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SHORT THOUGHTS

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Calibrating The Fed View For 2024

Less Dovish Than The Market

It's that time of year again, when The Street publishes annual outlooks. Ours will be released in early January but it's probably a good time now to contrast our 2024 Fed view with both consensus and the market's implied policy path. In short, we are more hawkish than both but still see 2-3 rate cuts, starting in midyear.

The chart below plots market pricing for the expected federal-funds rate every month from now through December 2024. While no more rate hikes are expected, a proposition with which we agree, the fed-funds futures curve we present shows rate cuts starting in May and almost a cut per meeting en route to an implied funds rate of just around 4.5% by year-end. The consensus of economists surveyed by Bloomberg (not shown) sees an even lower policy rate, just 4.45%. Altogether, given an effective funds rate currently at 5.33%, this would imply nearly 100bp of cuts next year. We also show the median dot for end-2024 from the FOMC's September Summary of Economic Projections, 5.1%.

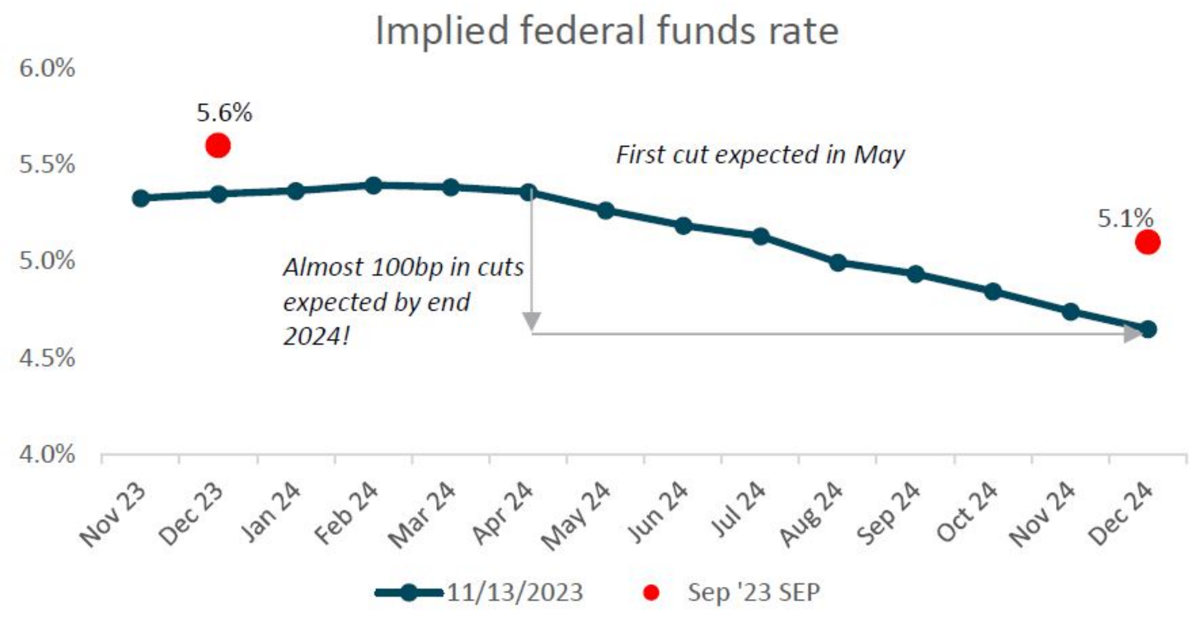
By contrast, we see the first rate cut in June or even July, with just – at most – two additional cuts by the end of the year, ending with a target federal-funds (upper bound) rate of 4.75% to 5%, a somewhat less-dovish trajectory, much like the September dots project. Our view is that inflation will take most of next year to get close to the Fed's 2% goal.

Our view for rates in 2024 supposes that the US economy begins to slow – probably as early as Q4 2023 – and runs below trend for at least a couple of quarters. This corresponds to the Fed's view that US GDP will run below trend as tightening credit conditions and higher rates begin to slow the economy. Inflation will probably – again, our view – be running close to 3% by midyear. We see this cooling of inflation, combined with below-trend growth in the real economy, inducing the Fed to dial down the restrictive policy setting currently in place, but not easing excessively.

More-dovish forecasts presumably presuppose that the economy will slow more than we foresee. Consensus forecasts have US GDP growth below 1% for the first half of the year, for example, ending 2024 at 1.7%. Furthermore, this consensus sees US core PCE inflation below 3% starting in Q2 2024 and ending the year at 2.5%. These numbers aren't out of bounds, in our view, and don't differ all that much from the Fed's September dots, which see core PCE at 2.6% and GDP growth at 1.5%.

