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SHORT THOUGHTS

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FOMC Preview: No Answers, Plenty Of Questions

Lots to discuss at FOMC presser

- Looking for Chair Powell to outline conditions for rate cut; we still think in March
- QT likely addressed in statement and/or presser; we expect reduced pace in May
- Treasury borrowing lower than expected, watch for details on coupon supply

Rates: What conditions required for a cut?

The outcome of this week's Federal Open Market Committee meeting could leave observers with more questions than answers across a wide range of issues, including the future path of interest rates, quantitative tightening (QT), the wrap-up of the Bank Term Funding Program and discount window borrowing, among others. The list of the Fed's concerns and agenda items is long, but we don't expect too much clarity on much of the aforementioned. Of course, no policy moves are expected Wednesday, so attention will focus first on the formal statement released after the meeting, and then on Chair Powell's ensuing press conference.

We will be keenly scrutinizing the statement for more moderate language on where officials stand on rates. In the past, the Committee has referred to "...the extent of any additional policy firming that may be appropriate...". We expect less of an emphasis (perhaps even omission altogether) on potential "policy firming" and a more two-sided description of the potential rate path. We also expect the language around QT to be more equivocal. While maintaining the current rolloff schedule, the statement could reference the Fed's openness to "adjusting" balance-sheet normalization in response to changing economic and financial conditions. If such changes to the text of the statement appear, we would view this as dovish.

We retain our view of a rate cut in March, even if markets currently price only a 50-50 chance of such an outcome. PCE inflation data from last week showed additional progress on inflation, with December's core measure now below 3% y/y and the 6-month annualized core

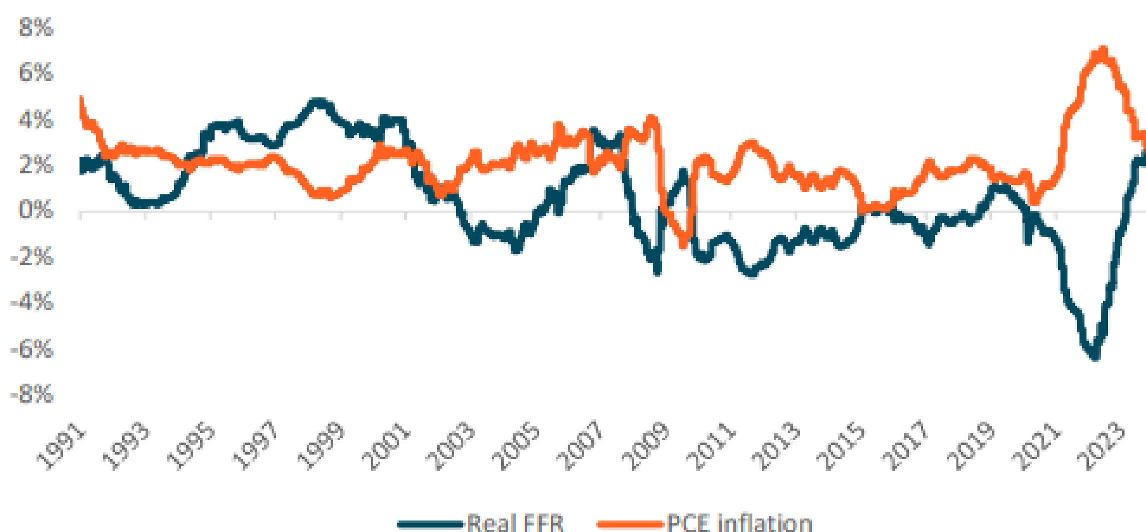
rate below 2% for the third straight month. We think additional data between now and March 19-20 (the next FOMC) will continue to deliver welcome news on inflation.

We did the math. If m/m increases in core PCE average 0.2% from here, annual inflation on this measure would be down to 2.1% by June; the same rate of monthly inflation for headline PCE would yield just 2.2%. If monthly increases were just a touch lower, say, 0.15%, we'd be looking at inflation rates of 1.8% (core) and 1.9% (headline). It would seem unwarranted to wait until inflation got to target before cutting rates. As it is, the average monthly increase in PCE inflation has been just a touch above 0.1% over the last six months.

Chair Powell has often discussed the level of real policy rates, which, using the effective funds rate and the PCE inflation rate, are now pushing 3% after a period of having been deeply negative (chart below). As inflation cools the real rate necessarily rises, meaning any desire by the Fed to move real rates has to come from the nominal funds rate being reduced.

