight against inflation through continued tightening, and that they remain optimistic on the possibility of a soft-landing (Table 1). Despite some encouraging signs lately that inflation is headed for a sustained decline and worrisome signs that the economy seems more likely than not to fall into a recession in 1H23, tomorrow's policy statement and Chair Powell's press conference remarks will most likely avoid signaling any significant dovish tilt and thus, avoid incorporating these forward-looking possibilities. The Fed will rather stick to its hawkish tone that more work needs to be done before they prepare to hold rates for quite some time. This has to do with the consistency the Fed has maintained so far in its approach to fighting the current inflationary gap: the costs and risks of allowing inflation to persist at high levels for a long period of time are higher than those of tightening too much.

- **Even if the Fed insists on the need for continued tightening, we think it will not be able to reverse market expectations.** The Fed will likely acknowledge that inflation has continued to slow, but will insist that the labor market remains tight and thus, that the job is not yet done. The Fed will convey one simple message: it is still more likely than not that the FOMC will take the fed funds rate above 5.0% (i.e., the latest dot-plot projections have not changed materially in their view), and a long pause with "sufficiently restrictive" policy is still the plan. So far, this message has not been able to convince the fed funds futures market (Figures 3 and 4). Thus, we think the Fed will be successful in conveying its planned messages only to an extent. The Fed might be able to avoid a further downshift in the yield curve for a few weeks if the economy holds up well, but is not likely to reverse market expectations of rate cuts starting in 2H23 in a backdrop of weakness spreading to hard data across all sectors, job creation and wage slowing, and easing inflation. **For now, we will likely stick to our 4.75%-5.00% peak rate forecast as we continue to think that the Fed will move to the sidelines following March's hike, as the discussion, and more pressing concerns, continue to gradually shift from (high) inflation to (weak) growth.**

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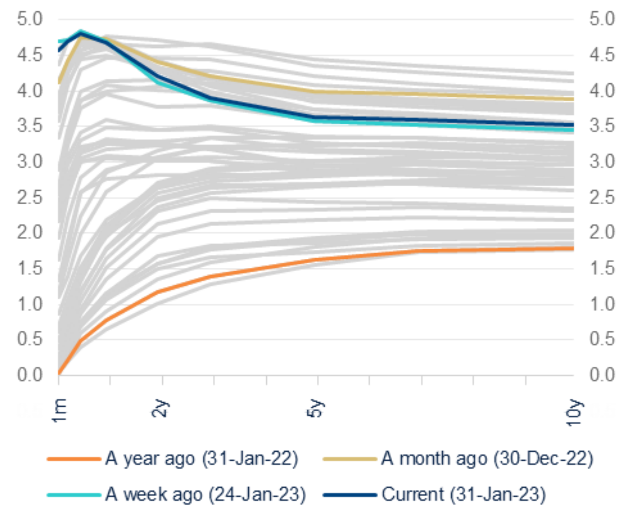
## The Fed will signal that it will press ahead with additional hikes to avoid an unwelcome further…

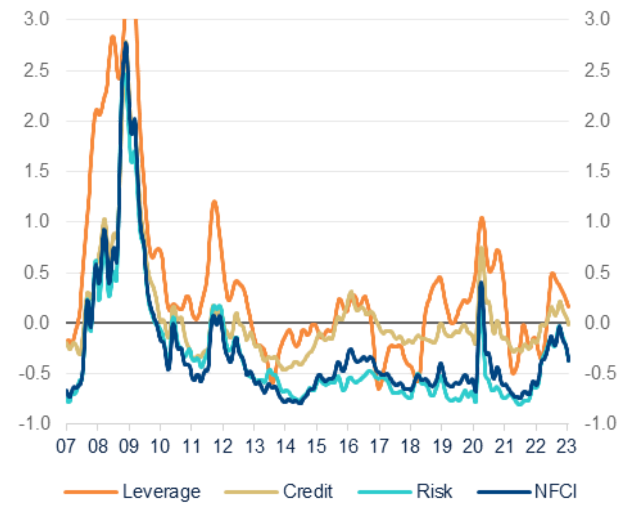
Figure 1. **TREASURY YIELD CURVE** (%)




The gray lines indicate weekly yield curves from a year ago.
Source: BBVA Research based on data by Haver Analytics.

