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Fed Watch

The Fed will try to push back the recent shift in market expectations

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We expect the FOMC to hold rates unchanged at 5.25-5.50% and to steer clear from fueling speculation about rate cuts in early-2024

- **Over the past six weeks, there's been a significant shift in the yield curve** (Figure 1) **reflecting investors' belief that the Fed is done raising rates and growing expectations that rate cuts could start earlier in 2024**. 10-year Treasury rates have come down from October highs to levels closer to 4.3%, even dropping briefly last week below 4.2%. Fed fund futures, which were still pricing in late October significant odds of a possible additional 25bp rate hike at this upcoming meeting, are now pricing in a near 40% chance of a 25bp rate cut by March and close to ⅔ odds of at least four rate cuts by the end of next year (Figure 2).
- **What drove this shift? It seems that reduced uncertainty on the fed funds rate path next year has been mostly driven by recent encouraging inflation data, which showed that the downward trend in core inflation seems to be starting to happen more quickly**. The core PCE price index (Fed's favorite inflation measure) rose 0.16% MoM in October, bringing the annual rate down to 3.5%. Over the last three months in annualized terms, core PCE inflation has risen at a 2.4% rate (Figure 3), and importantly, core services ex-housing rose by only 0.1% MoM (Figure 4). Overall, inflation has moved in the right direction during the intermeeting period, and will likely reassure the Fed that the current policy tightness is enough to bring down inflation back to its target. Besides, dovish comments by Governor Christopher Waller (a hawk) clearly suggesting that the Fed will likely cut rates next year even if the economy is not weak, fueled this shift in expectations and the bond rally. He noted that if disinflation continues for several more months "you could then start lowering the policy rate just because inflation's lower," adding that "there's just no reason to say you would keep [rates] really high and inflation is back at target, for example."
- **How will the Fed react to this shift? We already had a preview with Chair Powell appearing to push back, stressing that "it would be premature to conclude with confidence that we have achieved a sufficiently restrictive stance, or to speculate on when policy might ease."** Thus, although markets seem to have pivoted already, signals from the Fed that a policy pivot might come in early 2024 are very unlikely. In fact, easier financial conditions along with the significant shift in fed funds futures have increased the risk that the Fed will likely attempt to bolster rates along the yield curve not only by signaling that the door for rate cuts is unlikely to open soon, but also by possibly retaining a tightening bias. Rates volatility and term-premia have come down as the outcome for the fed funds rate path seems more predictable, i.e., markets are now only questioning the timing and the extent of the rate cuts in 2024.
- **With markets convinced that the fed funds rate has peaked, all eyes will be on any hints as to how soon and by how much the Fed thinks that rates could be cut in 2024**. The Fed will try to convince markets that rates will stay high for long. Yet, it will have to acknowledge that economic activity is slowing, labor market demand is easing, and inflation continues to move in the right direction. Thus, the Fed will likely feel forced to keep the tightening bias in the wording of the statement to avoid sending a message that the Fed does not

want to convey (i.e., that a rate cut cycle could start in early 2024). The assessment on growth should be downgraded from “strong” while inflation could continue to be characterized as “elevated” (for the last meeting?). However, the focus will be on the updated economic projections (SEP). Core PCE inflation has already fallen to 3.5% YoY, below the 3.7% YoY 4Q average projection made by the Fed in September. Thus, the Fed will likely revise down this forecast and to be consistent should also adjust somewhat down the 2.6% year-end 2024 forecast. Growth and unemployment rate forecasts might be fine-tuned but will continue to signal a soft landing. Lastly, given that the fed funds rate will end the year below the 5.6% September’s projection, even if officials keep the number of cuts for next year unchanged (at two), year-end 2024 and 2025 interest rate projections should be revised down by at least 25 bps each. Although 2024 projections might be revised down by another 25bp rate cut (to three), we think that it is more likely than not that the Fed will lean to keep the two rate cuts forecast unchanged to avoid fueling rate cuts speculation at this moment in time.

