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Fed Watch

Has the fed funds rate finally peaked?

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The strength of the economy and the job market will hold back the Fed from ruling out the chance of an additional rate hike this year

- **We expect the FOMC to hold the fed funds rate steady at its 5.25-5.50% target range, but also to keep its doors open for an additional rate hike in December**, as signaled by the 5.6% median peak rate projection revealed in the September SEP. To some extent, the decision to extend last meeting's pause will likely come from a prevailing opinion among FOMC participants to proceed cautiously amid mixed data releases and an uncertain outlook. Inflation continued to show encouraging signs of cooling during the intermeeting period, with core CPI inflation excluding shelter falling to 2% in September (Figure 1) and core PCE inflation dropping to a 2.4% annualized rate in 3Q23. On the other hand, the economy continued to hold up well: 336,000 jobs were added in September (almost doubling the 170,000 consensus estimate), while GDP posted a stronger-than-expected 4.9% SAAR growth in 3Q23, mainly driven by consumer spending strength. Yet, headwinds also continued to build up: student debt payments resumed in October, real disposable income contracted in 3Q23, the savings rate fell to 3.4% in September (from 4.1 and 4.0% in July and August, respectively), household's excess savings are likely depleted by now, and both households and businesses will face growing interest costs as maturing debt is refinanced at higher rates (Figure 2).
- **Besides, recent soaring long-term rates seem to have joined the Fed in its fight against inflation, probably offsetting some of the previously planned additional policy firming** (for more see). The Treasury yield curve has flattened recently with steady short-term yields on "higher for longer" policy rate expectations (see Figure 3) and soaring long-term yields (see Figure 4). Hovering around 4.9% since mid-October (c. 55 bps above its September-meeting level), the 10-year Treasury yield is now near levels not seen since the pre-global-financial-crisis tightening cycle. The reason why some Fed members are likely to believe that recent higher long-term rates are helping them to further tighten financial conditions is that the recent spike in the 10-year Treasury yield seems to stem from a higher real rate and an increased term premium, rather than from higher inflation expectations (which have remained well anchored). Several interlinked factors such as a stronger-than-expected economy, a possible increase in the neutral policy rate, greater economic and policy uncertainty, larger-than-expected borrowing from the Treasury, and structurally-evolving global bond supply-demand dynamics are all likely to be behind the recent rise in longer-term nominal Treasury yields. With the added uncertainty stemming from the fact that the term-premium is not directly observable, the matter at hand is whether officials are certain that these factors will genuinely result in a lasting impact on long-term interest rates (and thus on financial conditions), and not just in a temporary deviation.
- **In the Fed's own words. FOMC members continued to emphasize the importance of a data-dependent approach, but also acknowledged that the additional tightening coming from higher long-term interest rates could mean that additional policy firming is no longer needed.** Some voting members started to lean towards a pause in a backdrop of much higher longer-term interest rates. Harker (Philadelphia), for example, argued that "absent a stark turn in what I see in the data [...], we are at the point where we can hold rates

where they are", while others such as Kashkari[1] (Minneapolis), and Logan[2] (Dallas) have suggested they are open to either a longer-lasting pause or a possible additional hike depending on the driver of higher long-term rates. Two weeks ago, Chair Powell also paved the way for this week's likely pause, but warned that higher policy rates are still possible if "persistently above-trend growth" or signs that "tightness in the labor market is no longer easing [...] put further progress on inflation at risk." In a strong sign that the Fed is likely set to skip raising the fed funds rate in the upcoming meeting, Powell said that "given uncertainties and risks, and how far [they] have come, the committee is proceeding carefully." He noted that there could still be "meaningful tightening" in the pipeline given the speed at which the Fed has raised interest rates, while signaling that risks of doing too little or doing too much are becoming more balanced: "doing too much could also do unnecessary harm to the economy." He also noted that higher longer-term bond yields have tightened financial conditions[3] and this could "have implications for the path of monetary policy."

- To sum up: i) although the economy has continued to grow above potential even as inflation continues to gradually ease, some signs and mounting headwinds suggest it should start to finally slow down in 4Q23; ii) even though job gains remain healthy, the labor market continues to gradually come into better balance as wages are gradually easing, and iii) even if progress on inflation seems to be slowing after dropping sharply from peak levels, core inflation excluding shelter is now at 2.0%, and further shelter inflation easing is in the pipeline as newly-signed rents have been easing sharply throughout 2023. **We expect the Fed to convey the message that if long-term interest rates remain elevated on higher term premia, there could be no need to raise the fed funds rate further.** We anticipate a somewhat less hawkish tone to start to pave the way for a definitive pause, while also stressing the continued need for a data-dependent approach alongside the need of below-potential growth in face of a still uncertain outlook.

[1] "It's certainly possible that higher long-term yields may do some of the work for us in terms of bringing inflation back down. But if those higher long-term yields are higher because their expectations about what we're going to do has changed, then we might actually need to follow through in their expectations in order to maintain those yields."

[2] "If long-term interest rates remain elevated because of higher term premiums, there may be less need to raise the fed funds rate. However, to the extent that strength in the economy is behind the increase in long-term interest rates, the FOMC may need to do more."

