BBVA Research

Fed Watch

Fed’s hawkishness likely to gear amid a bump in the road in 1Q24

Javier Amador / Iván Fernández

April 29, 2024

While it will take “longer than expected” to gain confidence on the path to 2%, the Fed is unlikely to rule out any rate cut this year

- **Last week’s advance estimate for real GDP confirmed that the underlying strength of economic activity extended through 1Q24 driven by services spending and residential investment.** Even though real GDP slowed down to a weaker-than-expected 1.6% SAAR in the first quarter of this year from its 4Q23 3.4% strong pace (the last GDPNow forecast for the first quarter pointed to a 2.7% growth rate), the slowdown was mainly explained by negative contributions from net exports and inventories (Figure 1). Consumption decelerated too but continued to grow at a solid 2.5% pace on strong services spending growth (4%), whereas fixed investment posted a 5.3% growth rate driven by a robust 13.9% change in residential investment. Final sales to private domestic purchasers (i.e., the sum of personal consumption expenditures and gross private fixed investment), which is a better gauge for underlying economic momentum, decelerated only to 3.1% from 3.3%.
- **The labor market continued to score strong job gains in March, but alternative measures of tightness suggest a gradual rebalancing process is still taking place.** Job creation has extended the good streak that began in December. The jobs report for March indicated that nonfarm payrolls increased by 303,000, well above both the 3- and 6-month trailing average pace (276,000 and 244,000, respectively), and the 251,000 monthly average gain of last year (Figure 2). While non-cyclical sectors such as government and health care contributed to roughly half of new jobs in March (152,000), notable job gains in leisure and hospitality (49,000) and construction (39,000) support the story from the 1Q GDP figure that economic strength was driven by services spending and residential investment. The 498,000 jobs increase from the household survey drove the unemployment rate to tick down to 3.8% from 3.9%. Despite these signs of tightening, wage-related inflation risks seem to remain on the sidelines as average hourly earnings slowed down to 4.1% YoY from its previous five-in-a-row 4.3% growth pace, likely driven by productivity gains that pose lower inflation risks. Even if the fastest pace of rebalancing in the labor market seems to be in the rearview mirror as most demand-driven indicators from the JOLTS data have returned to pre-pandemic norms, there is still room for some additional easing with job-openings still on a downward trend and private job quits pointing to further deceleration of wage increases.
- **Core inflation came in hotter than expected again in March, wiping out any chance of a rate cut in the short term and triggering a further reassessment of rate-cut expectations.** Core CPI inflation increased 0.4% MoM for the third month in a row. While it remained unchanged at 3.8% YoY, the three-month annualized rate jumped to 4.5% from 4.2% in February. Headline inflation also increased 0.4% MoM (3.5% YoY, +0.3 pp). Although March's jump is mostly explained by a one-off sharp 2.6% MoM increase in motor vehicle insurance, disinflation evidently hit a bump in the road during 1Q. While core PCE inflation continues to run at a slower pace due to different relative weights, particularly for shelter, it also increased more than anticipated in 1Q24 and came in somewhat hotter than expected in March, rising 0.3% MoM. Even if the 12- and 6-month

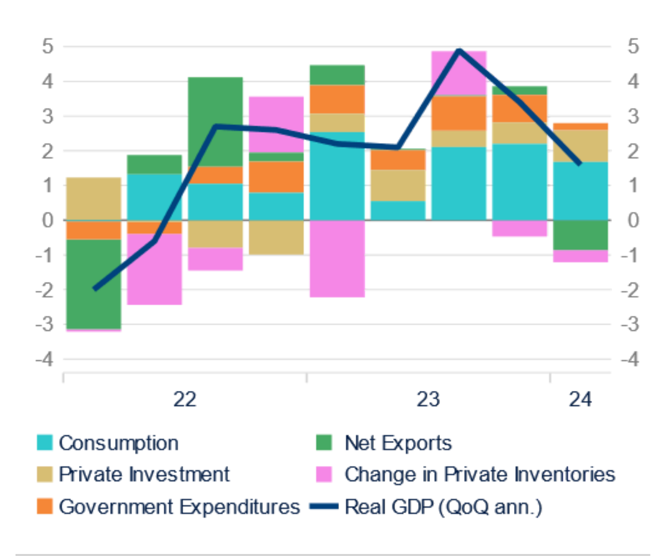
annualized rates were unchanged at 2.8% and 3.0%, respectively, the 3-month annualized rate jumped to 4.4% (Figure 3). Although we expect the disinflationary trend to resume in 2Q, the setback in 1Q erased any chance of a rate cut soon.

