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Fed Watch

No need for a hawkish Fed tone amid an increasingly convincing inflation easing

Javier Amador / Iván Fernández

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We expect the FOMC to hold rates unchanged at 5.25-5.50% amid the recent market reassessment of policy rate expectations

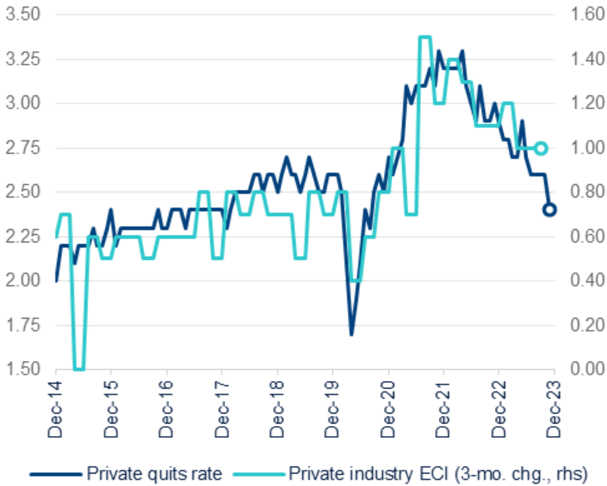
- **Given that economic activity has continued to show strength, the Fed will likely convey that it needs a bit more time before feeling confident to signal its willingness to begin a rate-cut cycle soon.** Last week, the advance estimate for 4Q23 real GDP was released, showing a 3.3% YoY growth rate. While notably lower than the robust figure for 3Q23 (4.9%), it exceeded the expectations of both analysts (1.9%) and the median FOMC participant (2.6%). While this figure continued to reflect the ongoing strength of the US economy, headwinds for economic activity remain well in place, and it's important to note that 4Q23 GDP data will be subject to a couple of revisions in February and March, which leaves the door open to a likely downward revision that could align it closer to pre-release expectations or the 2.4% Atlanta Fed's GDPNow estimation.
- **Employment data did not yield broad-based positive surprises either, but it continued to signal a gradual rebalancing in the labor market, still free from a worrying level of layoffs.** Nonfarm payrolls increased by 216,000 in December, exceeding consensus expectations (+150,000). However, a closer look at the data revealed that job gains continued to trend up primarily in non cyclical sectors such as government (+52,000) and health care (+38,000). Payrolls in more cyclical sectors, excluding construction, changed little (leisure and hospitality, retail trade, and professional and business services) or even declined (transportation). Following a downward revision to October and November data, monthly job gains averaged 165,000 in 4Q23, broadly in line with pre-pandemic dynamics. The household survey revealed that employment decreased by 683,000, but a similar decline in the labor force (676,000) kept the unemployment rate unchanged at 3.7%. Perhaps the most discouraging figure from the jobs report was average weekly earnings, which rose slightly to 4.1% from 4.0% YoY. However, it's likely that labor costs will continue to cool down. While last month's JOLTS survey showed that the job openings rate remained stable in November (5.3%), the hires rate plunged to a 10-year minimum. Most importantly, the total private quits rate dropped to 2.4% from a four-month 2.6% streak, providing a strong signal of further labor costs deceleration in the near future (Figure 1).
- **December's CPI inflation was also somewhat higher than expected, but the Fed's preferred PCE index inflation figure released last week continued to suggest that the inflationary issue is largely resolved.** Headline and core CPI inflation continued to run above 2% at 3.4% and 3.9% YoY, respectively. The 0.3% MoM uptick in core inflation (from a 0.2% expectation) was driven by strong increases in used vehicle prices (0.5%) and rent of shelter (0.4%). However, there is strong evidence of further deceleration ahead for the latter (which accounts for nearly half the core CPI index) as lower prices for newly-signed rental contracts continue to feed through the official CPI inflation data. On the other hand, the 0.2% MoM growth rate for the core PCE index released last week for December was broadly in line with expectations. It translated into a 2.9% YoY growth rate, down from 3.2% a month before, and at its lowest since April 2021. This means also that both the three-

and six-month annualized core PCE inflation rates are now running below the Fed's target at 1.5% and 1.9%, respectively (Figure 2).