As for the press conference, we'll be listening carefully if Powell gives anything away on any of the issues we identified in the first paragraph above. In particular, we expect the Chair to be coaxed into obliquely identifying the conditions under which a rate cut could occur. He'll doubtlessly re-assert the doctrine of data dependency and a meeting-by-meeting approach to policy, but we might get a sense of what the Committee is watching for signals on the timing of the initial rate cut. The same goes for QT, but we would expect him to be pressed about bank funding costs, reserve abundancy, and – again – conditions which would see balance-sheet shrinkage slow down.

Real Rates Rising Thanks To Falling Inflation



Source: BNY Mellon Markets, Bloomberg, Bureau of Economic Analysis

QT: Ready to consider slowing runoff?

As mentioned above, the future of QT is currently a focus of market participants as well as the Fed, which mentioned initial discussions at the last FOMC in December, according to the minutes. Furthermore, influential Dallas Fed President Logan addressed the topic directly in a recent speech. Clearly, funding market stresses at the end of November and December last year have raised at least some concerns that liquidity may be getting tighter, and the possibility that even though system-wide reserves are well above $3trn, they may not be distributed evenly across the banking universe.

We continue to think that the Fed will reduce the pace of balance-sheet runoff – we target the May 1 FOMC for an announcement. That is, unless and until money market stresses intensify before then, requiring use of either the discount window or the recently established Standing Repo Facility. We discussed these topics last week (see here). Regarding the window, we know the Fed is actively trying to reduce any stigma associated with its use and, along with the OCC and FDIC, are working to require banks to tap it once a year.

We don't know how open Powell will be in his press conference on Wednesday to providing too much light, but we expect him to be pressed on QT, bank liquidity and the discount window. His answers, even if couched in traditional ambiguity, could be useful to the market in calibrating the timing and amounts of any slowing in QT.

Bonus: Treasury Refunding Announcement - Slightly Lower

On Monday afternoon, the US Treasury revealed its expected funding needs for the January-March quarter. Most market participants were looking for a number around or above $800bn, which would have been a slight increase over last quarter ($776bn) and the second-highest quantity since the pandemic-era fiscal stimulus. In actual fact, the Treasury indicated a lower amount of borrowing, $760bn. This is still a large number, but markets on Monday afternoon greeted the announcement positively, with 10y note yields dropping and risk assets rallying.

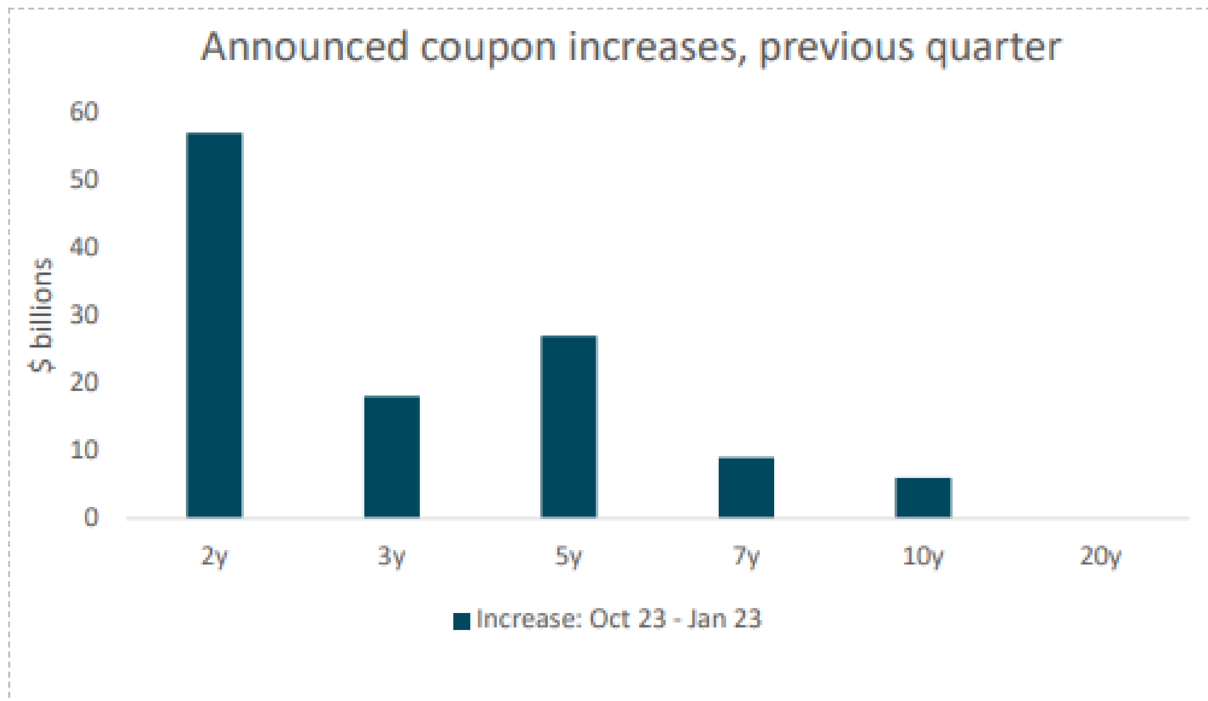
Treasury pointed to two developments that kept borrowing needs down. Revenue to government coffers is projected to be higher, thanks to higher capital gains taxes after a generally strong year in asset markets. Secondly, the balance of Treasury General Account was expected to be $750bn, but will likely begin the January-March quarter somewhat higher, close to $770bn.