- **This bump in the road in the slowing pace of inflation has driven financial markets to price in that the Fed will push back the start of the rate cut cycle to July at the earliest, more likely to the fall.** Financial markets' expectations on the future path of monetary policy shifted significantly (Figure 4). While the futures market had already priced in the FOMC would stay put in May following last month's FOMC meeting, the implied probability of a rate cut in June shrinked from 57% to 17% following the most recent CPI report earlier this month. The futures market now expects a first rate cut until September (58% chances of such an outcome) at the same time it casts doubts on whether the Fed will adhere to its median projection for three rate cuts this year (the implied probability of at least three rate cuts this year went from 70% a month ago to 12%). This reassessment of expectations was also evident in the yield curve. The single-day 20bp jump in the 10-year Treasury yield following the CPI report for March was the largest since September, and last week hit a 5-month 4.7% high. As long as uncertainty continues to revolve around how much longer should the policy rate remain at its current level, and not about how higher should it go (as it was the case during 3Q23), it is likely that the 10-year Treasury yield won't climb to its October 5% peak (see here for more on the recent evolution of US interest rates and broad financial conditions).
- **FOMC members are likely to formally convey their plan to slow down the pace of its quantitative tightening (QT), probably starting in June.** The March-meeting minutes revealed that QT was expected to begin "sooner rather than later" in order to prevent reserve balances from declining at an uncomfortably rapid pace. FOMC participants are likely to officially agree on a date for implementing the plan discussed in the last meeting consisting on reducing the monthly pace of Treasuries runoff by half (from 60 to 30 billion) and maintaining the existing cap on MBS (35 billion), which would be consistent with the Fed's intention to hold primarily Treasury securities.
- **While it will evidently take "longer than expected" to gain confidence on the path to 2%, the Fed is unlikely to rule out any rate cut this year.** We expect both the policy statement and Powell's press conference to reinforce the already-priced-in-by-financial-markets takeaway that it will take longer than expected to begin a rate cut cycle. The assessment of both the pace of economic activity and inflation is likely to be upgraded in the policy statement, which opens the door to a slight worsening of the balance of risks for inflation amid sticky core inflation. Powell is likely to adhere to his recent script and point out that the latest developments suggest it will likely take more time before the FOMC reaches a substantial level of confidence before concluding that inflation is sustainably slowing down towards 2%. The set of economic data so far this year gives the FOMC less room to attribute the recent lack of progress to a bump in the road related to seasonal distortions. While this has raised some concerns on the possibility of the Fed ruling out a rate hike at any of the upcoming meetings, chances are that FOMC members will decide to act cautiously and try not to strike an overly hawkish tone that drives markets to price in such a scenario by reiterating that policy is "well positioned to handle the risks [faced] if higher inflation does persist." While core inflation is proving to be stickier than expected, we think that disinflation is likely to resume in 2Q24 as lower rent prices continue to feed into the official inflation data, the labor market continues to gradually rebalance, and inflation expectations remain well anchored. This will likely drive the FOMC to continue to expect rate cuts "at some point" this year as depicted by last month's SEP. In light of recent developments, risks are biased towards the Fed staying on the sidelines for longer, so we pushed back our call for the rate cut cycle to start in July, and now expect only three rate cuts this year (to a 4.50-4.75% target range by year-end). Risks are now tilted towards an ever later start to the rate-cut cycle which would probably imply less rate cuts this year (possibly only two). Furthermore, we now think that the probability of no rate cuts this year is not negligible.

BBVA Research

Economic activity strength extended through 1Q24 driven by consumption and investment

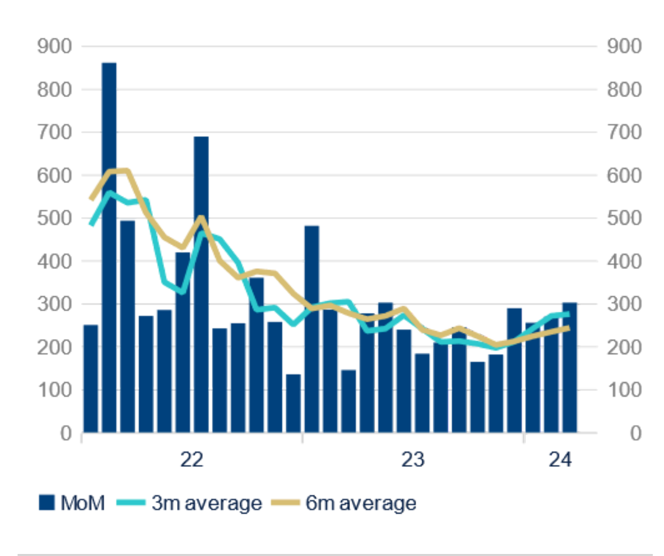
Figure 1. **REAL GDP GROWTH** (%)