Where we – and the Fed – differ from consensus and market expectations seems to be in the view of the Fed's reaction function. While they believe that that the Fed will respond more rapidly to a cooling of growth and a slow deceleration in inflation, we do not. We think the dots are again illustrative of a Fed that is content to see growth cooling, even with some decline in inflation, but maintaining a relatively tight policy stance.

Market Expecting More Cuts Than The Fed



Source: BNY Mellon, Bloomberg, Federal Reserve Board of Governors

Proposed FHLB Reform

Proposed reforms to the Federal Home Loan Bank (FHLB) system would limit member banks' ability to provide liquidity during times of stress in the banking system. FHLBs currently issue advances to commercial banks as a source of liquidity and funding. The proposed changes to this setup encourage banks to tap the discount window instead for short-term liquidity.

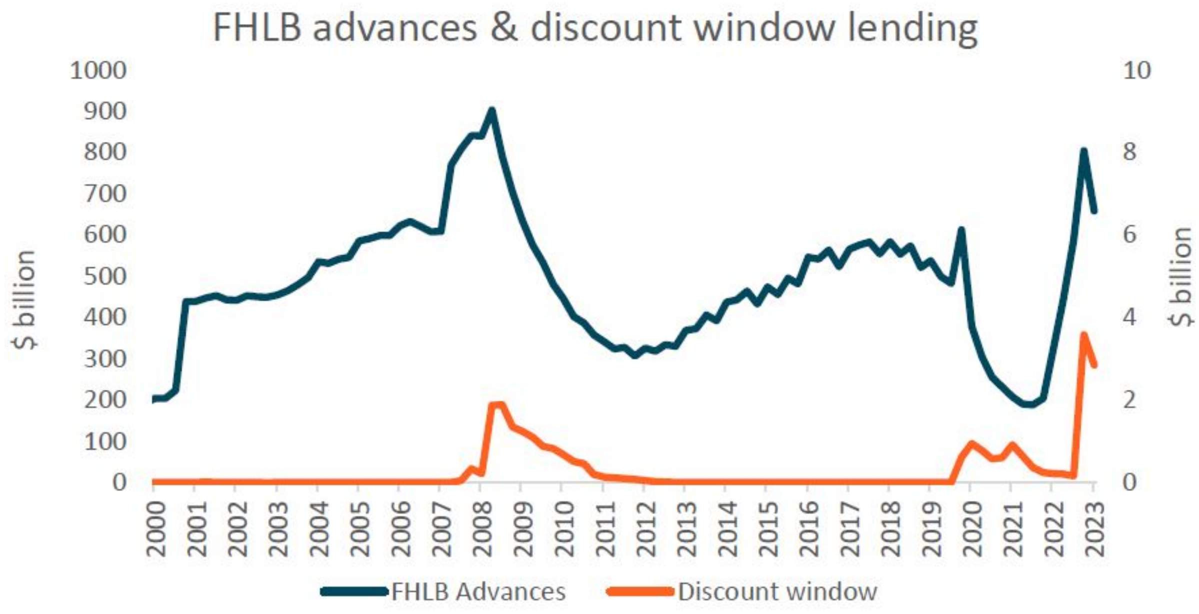
The chart below shows the size of FHLB advances – lending – to the banking system since the year 2000. We also plot take-up at the Fed's discount window over the same period, at a quarterly frequency. A few things stand out. Notably, the amount of FHLB lending that takes place during periods of stress dwarfs discount window borrowing. Episodes like the GFC or the COVID lockdowns or the more recent regional banking stresses of March-April 2023 all show the primacy of FHLB liquidity provision over use of the discount window. This is likely due to the stigma still associated with the discount window; FHLB advances are more masked and less frequently reported.

Also, note that in the years leading up to the pandemic, FHLB use increased steadily. Between 2012 and the end of 2018, usage increased from about $300bn to over $500bn. Interestingly, and not surprisingly, FHLB advances were quite low in 2021 and 2022. This is thanks to excess liquidity provision from the Fed after the March 2020 lockdowns and the zero rate environment, during which cheap bank funding was readily available.

The proposed reforms are not close to being implemented and there is no timeline for finalizing them. But criticism of the proposals are numerous. The first, of course, is if there is a liquidity event in the banking system and FHLB advances aren't forthcoming, will banks actually seek discount window financing? If they are disinclined to go to the window, where will they get liquidity in times of stress? This leads to the notion that in periods of tranquility, banks will hoard liquidity in anticipation of potential liquidity events, making financing in even normal times potentially more expensive. Precautionary liquidity stockpiling would probably mean that the lowest comfortable level of reserves in the banking system (see here for a recent discussion) might be higher than it would be otherwise, putting stress on both bank funding and balance sheets.

