BNY MELLON

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MACRO MORNING BRIEFING

February 1, 2024

January FOMC: Greater Confidence

Cold Water Poured On Prospect Of March Rate Cut

- Fed says it needs more confidence that inflation is moving towards target
- Rate cut in March dismissed as unlikely
- We still see a cut in March – data will provide the necessary confidence

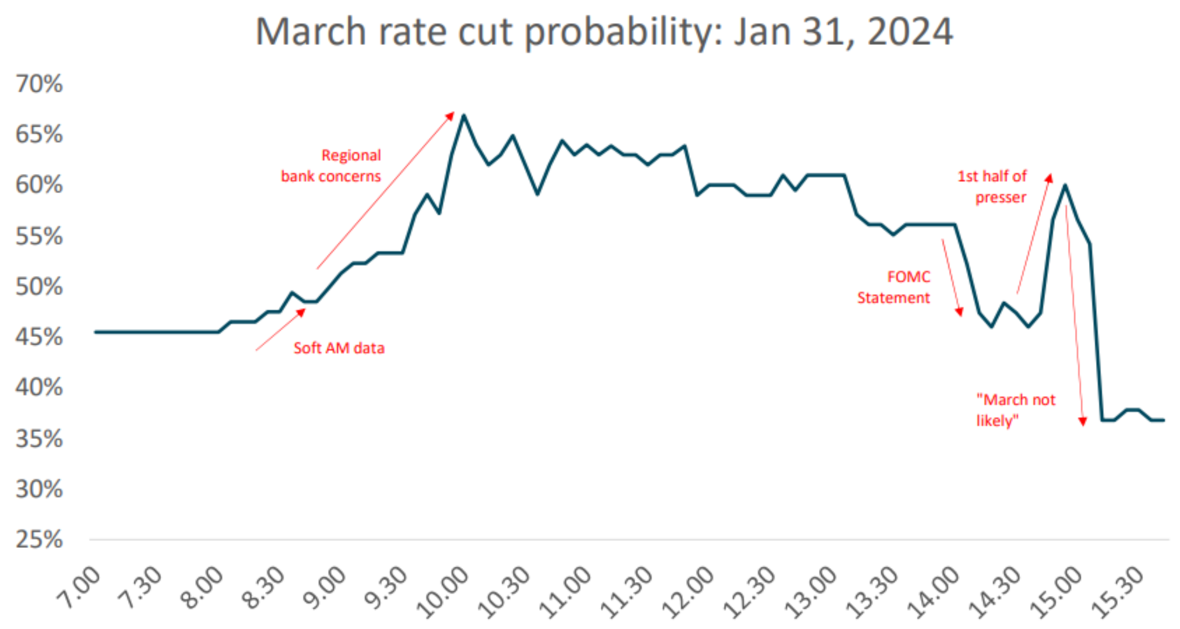
How Much More Confidence Does the Fed Need?

If “nimble” was a frequent Federal Open Market Committee watchword regarding interest-rate policy in 2023, “greater confidence” seems the refrain for the first part of 2024. The Fed’s statement Wednesday replaced it’s late-2023 standard of “In determining the extent of any additional policy firming that may be appropriate...” with “The Committee does not expect it will be appropriate to reduce the target range until it has gained greater confidence that inflation is moving sustainably toward 2 percent.” The word “confidence” appears 30 times in the initial press conference transcript and “confident” twice.

In other words, while there is no need for additional policy firming any longer, the FOMC is not sufficiently “confident” that it can move policy rates lower just yet. In the press conference, Chair Powell clearly stated that “...don't think it is likely that the Committee will reach a level of confidence by the time of the March meeting to identify March at as the time [to start cutting rates].” While, for now, this suggests our call for the initial reduction in the federal-funds rate in March is in jeopardy, we haven’t abandoned our view, yet.

Market pricing for a March cut derived from federal-funds futures zigged and zagged throughout the day. The chart below shows the impressive swings in the implied probability of a cut during Wednesday's session. It ticked up a bit from 46% to around 50% at 8:30 on some weaker-than-expected second-tier macro data, and then soared up to 67% during the morning as regional banking developments dominated the headlines. On the release of the FOMC statement at 2:00pm, rate-cut expectations fell back, then increased during the first half of the press conference, only to collapse after Powell poured cold water on the prospect of a March cut. Swings of 30% in a day are quite remarkable. We expect data and Fedspeak to move the futures curve vigorously over the next several weeks.

