BNY MELLON

iFlow

SHORT THOUGHTS

December 12, 2023

December FOMC Preview: Fed Versus Markets

Market Pricing More Dovish Than The Fed

- This FOMC the last chance this year for Fed to push back against dovish pricing
- We expect the dots to be used to convey a more hawkish outlook than in markets
- Expect showdown between Fed and market views – and more fixed income volatility

Last Best Chance In 2023 For Fed To Push Back Against Markets

We view this week's FOMC meeting, likely the last major US economic event this year, with great interest. At its conclusion Wednesday, it seems all but assured the there will be no rate moves. We are curious to see if, and how successfully, the Fed will push back against market pricing for the first rate cut of 2024, as well as for total cuts over the year.

Currently, the market is split almost 50-50 for an initial reduction in the federal-funds rate next March, and priced with near certainty that a cut will occur by May. We are more skeptical – we foresee the Fed holding its target range at 5.25%-5.50% until July. Fedspeakers have been clear and consistent that it is – in Chair Powell's words from his most recent public appearance before the blackout period – "premature" to discuss or contemplate rate cuts. Sure, progress has been made on inflation and in bringing the economy into better balance between supply and demand. Yet, inflation remains too high and the labor market too tight for an early move, in our view.

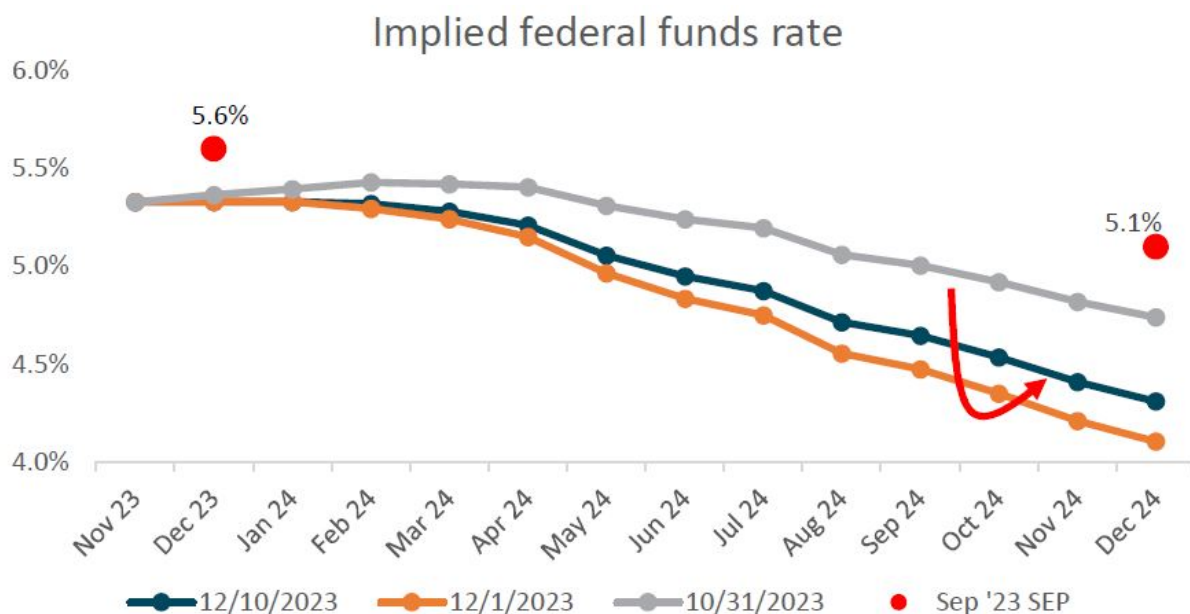
We acknowledge that data in recent weeks has suggested some softening in both price pressures and economic activity. However, we think this reflects an expected cooling in the economy but is not enough to induce the Fed to cut rates any time soon. Nevertheless, although rate-cut expectations were pared back last Friday following stronger-than-expected nonfarm payrolls (our assessment of the labor market here), the market is still much more dovish in its rate outlook than we – and presumably the Fed – think is correct.

This leaves the Fed one last chance before year-end to try to push back on those rate-cut expectations on Wednesday. The main vehicle via which the Fed can attempt to deliver a strong signal to the market is the December Summary of Economic Projections (aka, “the dots”), due at the same time as the rate decision. The last set of dots in September foresaw an additional hike in 2023 (hasn’t materialized) to a median level of 5.6%, and a year-end 2024 level of 5.1%. For reference, the federal-funds futures-implied interest rate for Dec24 is 4.2%, nearly a full hundred basis points below where the September dots predicted.

Although we expect the December dots to be materially higher than current market pricing, there are questions about how much lower the end-2024 dot will be, as well as the extent of dispersion among officials' submissions. A dot plot that suggests three or fewer rate cuts next year is likely, in our view. However, we wonder if this signal alone would be enough to move the market more hawkish than it’s been – as well as more realistic, in our view.