[3] "Financial conditions have tightened significantly in recent months, and longer-term yields have been an important driving factor in this tightening. We remain attentive to these developments because persistent changes in financial conditions can have implications for the path of monetary policy."

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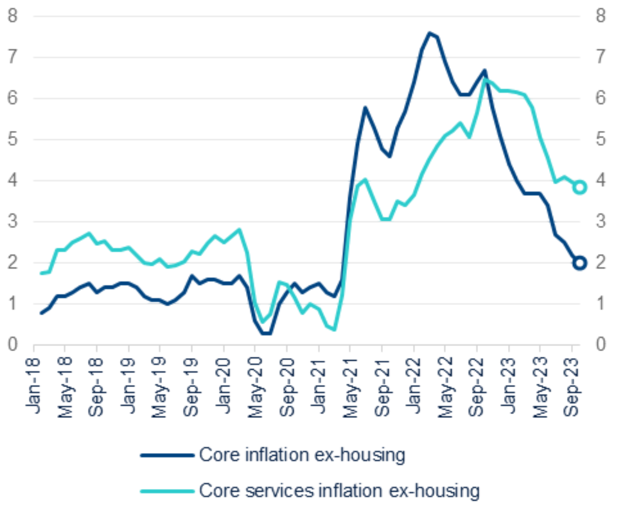
Inflation continued to show encouraging signs of cooling during the intermeeting period

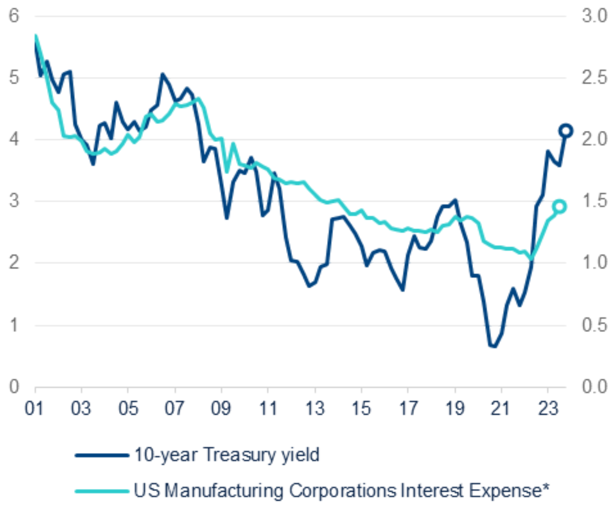
Figure 1. **SELECT CORE CPI INFLATION SUBINDICES** (%)



Source: BBVA Research based on data by Haver Analytics.

Businesses will face growing interest costs as maturing debt is refinanced at higher rates

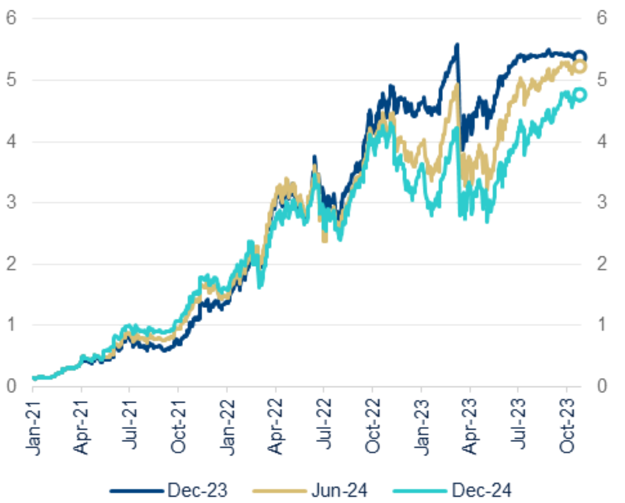
Figure 2. **10Y TREASURY YIELD AND US MANUF. CORPORATIONS INTEREST EXPENSE** (%)



* As a percentage of long-term debt due in more than 1 year.
Source: BBVA Research based on data by the US Census Bureau and Haver Analytics.

Recent soaring long-term rates seem to have joined the Fed in its fight against inflation…

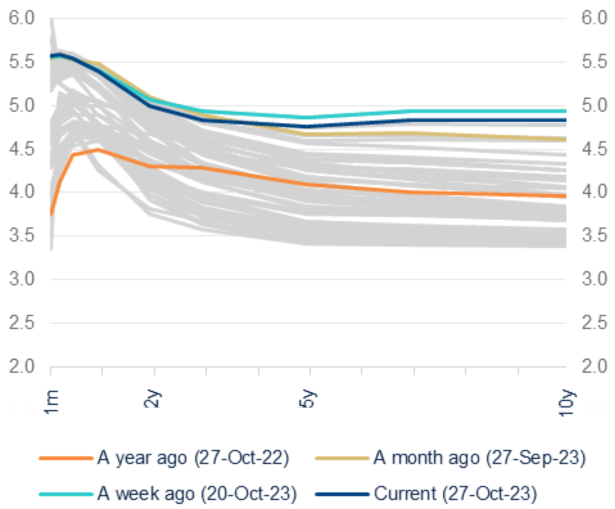
Figure 3. **IMPLIED RATE IN 30-DAY FED FUNDS FUTURES** (%)



Source: BBVA Research based on data by Bloomberg.

… probably offsetting some of the previously planned additional policy firming

Figure 4. **TREASURY YIELD CURVE** (%)



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

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