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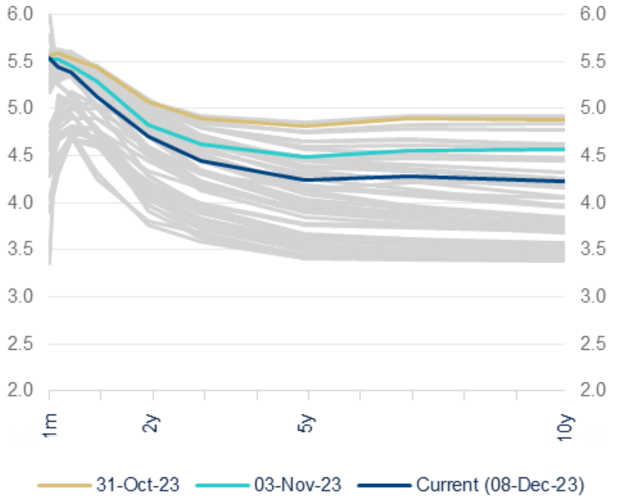
There's been a significant shift in the yield curve reflecting investors' belief that the Fed is done…

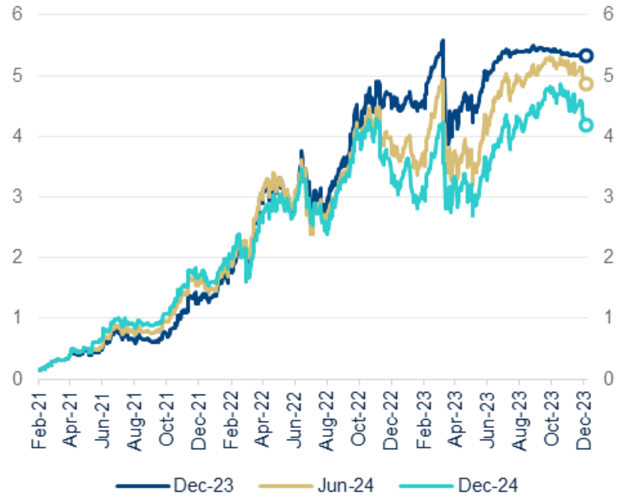
Figure 1. **TREASURY YIELD CURVE** (%)



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

… raising rates and growing expectations that rate cuts could start earlier in 2024

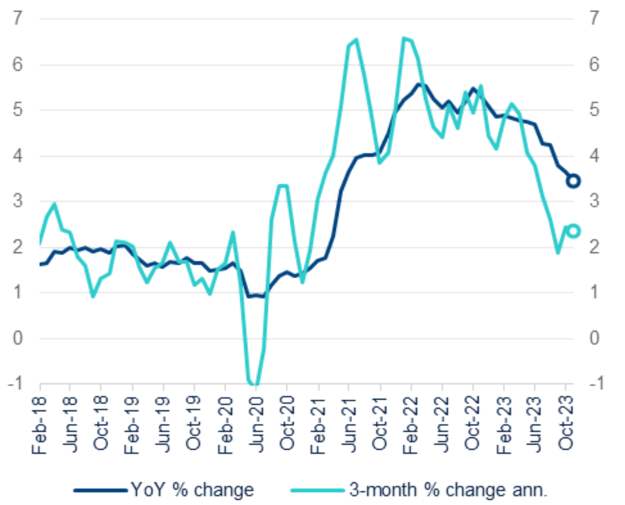
Figure 2. **IMPLIED RATE IN 30-DAY FED FUNDS FUTURES** (%)



Source: BBVA Research based on data by Bloomberg.

Inflation has continued to move in the right direction, and will likely reassure…

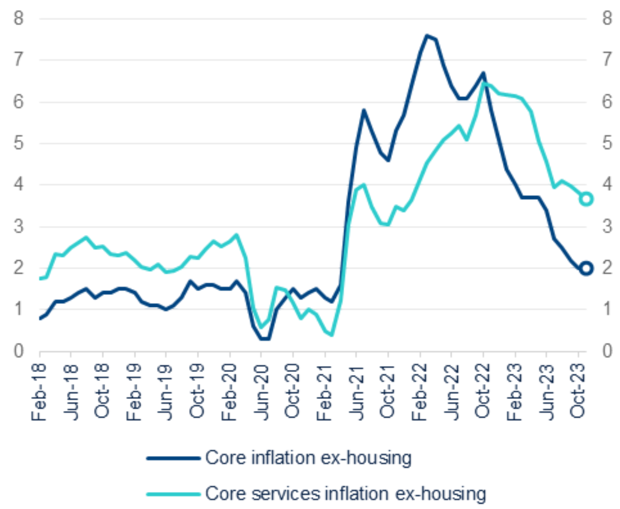
Figure 3. **CORE PCE PRICE INDEX** (%)



Source: BBVA Research based on data by Haver Analytics.

… the Fed that the current policy tightness is enough to bring down inflation back to its target

Figure 4. **SELECT CORE CPI INFLATION SUBINDICES** (%)



Source: BBVA Research based on data by Haver Analytics.

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