## … downshift in the yield curve and an unjustified easing of broad financial conditions

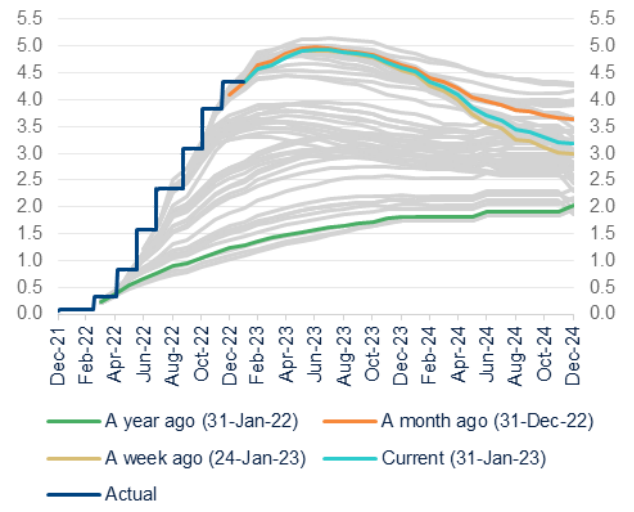
Figure 2. **CHICAGO FED NATIONAL FINANCIAL CONDITIONS INDEX** (>0 = TIGHTER THAN AVG)




Source: BBVA Research based on data by Haver Analytics.

## The insistent message about the need for a fed funds rate above 5.0% and a long pause with…

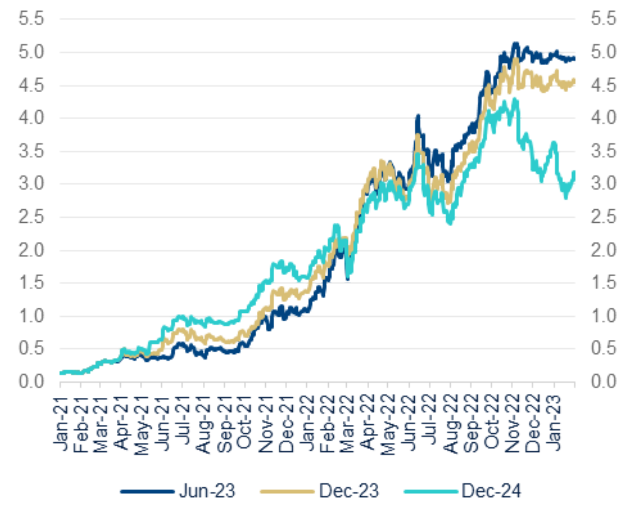
Figure 3. **IMPLIED RATE IN 30-DAY FED FUNDS FUTURES** (%)




Source: BBVA Research based on data by Bloomberg and Haver Analytics.

## … "sufficiently restrictive" policy has not been able to convince the fed funds futures market

Figure 4. **IMPLIED RATE IN 30-DAY FED FUNDS FUTURES** (%)




Source: BBVA Research based on data by Bloomberg.

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## FOMC members have already paved the way to slow the pace of rate hikes at this meeting

