

MARKET COMMENTARY

Fed counts on tighter finance to calm inflation

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- At yesterday's meeting, the Fed left the door open to a further raise in December or Q1, but the overall tone of the statement and press conference strengthened the conviction that the bank is done hiking. The press release and the Q&A underlined the role of tighter financial conditions in taming demand. Paradoxically the drop in bond yield following the meeting, if protracted, could lead to looser financial conditions and another rate rise.
- The FOMC has also become more concerned about the risk of overtightening, despite the very strong Q3 GDP figures and solid employment growth. The much weaker than anticipated manufacturing ISM is a reminder that higher rates and a complicated global outlook are set to weigh on the economy.
- We continue to predict a marked growth slowdown into 2024. We still see June as the likely beginning of rate cuts, but resilient activity and sticky inflation may force the Fed to maintain the policy rate at the current level into H2.

Chair Powell struck a rather dovish tone at yesterday's meeting, over and above the widely anticipated and unanimous decision not to move rates. The Press release contained few changes (see below). The view on the current economic situation was upgraded and, more importantly, the FOMC recognised the role tighter financial conditions are having in moderating inflation.

Recent indicators suggest that economic activity ~~has been expanding~~ expanded at a ~~solid strong~~ solid strong pace. ~~in the third quarter.~~ Job gains have ~~slowed in recent months~~ moderated since earlier in the year but remain strong, and the unemployment rate has remained low. Inflation remains elevated.

The U.S. banking system is sound and resilient. Tighter financial and credit conditions for households and businesses are likely to weigh on economic activity, hiring, and inflation. The extent of these effects remains uncertain. The Committee remains highly attentive to inflation risks.

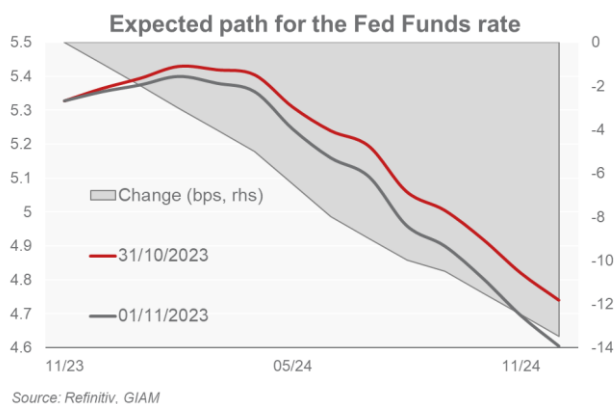
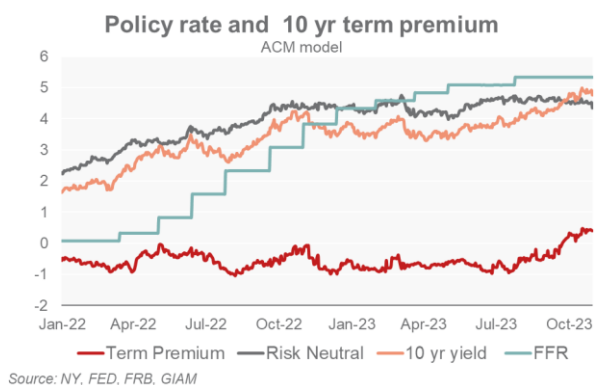
Powell significantly downplayed the message of the September dots, which signal another hike for Decembers: dots "decay" as new information comes in. Moreover, risks are becoming more "two sided". Indeed the worse than expected reading of the Oct. Manufacturing ISM (down 2.3 to 46.7) is a reminder that tighter finances are having an impact on the economy. Moreover, , strong

consumption in Q3 defied falling real incomes and a lower saving rate, casting doubts on its durability; this point was also made by Powell, who maintained the rather dovish take on data which was prevalent before the blackout period, as tighter financial conditions may soon erode the past growth resilience. He acknowledged that the labour market remains strong, a view confirmed by the last JOLTS showing an unexpected pick up in demand and stable quits. But the increase in labour supply is being instrumental in moderating wage inflation.

Yet, in a difficult balancing act, Powell had to sound hawkish enough to prevent financial conditions from slipping, undoing some of the Fed's work and possibly leading to another hike. The FOMC, he claimed, is not fully convinced yet that they have reached a "sufficiently restrictive" stance and has not yet reached a decision on what to do in the next few meetings. He cautioned against extrapolating the Fed's pausing for two meetings in row: "the idea that it would be difficult to raise again after stopping for a meeting or two is just not right". Moreover, the current tightening in financial conditions will matter as long as it proves sustained. Moreover, he stressed that the FOMC thinks that the rise in rates is driven more by the term premium than the expectations on the Fed, which adds to the view that tighter financial conditions are complementing higher policy rates. He sounded happy about the progress on inflation but "a few months of good data are only the beginning of what it will take to build confidence that inflation is moving down sustainably toward our goal". Disinflation will be bumpy, and the process is likely to slow further down as inflation fails. Finally citing rising labour supply, Powell stated that this could lift potential growth for a couple of years, raising temporarily R^* and thus allowing for a very gradual unwinding of the rate rise.

On QT, Powell stressed that the current high level of interest rates is not a reason for tweaking the pace of balance sheet runoff, as the current level of reserves (3.3 US\$ tn) is far from scarce. Finally, the future of the emergency Bank Term Funding program will be decided in Q1 next year.

Markets focused on the dovish elements in the decision, with UST yields falling, rate expectations pared and equities bouncing back. Given our expectation of a marked slowdown in H1 we continue to have a first rate cut in our books for June. A more resilient economy, stickier inflation or fast reversal of recent yield increases could delay the rate cut into H2. In a forthcoming Focal Point we will detail our view of the next Fed's moves.



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