- **Unlike the broadly encouraging data released ahead of last month's FOMC meeting and its effect on a dovish Fed's tone, recent data drove markets to slightly reassess their rate expectations.** Following last month's FOMC meeting, markets significantly brought forward their policy path projections for the upcoming rate cut cycle. Fed funds futures priced in a probability of a rate cut in March of as much as 75% during the last week of December. Today, implied chances for such an outcome are more akin to a coin toss. The futures market prices in a 90% chance for a rate cut in May, which is fully priced in by the time of the June meeting. The same market anticipates 125 bps worth of rate cuts throughout 2024, down from 150 bps some weeks ago (Figure 3). Treasury bond yields also halted their 4Q23 steady decline and partially reversed it in the most recent weeks, especially the longer-terms ones. This translated into an upward shift of the yield curve (Figure 4). While it remains well below its 5.0% October's peak, the 10-year Treasury yield now stands at 4.1% after having dipped below 3.9% following December's FOMC meeting.
- **Overall, evidence since the last meeting suggests that a strong hint of a rate cut in March is unlikely, but the Fed could take another step to pave the way for the start of a rate cut cycle soon.** The continued strength in recently released data is likely to reinforce the long-held opinion among several FOMC participants on the importance of remaining data-dependent, and on the "need to see more evidence that inflation pressures [are] abating to become confident in a sustained return of inflation to 2%." Their intention will be gaining some more time to let some fresh 1Q24 economic data accumulate. By 2Q24 the Fed will feel more confident that core disinflation will be sustained, and in the absence of an abrupt downshift in labor market conditions, it will likely start to cut rates in May. This move could be more clearly signaled during the March meeting, when FOMC participants will be required to update their economic projections. To some extent, the recent adjustment in market expectations and its corresponding impact on broad financial conditions give the Fed some room to continue to convey that the next move will be a rate cut without risking an over-easing of financial conditions.

The quits rate dropped to 2.4% providing a strong signal of further labor costs deceleration ahead

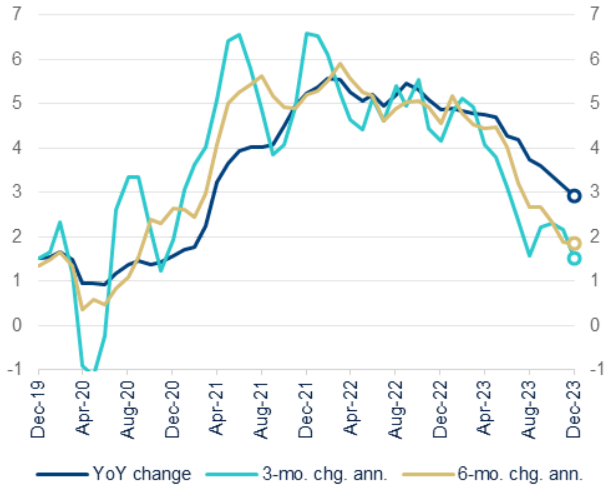
Figure 1. **PRIVATE QUITS RATE AND EMPLOYMENT COST INDEX** (%)



Source: BBVA Research / Haver

Both the three- and six-month annualized core PCE inflation are now running below 2%

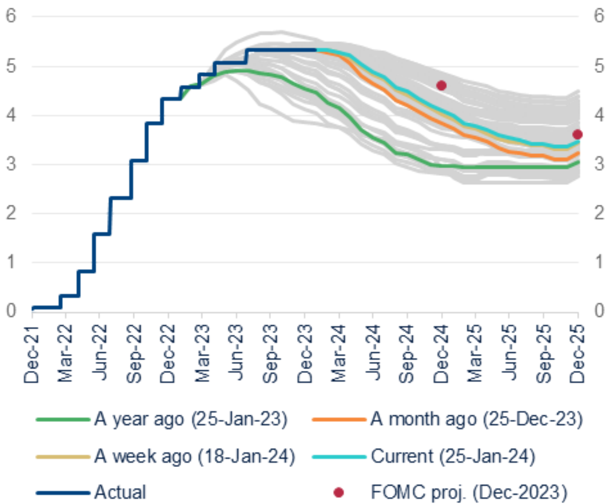
Figure 2. **CORE PCE PRICE INDEX** (%)



Source: BBVA Research / Haver

Futures anticipates 125 bps worth of rate cuts during 2024, down from 150 bps some weeks ago

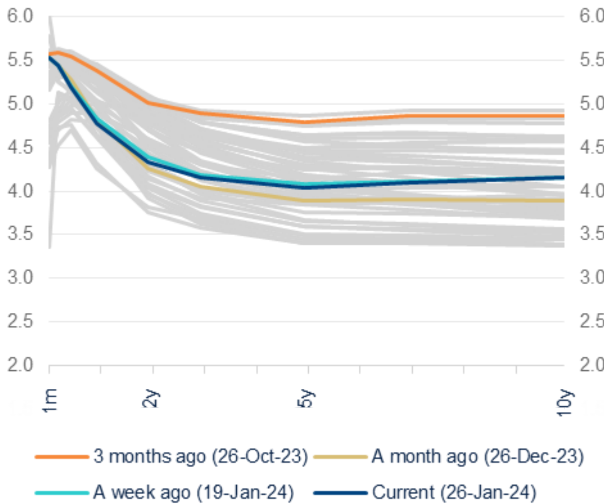
Figure 3. **IMPLIED RATE IN 30-DAY FED FUNDS FUTURES** (%)



The gray lines indicate weekly implied rate paths from a year ago
Source: BBVA Research / Bloomberg

Treasury yields halted their steady decline and partially reversed it in the most recent weeks

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



The gray lines indicate weekly yield curves from a year ago
Source: BBVA Research / Haver

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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