Then there is Chair Powell’s post-meeting press conference. When questioned in the past about the disparity between the views of the market and Fed, he has been rather nonchalant. He has argued that the market is operating on a different model and assumptions than the Fed, and that it’s not his job to address market pricing. Such a dismissive attitude, if repeated on Wednesday, will likely do little to move market pricing, even with relatively hawkish 2024 dots. We think this would set up 2024 beginning with an intellectual battle between the Fed and the market, in which case we would expect a rhetorical assault by Fedspeakers in January on market pricing, as well as an intense focus on the vagaries of important economic data as it comes in.

Exhibit 1: Dovish Market Pricing In The Curve



Source: BNY Mellon Markets, Bloomberg

This focus on data, and a Fed that has and will likely continue to declare its approach as data-dependent, points to a scenario for early next year in which each major economic release becomes a referendum on the path of the federal-funds rate. This has been the case for several weeks now already, and we have seen large swings in market pricing for both the Fed and rates across the curve. Volatility in asset prices should result – as it has already.

This data-induced volatility would occur in a bond market that has already been buffeted by increases coupon supply, large intra-day price swings and challenging liquidity. The chart below shows the MOVE index of fixed income volatility (orange line) alongside an off-the-shelf index of US Treasury liquidity (blue line). Note that the higher the liquidity index, the worse liquidity is. It's been elevated since mid-2021 and didn't really fall this autumn, even after spiking a few weeks ago. Market-implied volatility is also quite high, and trailing volatility (not shown) also remains structurally higher than it has been.

In short, we expect a relatively hawkish December FOMC meeting, against the context of a dovish market outlook and the likely end of the rate-hike cycle. Our question is whether or not the markets will take any direction from the dots or the press conference. If they don't, we expect that we'll enter 2024 with the Fed and investors of two different minds on the policy rate path, which we see leading to a volatile set of market reactions early in the year.

Exhibit 2: Volatility And Liquidity Challenge Bond Market

Source: BNY Mellon Markets, Bloomberg

Please direct questions or comments to: iFlow@BNYMellon.com

bnymellon.com

BNY Mellon is the corporate brand of The Bank of New York Mellon Corporation and may be used as a generic term to reference the corporation as a whole and/or its various subsidiaries generally. This material and any products and services may be issued or provided under various brand names in various countries by duly authorized and regulated subsidiaries, affiliates, and joint ventures of BNY Mellon, which may include any of the following. The Bank of New York Mellon, at 225 Liberty St, NY, NY USA, 10286, a banking corporation organized pursuant to the laws of the State of New York, and operating in England through its branch at One Canada Square, London E14 5AL, UK, registered in England and Wales with numbers FC005522 and BR000818. The Bank of New York Mellon is supervised and regulated by the New York State Department of Financial Services and the US Federal Reserve and authorized by the Prudential Regulation Authority. The Bank of New York Mellon, London Branch is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. Details about the extent of our regulation by the Prudential Regulation Authority are available from us on request. The Bank of New York Mellon SA/NV, a Belgian public limited liability company, with company number 0806.743.159, whose registered office is at 46 Rue Montoyerstraat, B-1000 Brussels, Belgium, authorized and regulated as a significant credit institution by the European Central Bank (ECB), under the prudential supervision of the National Bank of Belgium (NBB) and under the supervision of the Belgian Financial Services and Markets Authority (FSMA) for conduct of business rules, and a subsidiary of The Bank of New York Mellon. The Bank of New York Mellon SA/NV operates in England through its branch at 160 Queen Victoria Street, London EC4V 4LA, UK, registered in England and Wales with numbers FC029379 and BR014361. The Bank of New York Mellon SA/NV (London Branch) is authorized by the ECB and subject to limited regulation by the Financial Conduct Authority and the Prudential Regulation Authority. Details about the extent of our regulation by the Financial Conduct Authority and Prudential Regulation Authority are available from us on request. The Bank of New York Mellon SA/NV operating in Ireland through its branch at 4th Floor Hanover Building, Windmill Lane, Dublin 2, Ireland trading as The Bank of New York Mellon SA/NV, Dublin Branch, is authorised by the ECB and is registered with the Companies Registration Office in Ireland No. 907126 & with VAT No. IE 9578054E. The Bank of New York Mellon, Singapore Branch, subject to regulation by the Monetary Authority of Singapore. The Bank of New York Mellon, Hong Kong Branch, subject to regulation by the Hong Kong Monetary Authority and the Securities & Futures Commission of Hong Kong. If this material is distributed in Japan, it is distributed by The Bank of New York Mellon Securities Company Japan Ltd, as intermediary for The Bank of New York Mellon. If this material is distributed in, or from, the Dubai International Financial Centre (“DIFC”), it is communicated by The Bank of New York Mellon, DIFC Branch, regulated by the DFSA and located at DIFC, The Exchange Building 5 North, Level 6, Room 601, P.O. Box 506723, Dubai, UAE, on behalf of The Bank of New York Mellon, which is a wholly-owned subsidiary of The Bank of New York Mellon Corporation. This material is intended for Professional Clients only and no other person should act upon it. Not all products and services are offered in all countries.

