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SHORT THOUGHTS

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FOMC Preview – Dot Dynamics

Expect Slightly More Hawkish Dots – But We're Skeptical

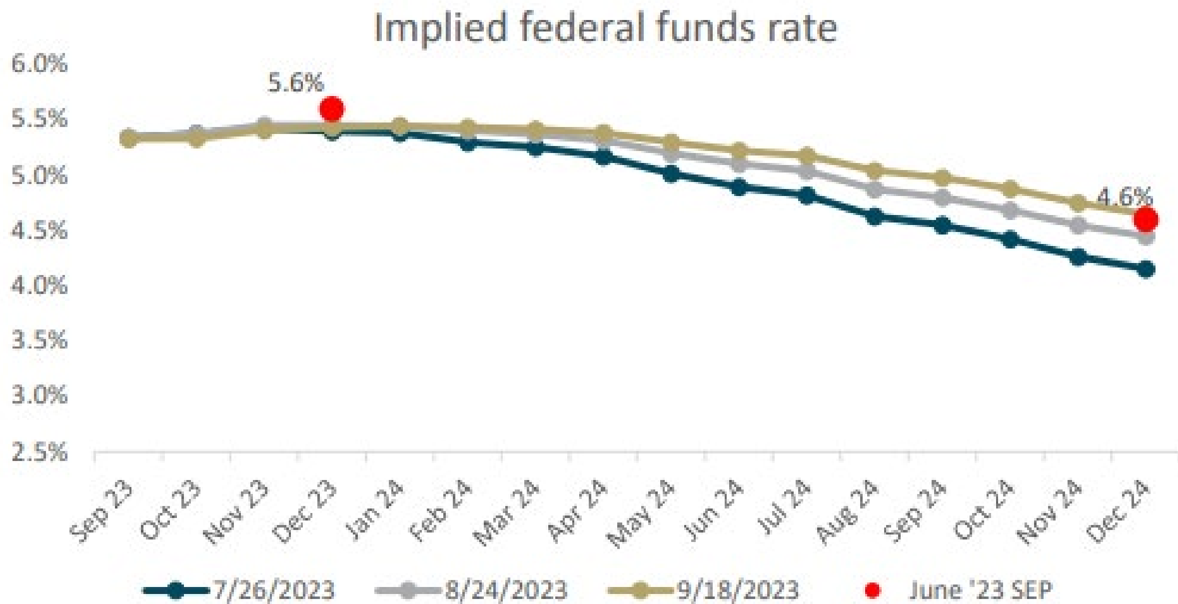
Like almost the entire market, we expect the FOMC on Wednesday to announce no change in the 5.25-5.50% range for the federal-funds rate. In comments made before the blackout period on communications began two Fridays ago, Fedspeakers ranging from the hawkish Governor Waller to the dovish Atlanta Fed President Bostic essentially ruled out a rate hike at the September meeting, leaving the prospect of additional hikes later this year somewhat up in the air. Market pricing for the Oct. 31-Nov. 1 FOMC meeting currently has about a 30% chance of a rate hike. For the meeting that follows on Dec. 12-13, there is a 15% chance of a hike priced. Taken together, the market is assigning a less than 50-50 chance of another hike this year, implying there will be no further rate increases this cycle. We agree with the market that there is only a partial chance of any more rate moves this year. We do, however, think that the Fed will indicate an additional hike this year, with the median "dot" for the federal-funds rate still near 5.6% for end-2023, equal to what the June SEP had. Despite this, we think that by the time the November meeting is upon us, conditions will not require that additional hike to be delivered. We still believe that the tightening cycle is over.

In addition to one more hike in the policy rate that we expect the new SEP to show on Wednesday, we're keen to see what the policy rate projected for the end of 2024 will be. Through the June dots, the median FOMC participant saw a policy rate of 4.6%, implying 100bp (probably in increments of 25bp) of rate cuts. We think there is a good chance that the 2024 projection for federal funds will be materially higher than 4.6%, indicating that the

Committee sees the “higher for longer” rate path as meriting a more cautious – and possibly delayed – approach to removing restrictive policy.

Market pricing is almost entirely on board with the June projections for the policy rate (see below). Furthermore, Dec24 fed funds futures have cheapened in recent months, moving from just over 4% on July 26 – the last FOMC meeting – up to 4.5% at this writing. We think this is still somewhat optimistic, and that the new dots will surprise the market.

