Fed Watch

Fed pivots instead of pushing back at the recent shift in market expectations…

Javier Amador / Iván Fernández

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… and fuels bets of rate cuts in early 2024; Treasury yields plummet along the yield curve

- **The FOMC puzzlingly kept a tightening bias in the statement in spite of clearly hinting that the next move will be a rate cut.** As widely expected, the Fed announced its unanimous decision to hold the fed funds rate steady at a 22-year-high 5.25-5.50% target range. The statement wording was mostly unchanged, but had some dovish tweaks. As we anticipated (see), the assessment of growth was downgraded as the Fed acknowledged that economic activity "has slowed" from its strong pace in 3Q. It also noted that labor market demand is easing ("job gains have moderated"), and importantly recognized that "inflation has eased". Although the wording of the statement kept the tightening bias, it now added the word "any" before the mention of possible additional hikes, strongly hinting that the Fed is now biased against any additional hikes—this was confirmed by the dot plot. Chair Powell explained in the Q&A that they added the word any "as an acknowledgement that [they] are likely at or near the peak rate for this cycle,"[1] i.e., the Fed is done hiking.

- **Not a single Fed official now forecasts that the fed funds rate needs to rise further from its current level in the updated Summary of Economic Projections (SEP) and dot plot (Figure 1).** As it seemed probable, the median forecasts for the fed funds rate at both end-2024 and end-2025 were revised down by 50 bps to 4.6% and 25 bps to 3.6%, respectively. That is, projections for the appropriate policy rate at the end of 2024 were revised down by an additional 25bp rate cut (from two to three), while the median still projects to cut four times (by 25 bps each) in 2025. Core PCE inflation was also revised down and is now projected to decline to 2.4% by year-end 2024 and to 2.2% by year-end 2025. Given that the three-month annualized core PCE inflation rate likely stayed close to 2.0% in November, and considering that it is set to further decrease as lower housing inflation is in the pipeline, we have a downward bias to our own inflation forecasts and to this recently revised Fed projections. The forecast for real GDP growth in 2024 was fine-tuned 0.1 pp down to 1.4% in 4Q, but growth and UR forecasts were kept mostly unchanged (Table 1).

- **From higher for longer to higher for shorter?** Powell noted in the press conference that the Fed will start cutting rates before inflation converges to the target: "you need to reduce [monetary policy] restriction on [the] economy well before [inflation reaches] 2%." Powell also mentioned that the Board has started to discuss potential rate cuts. That is, opposed to expectations, including ours, it was a meeting without any pushback at the recent strong shift in market interest-rate expectations. That had not happened throughout the hiking cycle and sends a strong signal: the Fed is pivoting and getting ready to discuss rate cuts relatively soon as the risks of doing too much seem to be now increasing with core inflation recently falling faster that what the Fed had forecasted. Fed's pivot fueled the recent shift in market expectations: odds of a rate cut as soon as in the next

[1] To justify the decision to retain the tightening bias, Chair Powell added that "participants did not want to take the possibility of further hikes off the table."

meeting (in late January) turned positive (c. 20%), and markets now think there's a ¾ chance of a rate cut in March and are also pricing in that there is a 90% probability that the Fed will cut rates five times (by 25 bps each) next year. Consistent with these movements, the yield curve strongly shifted down: the two-year Treasury yield fell by c. 30 bps to around 4.5% compared to the previous day, while the 10-year yield to c. 4.0%, almost 100 bps below the 5.0% October peak. Given that it seems that the Fed will no longer push back at market expectations, and considering that we have a downward bias to our and Fed's inflation projections, we now have a downward bias to our expectation of three rate cuts next year. A rate cut cycle could start earlier, as soon as in March.

Not a single Fed official now forecasts that the fed funds rate needs to rise further from its current level in the updated Summary of Economic Projections (SEP) and dot plot

Table 1. **FOMC PARTICIPANTS' SUMMARY OF ECONOMIC PROJECTIONS** (DECEMBER 2023, %)

Variable	Median					Central tendency					Range				
	2023	2024	2025	2026	LR	2023	2024	2025	2026	LR	2023	2024	2025	2026	LR
Change in real GDP	2.6	1.4	1.8	1.9	1.8	2.5-2.7	1.2-1.7	1.5-2.0	1.8-2.0	1.7-2.0	2.5-2.7	0.8-2.5	1.4-2.5	1.6-2.5	1.6-2.5
Sep-23	2.1	1.5	1.8	1.8	1.8	1.9-2.2	1.2-1.8	1.6-2.0	1.7-2.0	1.7-2.0	1.8-2.6	0.4-2.5	1.4-2.5	1.6-2.5	1.6-2.5
Unemployment rate	3.8	4.1	4.1	4.1	4.1	3.8	4.0-4.2	4.0-4.2	3.9-4.3	3.8-4.3	3.7-4.0	3.9-4.5	3.8-4.7	3.8-4.7	3.5-4.3
Sep-23	3.8	4.1	4.1	4.0	4.0	3.7-3.9	3.9-4.4	3.9-4.3	3.8-4.3	3.8-4.3	3.7-4.0	3.7-4.5	3.7-4.7	3.7-4.5	3.5-4.3
PCE inflation	2.8	2.4	2.1	2.0	2.0	2.7-2.9	2.2-2.5	2.0-2.2	2.0	2.0	2.7-3.2	2.1-2.7	2.0-2.5	2.0-2.3	2.0
Sep-23	3.3	2.5	2.2	2.0	2.0	3.2-3.4	2.3-2.7	2.0-2.3	2.0-2.2	2.0	3.1-3.8	2.1-3.5	2.0-2.9	2.0-2.7	2.0
Core PCE inflation	3.2	2.4	2.2	2.0		3.2-3.3	2.4-2.7	2.0-2.2	2.0-2.1		3.2-3.7	2.3-3.0	2.0-2.6	2.0-2.3	
Sep-23	3.7	2.6	2.3	2.0		3.6-3.9	2.5-2.8	2.0-2.4	2.0-2.3		3.5-4.2	2.3-3.6	2.0-3.0	2.0-2.9	
Federal funds rate	5.4	4.6	3.6	2.9	2.5	5.4	4.4-4.9	3.1-3.9	2.5-3.1	2.5-3.0	5.4-5.4	3.9-5.4	2.4-5.4	2.4-4.9	2.4-3.8
Sep-23	5.6	5.1	3.9	2.9	2.5	5.4-5.6	4.6-5.4	3.4-4.9	2.5-4.1	2.5-3.3	5.4-5.6	4.4-6.1	2.6-5.6	2.4-4.9	2.4-3.8

Figure 1. **FOMC PARTICIPANTS' PROJECTED APPROPRIATE FEDERAL FUNDS RATE** (%)

Source: BBVA Research based on data by the Federal Reserve and Haver Analytics.

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ENQUIRIES TO:
BBVA Research: Paseo de la Reforma 510, Colonia Juárez, C.P. 06600 Mexico City, Mexico.
Tel.: +52 55 5621 3434
www.bbvaresearch.com