The information contained in this material is intended for use by wholesale/professional clients or the equivalent only and is not intended for use by retail clients. If distributed in the UK, this material is a financial promotion.

This material, which may be considered advertising, is for general information purposes only and is not intended to provide legal, tax, accounting, investment, financial or other professional advice on any matter. This material does not constitute a recommendation by BNY Mellon of any kind. Use of our products and services is subject to various regulations and regulatory oversight. You should discuss this material with appropriate advisors in the context of your circumstances before acting in any manner on this material or agreeing to use any of the referenced products or services and make your own independent assessment (based on such advice) as to whether the referenced products or services are appropriate or suitable for you. This material may not be comprehensive or up to date and there is no undertaking as to the accuracy, timeliness, completeness or fitness for a particular purpose of information given. BNY Mellon will not be responsible for updating any information contained within this material and opinions and information contained herein are subject to change without notice. BNY Mellon assumes no direct or consequential liability for any errors in or reliance upon this material.

This material may not be distributed or used for the purpose of providing any referenced products or services or making any offers or solicitations in any jurisdiction or in any circumstances in which such products, services, offers or solicitations are unlawful or not authorized, or where there would be, by virtue of such distribution, new or additional registration requirements.

The terms of any products or services provided by BNY Mellon to a client, including without limitation any administrative, valuation, trade execution or other services shall be solely determined by the definitive agreement relating to such products or services. Any products or services provided by BNY Mellon shall not be deemed to have been provided as fiduciary or adviser except as expressly provided in such definitive agreement. BNY Mellon may enter into a foreign exchange transaction, derivative transaction or collateral arrangement as a counterparty to a client, and its rights as counterparty or secured party under the applicable transactional agreement or collateral arrangement shall take precedence over any obligation it may have as fiduciary or adviser or as service provider under any other agreement.

Pursuant to Title VII of The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and the applicable rules thereunder, The Bank of New York Mellon is provisionally registered as a swap dealer with the Commodity Futures Trading Commission (“CFTC”) and is a swap dealer member of the National Futures Association (NFA ID 0420990).

BNY Mellon (including its broker-dealer affiliates) may have long or short positions in any currency, derivative or instrument discussed herein. BNY Mellon has included data in this material from information generally available to the public from sources believed to be reliable. Any price or other data used for illustrative purposes may not reflect actual current conditions. No representations or warranties are made, and BNY Mellon assumes no liability, as to the suitability of any products and services described herein for any particular purpose or the accuracy or completeness of any information or data contained in this material. Price and other data are subject to change at any time without notice.

Rates: neither BNY Mellon nor any other third party provider shall be liable for any errors in or delays in providing or making available the data (including rates, WM/Reuters Intra-Day Spot Rates and WM/Reuters Intra-Day Forward Rates) contained within this service or for any actions taken in reliance on the same, except to the extent that the same is directly caused by its or its employees’ negligence. The WM/Reuters Intra-Day Spot Rates and WM/Reuters Intra-Day Forward Rates are provided by The World Markets Company plc (“WM”) in conjunction with Reuters. WM shall not be liable for any errors in or delays in providing or making available the data contained within this service or for any actions taken in reliance on the same, except to the extent that the same is directly caused by its or its employees’ negligence.

The products and services described herein may contain or include certain “forecast” statements that may reflect possible future events based on current expectations. Forecast statements are neither historical facts nor assurances of future performance. Forecast statements typically include, and are not limited to, words such as “anticipate”, “believe”, “estimate”, “expect”, “future”, “intend”, “likely”, “may”, “plan”, “project”, “should”, “will”, or other similar terminology and should NOT be relied upon as accurate indications of future performance or events. Because forecast statements relate to the future, they are subject to inherent uncertainties, risks and changes in circumstances that are difficult to predict. iFlow® is a registered trademark of The Bank of New York Mellon Corporation under the laws of the United States of America and other countries.

This document is intended for private circulation. Persons accessing, or reading, this material are required to inform themselves about and to observe any restrictions that apply to the distribution of this information in their jurisdiction.

Currency Administration is provided under and subject to the terms of a definitive agreement between BNY Mellon and the client. BNY Mellon exercises no investment discretion thereunder, but acts solely pursuant to the instructions in such agreement or otherwise provided by the client. Unless provided by definitive agreement, BNY Mellon is not an agent or fiduciary thereunder, and acts solely as principal in connection with related foreign exchange transactions.

All references to dollars are in US dollars unless specified otherwise.

This material may not be reproduced or disseminated in any form without the prior written permission of BNY Mellon. Trademarks, logos and other intellectual property marks belong to their respective owners.

The Bank of New York Mellon, member FDIC.

© 2020 The Bank of New York Mellon Corporation. All rights reserved.