Source: BBVA Research / BEA

Nonfarm payrolls increased by 303k, well above both the 3- and 6-month trailing average pace

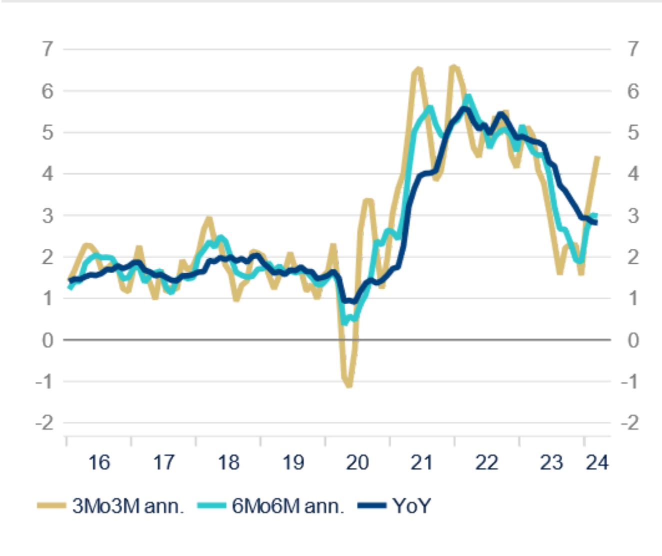
Figure 2. **CHANGE IN NONFARM PAYROLL EMPLOYMENT** (THOUSANDS)



Source: BBVA Research / BLS

Core PCE inflation came in somewhat hotter than expected; the 3m annualized rate jumped to 4.4%

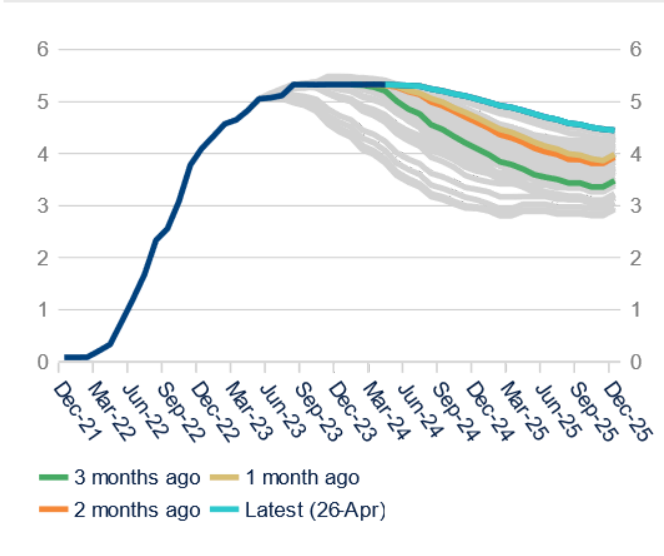
Figure 3. **CORE PCE INFLATION** (%)



Source: BBVA Research / BEA

Financial markets' expectations on the future path of monetary policy shifted significantly

Figure 4. **FUTURES-IMPLIED POLICY RATE PATH** (%)



Gray lines indicate weekly implied rate paths since a year ago
Source: BBVA Research / CME

BBVA Research

DISCLAIMER

The present document does not constitute an "Investment Recommendation", as defined in Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse ("MAR"). In particular, this document does not constitute "Investment Research" nor "Marketing Material", for the purposes of article 36 of the Regulation (EU) 2017/565 of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive (MIFID II).

Readers should be aware that under no circumstances should they base their investment decisions on the information contained in this document. Those persons or entities offering investment products to these potential investors are legally required to provide the information needed for them to take an appropriate investment decision.

This document has been prepared by BBVA Research Department. It is provided for information purposes only and expresses data or opinions regarding the date of issue of the report, prepared by BBVA or obtained from or based on sources we consider to be reliable, and have not been independently verified by BBVA. Therefore, BBVA offers no warranty, either express or implicit, regarding its accuracy, integrity or correctness.

This document and its contents are subject to changes without prior notice depending on variables such as the economic context or market fluctuations. BBVA is not responsible for updating these contents or for giving notice of such changes.

BBVA accepts no liability for any loss, direct or indirect, that may result from the use of this document or its contents.

This document and its contents do not constitute an offer, invitation or solicitation to purchase, divest or enter into any interest in financial assets or instruments. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.

The content of this document is protected by intellectual property laws. Reproduction, transformation, distribution, public communication, making available, extraction, reuse, forwarding or use of any nature by any means or process is prohibited, except in cases where it is legally permitted or expressly authorised by BBVA on its website www.bbvaresearch.com.

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