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Fed Watch

Fed is set to signal there's no rush to start cutting rates

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Both the statement and SEP projections are likely to remain broadly unchanged pointing to three rate cuts this year

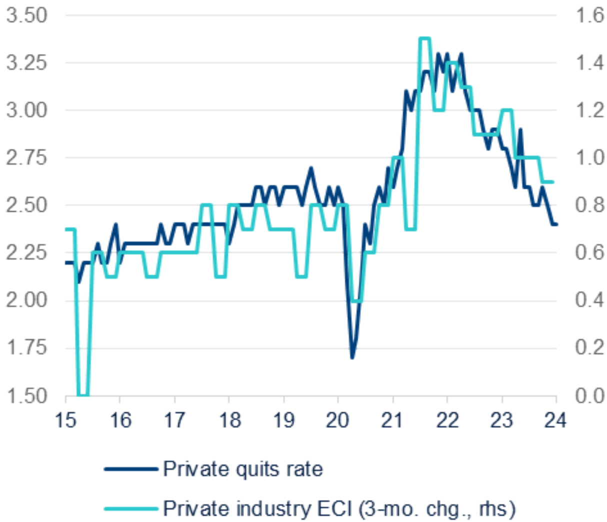
- **The Fed will likely convey that it continues to look for "more good data" before feeling enough confidence to begin cutting rates as the strength of economic activity has extended.** The second estimate for 4Q23 real GDP released last month confirmed that the US economy expanded by a strong 3.2% QoQ SAAR growth rate in 4Q23 (only 0.1 pp down from the advance estimate), and though combined survey evidence from both the ISM Manufacturing and Services indexes has been pointing to a stagnation in GDP in the first quarter of this year, the most recent Atlanta Fed's nowcast for real GDP growth in 1Q24 points to a still strong and above-trend 2.3% QoQ SAAR growth rate.
- **The labor market has remained strong in recent months, but a wider perspective suggests that it continues to gradually cool supported by the supply side.** An average of 252,000 non-farm payrolls were added in the first two months of this year, well above the 213,000 average gain during 2H23. However, the significant revision to the January figure (to 229,000 from 353,000) eased initial concerns about a significant reacceleration of the labor market to start off the year. The fact that just over half of new jobs continue to be concentrated in non-cyclical sectors (government and health care and social assistance), and that most recently resurging sectors are services-related (leisure and hospitality, transportation and warehousing, and retail trade), suggests that the labor market probably continues to reflect some of the revenge spending caused by the pandemic as job gains in goods-producing sectors continue to show weakness. The household survey showed that the unemployment rate rose to a two-year high of 3.9%, driven by lower employment (-184,000) and more people entering the labor force (+150,000). The 5-month stickiness of 4.3% YoY growth in average hourly earnings remains an upward risk for inflation, but alternative measures from the most recent JOLTS survey continue to suggest the absence of strong demand pressures in the labor market, with the job-openings rate in evident decline and the private job quits rate, at its lowest since 2017, pointing to further deceleration of wage increases (Figure 1).
- **The most recent CPI inflation reports suggest that the pace of disinflation has somewhat slowed down, but a 1970s-like inflation resurgence that calls for further tightening is highly unlikely.** Core CPI inflation increased 0.4% MoM in February for the second month in a row, but edged down to 3.8% YoY (from 3.9%). Owners equivalent rent posted a more modest 0.4% MoM increase, easing concerns driven by the puzzling 0.6% MoM jump in January, but the eye-catching rebound in some core goods (apparel and used vehicles) and core services (airline fares) prices suggest that economic activity did start the year on a strong foot as depicted by the job creation data. Headline inflation also increased 0.4% MoM (3.2% YoY) driven by a 3.8% MoM rebound in gasoline prices. Core CPI inflation ex-shelter is still running below 2.0% (1.8% YoY), which continues to suggest that there's still a lot of disinflation in the pipeline. Particularly, the recent resurgence in housing inflation is at odds with more timely measures that show that prices at which rental contracts are

currently being signed are increasing at a much slower pace (even declining) than what the official indices suggest (Figure 2). Core PCE grew 0.4% MoM in January too, translating into a 2.8% YoY growth rate (down from 2.9%), but also driving up the six-month annualized inflation rate to 2.5% after being running below 2% for a couple of months.

