Fed Watch

Fed keeps easing bias but signals high rates for longer

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Rate hikes are off the table despite lower confidence on the inflation outlook due to 1Q24's lack of progress on inflation

- **The FOMC continued to judge that the current 5.25-5.50% policy rate is well positioned to deal with faced risks and uncertainties around their dual mandate.** The policy statement showed a slight upgrade to the assessment of economic activity, which "has continued to expand at a solid pace" as evidenced by the continued strength of both services spending and residential investment from last week's GDP report. While participants continued to judge that "jobs gains have remained strong" and that "inflation has eased over the past year," they also explicitly acknowledged that "in recent months, there has been a lack of further progress" towards 2% inflation, just as already conveyed by Powell in recent weeks. In prepared remarks ahead of the Q&A session, Powell pointed out that "so far this year, the data have not given [them] that greater confidence" to consider rate cuts, and that "it is likely that gaining such greater confidence will take longer than previously expected." This more hawkish tone suggests a wider consensus among participants on dismissing 1Q24 developments as merely expected "unevenness." The recent degree of confidence erosion among participants is likely to be varied and will ultimately determine to what extent will median economic projections and the dot-plot move in June. But for now, this change of view does not seem to have had a significant impact on the agreed judgment around the risks for employment and inflation. The Fed's assessment on the risks to its dual mandate is broadly the same as in March—they "have moved toward better balance—and thus, it supports the continuation of an easing bias. We argued that the Fed would try not to strike an overly hawkish tone that drove markets to price in the recently-raised concerns around the need for a rate hike in the short term (see here), and that was clearly the case as the message around the restriction level was limited to reiterating that "policy is well positioned to deal with the risks and uncertainties [faced] in pursuing both sides of [the] dual mandate."
- **During the Q&A, chair Powell dismissed the odds of possible rate hikes as the policy focus continues to be on for how long to keep policy restrictive.** He was repeatedly asked about the possibility of a rate hike due to the lack of progress on inflation in 1Q24, but he left little doubt about the Fed's most likely move. He said "it is unlikely that the next policy rate move will be a hike," adding that the Fed believes that the policy stance is in a good place, and is weighing on demand, which "has come down a lot." As "restrictive monetary policy needs more time to do its job", the Fed will "see how long it will take and how patient [it needs] to be." The Fed focus continues to be on the two most likely paths for the economy: i) the paths to cutting rates in which the Fed gains greater confidence that inflation is coming back to 2% or there is an unexpected softening in the labor market, and ii) an alternative path in which "inflation moves sideways [and] the Fed will hold off rate cuts." Neither involves the need for a more restrictive monetary policy stance, i.e., rate hikes are not on the table. Albeit Powell didn't bite into talking about likelihoods or probabilities, he insisted that the Fed is focused "on paths that would involve cuts and paths that wouldn't," and with a strong economy and confidence that monetary policy is restrictive, the Fed can be patient and is going to "let the data lead [them] on that." When

asked if there was something more worrying about inflation than just expected bumpiness, Powell was very clear and explicit: “not really”. Although he clearly acknowledged the inflation rebound (in MoM terms) in 1Q24, and said the Fed took “a signal from a full quarter”, Powell signaled they were not overly concerned as the signal was that “it [was] likely to take longer for [them] to gain confidence that [they’re] on a sustainable path down to 2% inflation,” conceding that their “confidence didn’t increase in the first quarter,” but also suggesting that the Fed is still comfortable with its current wait-and-see approach as it “came to the view that it will take longer to get that confidence.” Moreover, he reminded that “[...] as inflation has come down now to below 3.0%, the other goal, the employment goal, now [also came back] into focus,” pointing again to the fact that risks are not as lopsided as they were last year and are now more two-sided.

- **The Fed’s tone has clearly turned more tough compared to the end of last year, but financial markets have so far priced in a less hawkish tone than expected for yesterday’s message.** While the futures market expectation is still consistent with no more than 2 rate cuts this year, implied chances for a rate cut in July rose somewhat from 23% to 35%, and while the probability for at least three rate cuts this year remains low, it more than doubled to 17% from 7%. Both 2- and 10-year Treasury yields also declined c. 10 bps to 4.9% and 4.6%, and the US dollar depreciated. Volatility is likely to continue in the coming weeks as further inflation data come in and provide more elements around the Fed’s next decision.

- **FOMC members formally conveyed their plan to begin to slow down the pace of QT in June.** The official plan turned out to be somewhat more aggressive as the monthly redemption cap on Treasury securities will be reduced from 60 to 25 billion (instead of being reduced by half, to 30 billion, as previously signaled in the March’s meeting minutes). While the monthly redemption cap on MBS will be held at 35 billion, Powell explained that “with principal payments on agency securities currently running at about 15 billion per month, total portfolio runoff will amount to roughly 40 billion per month.” Powell insisted that plans around QT are not intended to manage the current stance of monetary policy, but rather to “help ensure a smooth transition [to its ultimate level], reducing the possibility that money markets experience stress, and thereby facilitating the ongoing decline in our securities holdings that are consistent with reaching the appropriate level of ample reserves.”

- **We push back the start of the rate cut cycle to September and now expect only two rate cuts this year.** In a context of a strong economy and a lack of further progress on inflation in recent months, the Fed unequivocally signaled that it can be patient and will give the restrictive monetary policy stance more time to do its job before deciding to cut rates. Given that a full quarter of upside surprises to inflation just took place, and it will take time for the 3-month annualized core inflation rate to come back down for the Fed to have a better signal on inflation, we now think that a rate cut in either of the next two meetings (in June and July) is unlikely, but as we expect inflation to ease ahead, we think that the door to start cutting rates will likely open in the third quarter. We now expect the first rate cut to come in September and anticipate that the Fed will cut the fed funds rate again in December to take it down to 4.75-5.00% by year end.

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