Furthermore, the FHLBs are among the most active players (lenders) in the federal-funds market, essentially offering the cash received from issuing agency discount notes to the market. Their absence from the federal-funds market could make the effective federal-funds rate much more volatile, perhaps even cause it to drift out of the target range.

FHLB Advances Outstrip Discount Window Borrowing



Source: BNY Mellon Markets, Bloomberg

Banks Not Buying

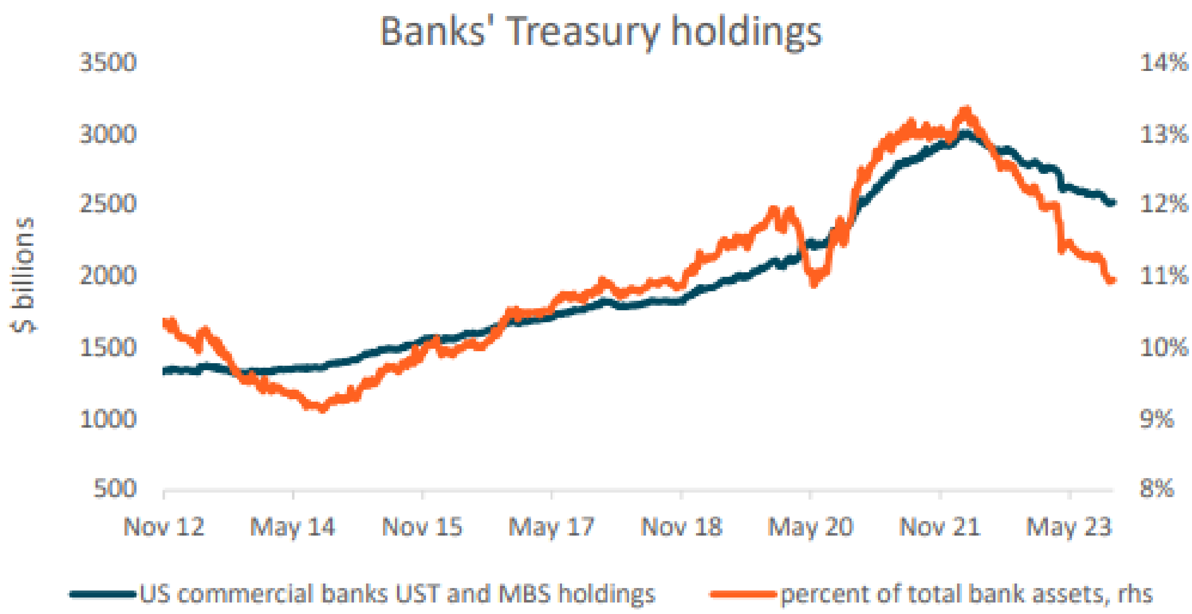
We have written a great deal about real money demand for US Treasuries, pointing out that for bills and coupons, demand from this sector of the market continues to be positive. In bills, institutional investors are content to run down their holdings of cash and other short-term securities and enter the bill market for higher returns – thanks in part to burgeoning supply and the likely end of the Fed‘s tightening cycle. This behavior is analogous to that of money market mutual funds, who have been exiting the Fed’s overnight reverse repo facility and buying T-bills since the postponement of the debt ceiling back in early June. Coupon demand remains robust as well in our iFlow data.

One major domestic market player is shedding Treasury holdings, however: US commercial banks’ holdings of USTs and agency MBS has been slipping since last year. According to official Fed statistics, US banks have shed approximately $500bn of these positions since February 2022. While total holdings are still up since the onset of the pandemic, the decumulation of UST and MBS holdings is not insignificant.

We know that banks have been shedding such holdings in response to the rise in interest rates and mark-to-market losses on securities portfolios. We also know that leverage constraints like the supplementary leverage ratio (SLR) have also hit banks.

Given our concerns about continued, heavy supply from the US Treasury into 2024, we continue to be similarly concerned that price-inelastic buyers of Treasuries are stepping out, leaving price-sensitive buyers to pick up the slack. We’re not sure if there will be enough demand from this latter segment of the market to smoothly absorb issuance next year.

Shedding Govvies



Source: BNY Mellon Markets, Bloomberg, Federal Reserve Board of Governors

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

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