

MARKET COMMENTARY

The Fed: high for a bit less long

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- The Fed acknowledged the better inflation outlook and the employment slowdown but was careful not to give in to market expectations of a quick pace of rate cuts. The 2024 year-end appropriate policy rate was lowered by 50 bps, implying a 75bps reduction from the current level (vs the around 100 priced by futures). The short-term inflation forecast was marked down, and growth revised up, but the macro outlook was little changed. The median neutral policy rate is still seen at 2.5% but the distribution of the projections is heavily tilted upwards.
- Chair Powell sounded rather optimistic on inflation and not particularly worried about the last leg of disinflation being particularly difficult. Risks are balanced and the Fed is aware of the risk of keeping rates tight for too long. Still he did not commit to a timing of the first cut nor stated with precision the economic conditions that will trigger it.
- We confirm our view of a 100-bps reduction next year, we see the first cut in May, when the Fed will have enough evidence on disinflation.

The Fed struck a balance between the evidence of the improved inflation outlook and the market expectations of a swift monetary easing by indicating a faster path of rate cuts. Rates are now seen at 4.6% next year, 50bps lower than in September, as the rate hike for this year was obviously taken out and another cut for 2024 added. By 2026, when inflation and unemployment will be around target, the policy rate is still seen at 2.9%, some 40 bps higher than the long term, neutral, level.

The press released contained only minor changes compared with November (see below): the acknowledgment of the moderation in activity and job creation and the fact that financial conditions have stopped tightening.

Recent indicators suggest that economic activity ~~expanded~~has been expanding at a strong solid pace ~~in the third quarter.~~ Job gains have ~~moderated since earlier in the year~~slowed in recent months 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.

The economic projections were marked to market, recognizing the quick fall of inflation in H2, and somehow weaker growth in the final months of the year. Projections for 2024 onward were basically unchanged. So the message remains the same: the Fed is convinced that inflation can be bough under control at a relatively low cost, as the unemployment rate is seen to peak at 4.1%, some 0.4pp higher than the November reading.

	2023	2024	2025	2026	Longer run
GDP growth (Q4/Q4 ann.)	2.6	1.4	1.8	1.9	1.8
<i>Jun. projections</i>	<i>2.1</i>	<i>1.5</i>	<i>1.8</i>	<i>1.8</i>	<i>1.8</i>
Unemployment rate	3.8	4.1	4.1	4.0	4.0
<i>Jun. projections</i>	<i>3.8</i>	<i>4.1</i>	<i>4.1</i>	<i>4.0</i>	<i>4.0</i>
PCE infl. (Q4/Q4 ann.)	2.8	2.4	2.1	2.0	2.0
<i>Jun. projections</i>	<i>3.2</i>	<i>2.4</i>	<i>2.2</i>	<i>2.0</i>	<i>2.0</i>
Core PCE infl. (Q4/Q4 ann.)	3.2	2.6	2.3	2.0	-
<i>Jun. projections</i>	<i>3.7</i>	<i>2.6</i>	<i>2.3</i>	<i>2.0</i>	-
Appropriate path for the policy rate					
Federal funds rate	5.4	4.6	3.6	2.9	2.5
<i>Jun. projections</i>	<i>5.6</i>	<i>5.1</i>	<i>3.9</i>	<i>2.9</i>	<i>2.5</i>

During the Q&A session Chair Powell spent quite a lot of time pushing back against any precise statement on the timing of the rate cuts or details on the level of inflation that would allow for that. The assessment of the economic conditions underlined the slowdown in activity from the very strong Q3 and, above all the ongoing rebalancing of the labour market, with a special mention to the increase in labour supply, determined also by higher immigration. Wage growth is “a bit” higher than what is consistent with 2% inflation but is cooling.

It is still too late to declare victory on inflation, but progresses are tangible: the three months annualised core PCE inflation is at 2.5% and all the main components (goods, ex-housing services and housing) are contributing to disinflation. But the Fed still needs to see progress on that front. Importantly, Powell is not convinced that the final part of the disinflation path needs to be harder than the previous one, as the normalisation of supply side still plays a role. Then, rate cutting can proceed smoothly as hoped by markets.