Table 1. **RELEVANT REMARKS FROM FOMC VOTING MEMBERS**

| Relevant remarks on the path of monetary policy |
| --- |
| **Jerome Powell (Board).** At the Symposium on Central Bank Independence in Sweden (see), Powell stressed the importance of the independence and transparency of the Fed to achieve its assigned goals of maximum employment and price stability. Though he did not comment on the next FOMC's steps, he spoke strongly about the recent debate on the scope of monetary policy in relation to the fight against climate change. By stating that the Fed "[is] not, and will not be, a climate policymaker", he argued that, without explicit congressional legislation, it would be inappropriate for the Fed to use its monetary policy or supervisory tools to promote a greener economy or to achieve other climate-based goals. |
| **Lael Brainard (Board).** At the University of Chicago Booth School of Business (see), Braindard reiterated that it will take time and resolve to get inflation back down and that the Fed is determined to stay the course. She said that inflation remains high even after the recent moderation, and that policy will need to be sufficiently restrictive to make sure inflation returns to 2% on a sustained basis. She acknowledged that given the speed and magnitude of the swing in the stance of monetary policy last year, it is likely that the full effect on demand, employment, and inflation of the cumulative tightening that is in the pipeline still lies ahead. However, she remained optimistic on the possibility of a soft landing by stating that a continued moderation in aggregate demand could facilitate continued easing in the labor market and reduction in inflation without a significant loss of employment. |
| **Christopher Waller (Board).** At the International Economics Council on Foreign Relations (see), Waller pointed out that he currently favors a 25bp hike and, beyond that, he expects to support continued tightening of monetary policy. He emphasized that the FOMC's goal in raising interest rates is to dampen demand and economic activity to support further reductions in inflation and that the goal is not to halt economic economic activity. He noted that he remains cautious about the latest CPI inflation reports because core inflation basically moved sideways all year, so he is not ready yet to substantially alter his outlook for inflation. He said he remains optimistic on the possibility of a soft-landing as a robust labor market shows that jobs and income can hold up to the effects of higher interest rates. |
| **Michelle Bowman (Board).** At the Florida Bankers Association (see), Bowman said that the Fed has a lot more work to do despite that some measures of inflation have declined in recent months. She argued that she will be looking for compelling signs that inflation has peaked and for more consistent indicators that inflation is on a downward path in determining both the appropriate size of future rate increases and the level at which the fed funds rate is sufficiently restrictive. She noted unemployment has remained low as the Fed has tightened monetary policy and made progress in lowering inflation, which is a hopeful sign that it can succeed in lowering inflation without a significant economic downturn. In her view, the ongoing strength of the labor market, strong households' balance sheets, and a strong US banking system are all encouraging developments for the uncertain path ahead. |
| **Lisa Cook (Board).** At the 2023 Allied Social Science Associations (ASSA) Annual Meeting (see), Cook noted that despite some encouraging signs lately, inflation remains far too high and is therefore of great concern. She cautioned against putting too much weight on the past favorable monthly data reports for total and core PCE inflation, especially since inflation in non-housing core services has remained stubbornly high, driven by labor costs growth rates above those consistent with 2% inflation. Despite having come up a little, she pointed out that medians of many surveys of longer-run measures of inflation expectations are still within their pre-pandemic ranges, but that any de-anchoring of inflation expectations would be a major concern, as it could cause high inflation to prove more persistent. |
| **Patrick Harker (Philadelphia).** At both the University of Delaware (see) and the New Jersey Bankers Annual Leadership Forum (see), Harker said that he expects that the Fed will raise rates a few more times this year, but that the days of 75bp hikes at a time have surely passed and hikes of 25 bps will be appropriate going forward. He noted that, at some point this year, the policy rate will be restrictive enough to hold rates in place to let monetary policy do its work. In his opinion, it is an underrated advantage that the Fed is taking on inflation from a position of a strong labor market. He forecasts core inflation to come in around 3.5, 2.5 and 2% in 2023, 2024 and 2025, respectively, while he expects real GDP growth of about 1% this year before climbing back up to trend growth of about 2% in 2024 and 2025. |
| **Neel Kashakari (Minneapolis).** Through an essay (see), Kashkari emphasized the Fed's responsibility to bring inflation back down to target. In his view, it will be appropriate to continue to raise rates before pausing to let the tightening work its way through the economy. He thinks the Fed should pause at 5.4%. He noted that cutting rates will only be considered once the Fed is convinced that inflation is well on its way back down to 2%, in order to avoid cutting rates prematurely and then have inflation flare back up again. |

Source: BBVA Research.

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