Wild Swings In March Cut Probabilities



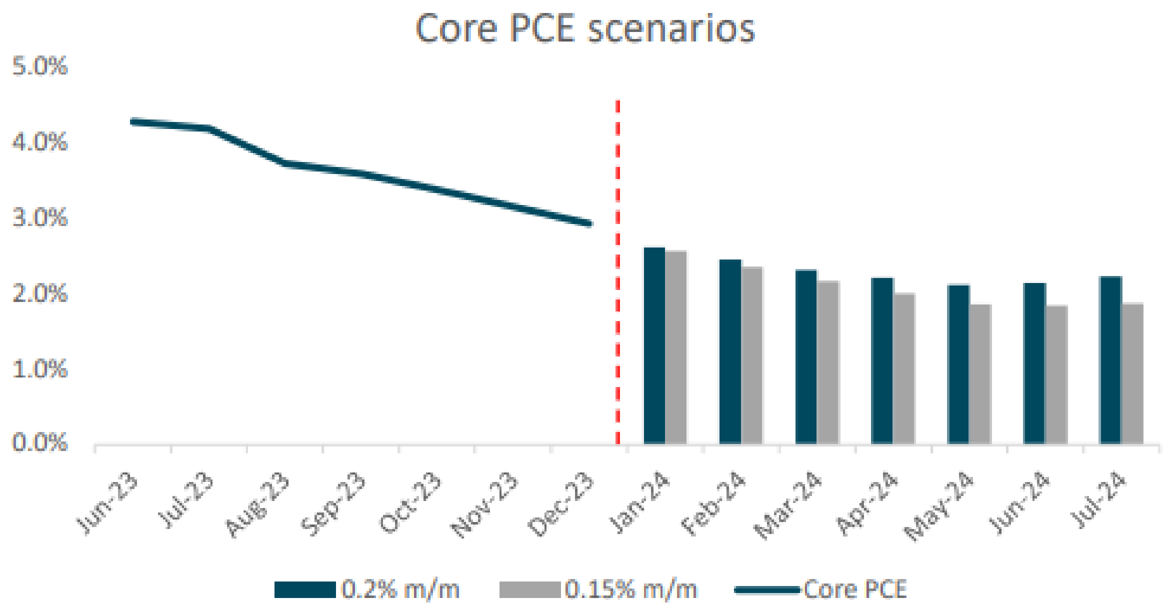
Source: BNY Mellon Markets, Bloomberg

Click on image to increase size

The Fed says it needs greater confidence, but our question – as well that of several journalists at the press conference – is: how much more confidence is necessary? The answer was ambiguous. On a yearly basis, core PCE inflation – the Fed's entire ballgame – has fallen for 11 straight months. The monthly rate of increase has averaged 0.15%. If we assume that rate of increase every month from now until June, the core PCE annual rate would be 2.1% then. If we extrapolate the aforementioned 0.15% per month, by June the core rate would be 1.9%. See the chart below for an illustration. If the Fed waits until June to cut rates, it would be doing something it said it wouldn't: waiting until the target is reached to cut rates. This would be a mistake, in our view.

Again we ask, how much more confidence is necessary? Does this suggest that the April 30-May 1 meeting is a good venue to start cutting rates? Perhaps. We concede that even though inflation is going the right way, there may not have been enough inflation and labor market data before March 20 to provide the Fed with the confidence it wants. There is only one more PCE release before the next FOMC, and two more employment reports. If the FOMC waits until May, there will be an additional six weeks of data that should in our view grant the Fed's wish. So, our call may be a victim of the data release calendar more than our analysis. Perhaps we're more confident than the Fed is.

Inflation Likely To Reach Target By June



Source: BNY Mellon Markets, Bureau of Economic Analysis

On top of the additional data to come between now and March, there is an important set of revisions to last year's CPI data as well. Essentially, the seasonal adjustment factors used by the Bureau of Labor Statistics will be recalculated and last year's data will be restated. We expect these restatements to push CPI inflation for the previous 12 months lower. Furthermore, the revised seasonal factors also enter into some categories of the PCE inflation index, so there is a good chance that last year's PCE data will move even lower than they had been trending. We also expect to see some weaker labor data in coming months. To put to a finer point on it, the data ought to show that the labor market is coming into "better balance", to use the Fed's lingo.

Therefore, this coming Friday will bring a test of our March rate-cut call. If we're wrong, at a minimum we'd expect the March meeting to feature a signal of an imminent cut in May. That alone would be worth more than a few basis points of loosening, in the sense that it would likely drive short-term interest rates lower in anticipation. It's simply a matter of not enough data between now and March. We think the additional six weeks of data between March 20 and May 1 will be more than sufficient to provide the Fed's needed confidence.

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