Macroeconomic conditions are consistent with the soft-landing scenario the Fed has long advertised as possible. While it is too early to state confidently that this will continue, Powell repeated that risks are broadly balanced (see bottom right chart), and the FOMC is aware about the danger of keeping rates higher for too long.

The committee is not discussing any change to the pace of QT. At some point the balance sheet reduction will be slowed down and then stopped, but there is no indication about the size of the balance sheet the Fed is targeting. QT and rates are seen as independent. In principle, Powell stated, the shrinking of the balance sheet can coexist with rate cuts. It all depends on the reason why rates are cut.

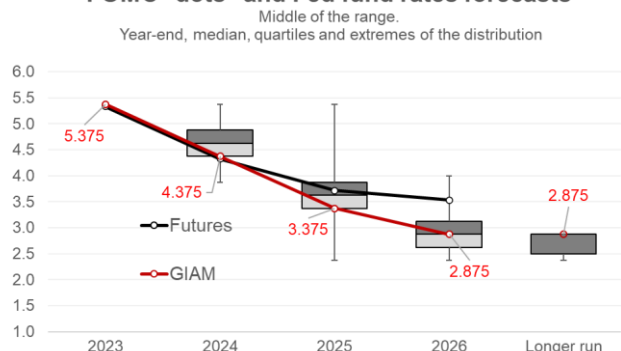
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If it happens to help the economy converge smoothly back to trend (as it seems to be the case now) QT and rate reductions are not conflicting.

When asked about the level of inflation that would be bring about the first cut Powell suggested to look at what the projections say: an informed guess would be that three/ four months of core inflation trending down to below 3% would trigger a rate cut. This is broadly consistent with our view of a first rate cut in May: by then the FOMC will have five more data points on core PCE inflation. We expect 100 bps cuts, in line with market expectations, which have sobered substantially over the last weeks.

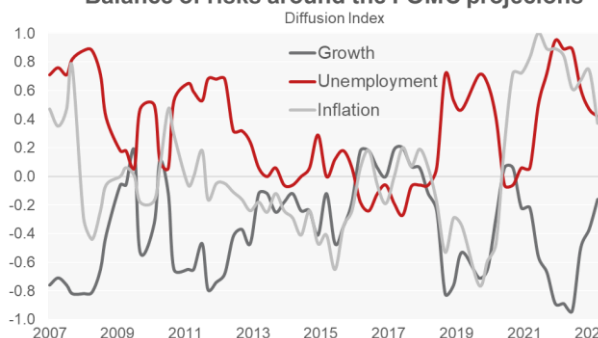
Markets welcome what is indeed a change in the monetary stance: the S&P gained 1.2% on the news, the yield on the 10 year Treasury dropped to below 4.2%.

FOMC "dots" and Fed fund rates forecasts



Source: Federal Reserve Board, Datastream, GIAM estimates

Balance of risks around the FOMC projections



Source: Federal Reserve Board

Variable	Prev. FOMC meeting	Latest	Chg.
Real Activity			
Weekly activity index (yoy GDP)	1.2	2.5	1.3
ISM - Manuf	46.7	46.7	0.0
ISM - Services	51.8	52.7	0.9
Macro Surprises	68.2	16.0	-52.2
Labor Market			
Payroll growth (3 mth. MA)	221	203	-18
Unemp. Rate	3.8	3.7	-0.1
Unemp. Rate (broad)	7.0	7.0	0.0
Hourly wages, % yoy (3 m. MA)	4.5	4.4	-0.1
Prices			
Core CPI	4.1	4.0	-0.1
Core PCE	3.7	3.5	-0.2
Trimmed PCE	3.8	3.6	-0.2
U. Mich 5 yr exp.	3.0	3.2	0.2
NY Fed 3 Y exp.	3.0	3.0	0.0
5Y5Y fwd exp.	2.5	2.3	-0.2
Financial Conditions			
Chicago Fed index*	-0.3	-0.5	-0.2
10 yr. Treasury	3.9	4.2	0.4
- Risk neutral Component	4.6	4.4	-0.1
- Term Premium	-0.7	-0.2	0.5
Yield curve (10Y - 3m)	-1.6	-1.2	0.4
S&P 500	4567	4644	1.7%
Trade Wighted Dollar	127.6	130.4	2.2%
WTI Crude Oil	78.8	68.3	-13.3%

* Decrease: looser conditions

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