The next data point for markets regarding refunding will be the so-called "policy statement", to be released on Wednesday morning. This will detail the Treasury's expected issuance across the curve, including bills and coupons. The Nov. 1 statement was comforting to bond investors in that it concentrated most of the funding schedule in bills and front-end coupons. The chart below illustrates how much the increase in quarterly funding announced last time was concentrated on the 1y, 2y, and 3y, sectors of the curve, dwarfing the associated

amounts for the back end of the curve. Furthermore, T-bill issuance was increased as a proportion of total issuance – to over 20% of all borrowing.

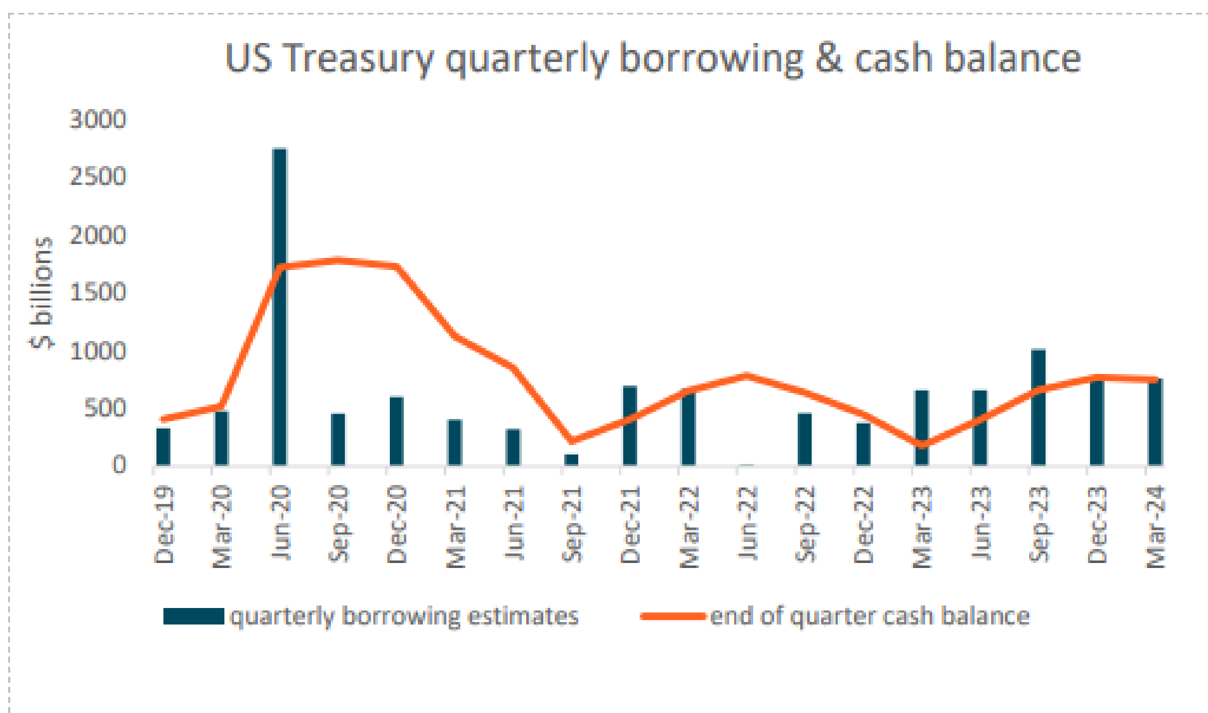
We expect the proportion of bill issuance to be reduced, with more concentrated on coupons, as well as more even distribution of coupon issuance across the curve. While bonds rallied on the smaller-than-expected borrowing needs announced Monday, we are anticipating a more subdued – and perhaps opposite – reaction Wednesday morning.

Coupon Supply To Become More Evenly Distributed?



Source: BNY Mellon Markets, US Treasury

Still A Big Number



Source: BNY Mellon Markets, US Treasury

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

John Velis

AMERICAS MACRO STRATEGIST

CONTACT JOHN

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