- **Evidence of a still strong economy has driven financial markets to price in that the Fed will push back the start of the rate cut cycle to June, and possibly even July.** Implied chances for a rate cut in March ahead of the late-January FOMC meeting were akin to a coin toss. Today, markets seem to have completely ruled out a rate cut in either March (1% chance) or May (5% chance). Instead, the implied probability of the rate cut cycle beginning in June stands at c. 60%. The futures market now anticipates 75 bps worth of rate cuts throughout 2024, down from 150 bps at the end of last year (Figure 3). This expectation shift is also reflected by the yield curve: mid- and long-term Treasury yields have reversed 1/3 of the previous 4Q23 rally (Figure 4) as markets try to reconcile recent signs of shelter inflation stickiness and long-held evidence of disinflation from measures of rental prices in newly-signed contracts. But even as uncertainty around the inflation outlook has prevented bond market volatility from returning to average historical standards, investors seem to be smoothly navigating the current environment of heightened data-dependency. As opposed to its dynamics in 3Q23, the evolution of the term premium this year reflects the markets' view that, although it is taking a bit longer than expected, pandemic-related inflation has been nearly resolved (see here for more on the recent evolution of US interest rates and broad financial conditions).
- **Overall, recent data pointing towards a possible slow down of the disinflationary process means the Fed is likely set to signal there is no rush to start cutting rates or to wind down QT.** A couple of weeks ago, at his semiannual testimony before Congress (just some days before the latest CPI and jobs reports were released), Powell stuck to his January script and said that rate cuts were likely “at some point” in 2024, but that the FOMC will be cautious as they do “not expect that it will be appropriate to reduce the target range until it has gained greater confidence that inflation is moving sustainably toward 2%.” While it may have been an opportunity to reinforce the relatively more hawkish tone of other FOMC members, it seems that Powell agreed then with the market’s view of a first rate cut in June. Therefore, we’re not expecting any meaningful changes in the wording of the statement or the SEP projections, which will likely continue to point to three rate cuts this year. In our view, the most recent developments don’t call for a significant change of tone since Markets have all but priced in the Fed’s median outlook from last December, and continued evidence of a cooling labor market means the FOMC is facing more balanced risks around its dual mandate. However, there’s a possibility that some of the more hawkish FOMC participants produce an unexpected change to the median figures of the SEP or the dot plot. But with a still-restrictive policy stance and a better balance of risks, the Fed's “cautious” decisions going forward will likely gradually focus on avoiding causing unnecessary harm to the labor market.

The job quits rate, at its lowest since 2017, points to further deceleration of wage increases

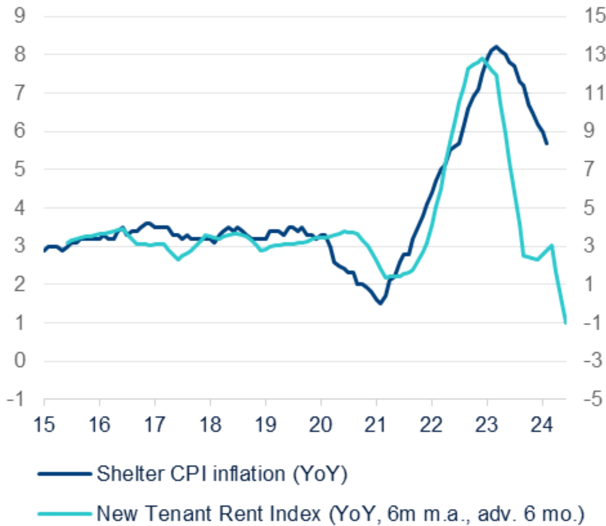
Figure 1. **PRIVATE QUITS RATE AND EMPLOYMENT COST INDEX** (%)



Source: BBVA Research / Haver

Newly-signed rental contract measures show that official shelter inflation figures are set to decline

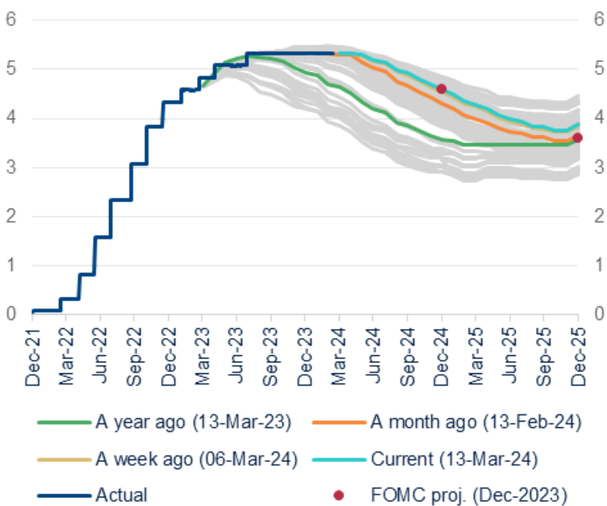
Figure 2. **SHELTER CPI INFLATION AND NEW TENANT RENT INDEX** (%)



Source: BBVA Research / Haver

The futures market now anticipates 75 bps worth of rate cuts throughout 2024

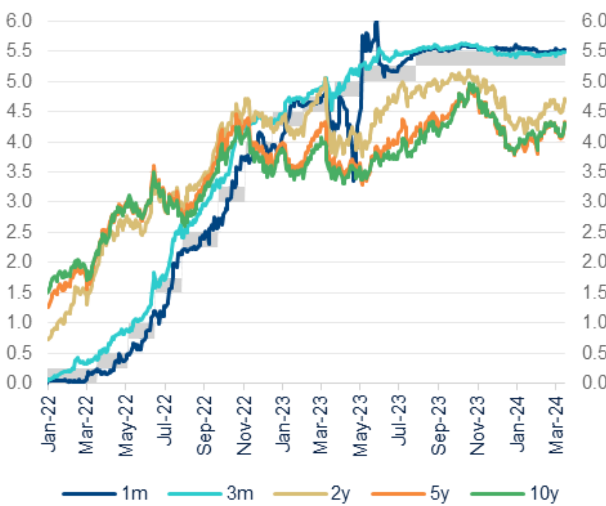
Figure 3. **IMPLIED RATE IN 30-DAY FED FUNDS FUTURES** (%)



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

Mid- and long-term Treasury yields have reversed 1/3 of the previous 4Q23 rally

Figure 4. **TREASURY YIELDS** (%)



The gray area indicates the federal funds rate target range.
Source: BBVA Research / Haver

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