Expecting Four Rate Cuts In 2024



Source: BNY Mellon, Bloomberg

SEP The Focus, Watching Four Key Variables

Given the near-zero chance of a rate move this week, the SEP is really where the focus will be. Aside from expecting another hike this year, and few cuts next year, we're keeping an eye out for what the FOMC sees for the key macro variables it includes in the dot plot.

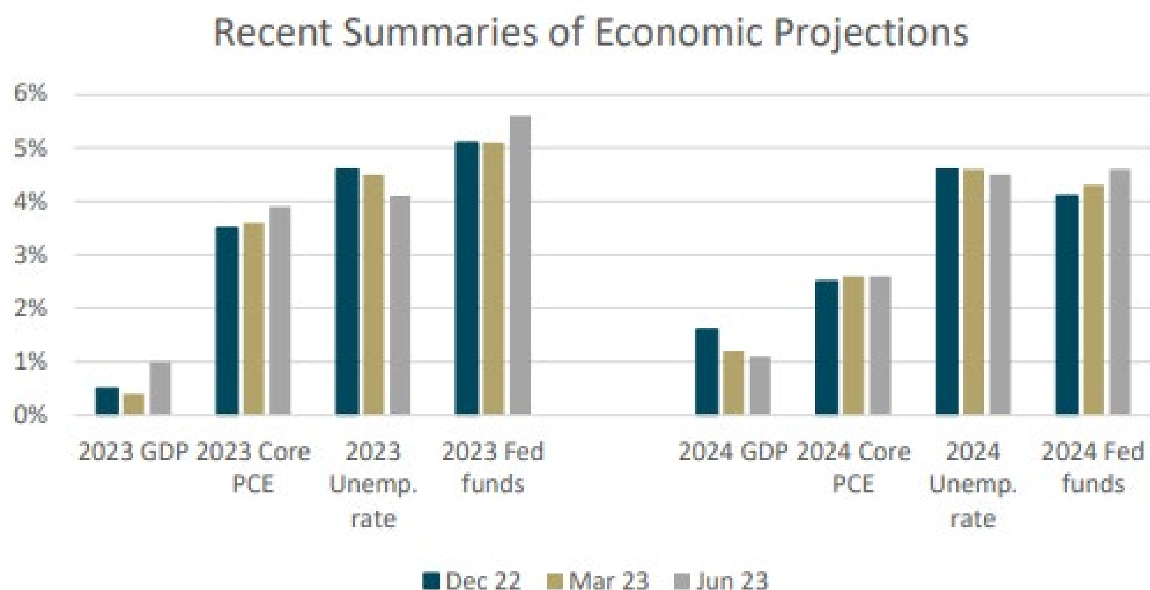
The chart below shows the projections for both 2023 and 2024 (and recall, these are year-end projections) for the four major variables included in the SEP: real GDP growth, core PCE inflation, the unemployment rate, and of course the policy rate. We plot the values for each of these as they appeared in the previous three sets of projections.

As the economy has continued to grow over the course of the year, surprising most observers, we see a gradual move up in GDP (at 1% in the June SEP) and core PCE (3.9% in June), while the unemployment rate projections have declined from 4.6% in

December last year to just 4.1% in the June dots. We think even 4.1% might be too ambitious there and are on the looking for something more modest in the September dots.

For 2024, projections have been pretty well-grounded throughout the year, with little movement between December 2022 and June 2023. As we indicated above, we do expect a higher federal-funds projection for next year – FOMC medians for this variable have slowly been revised higher, from 4.1% in December 2022 to 4.6% last quarter. We would expect something higher than 4.6%, possibly as high as 4.8% or so, indicating fewer cuts next year than are currently expected. In all, this should be a slightly more hawkish set of dots, both when compared to the June SEP and market pricing as of the moment.

How Much Do The Dots Change This Quarter?



Source: BNY Mellon Markets, Board of Governors of the Federal Reserve System

Need Relief On Core Services

In his late-August remarks at Jackson Hole, Fed Chair Powell spent 970 words (of 2085) on the drivers of core PCE inflation. He identified the three key components of this inflation measure – core goods, housing, and core services ex housing. Progress on goods has been notable. Indeed, the y/y price index for core PCE goods has turned negative. Disinflation in this category is one of the more important developments in the inflation fight.

For housing costs, it’s well known that these prices tend to reflect developments in home

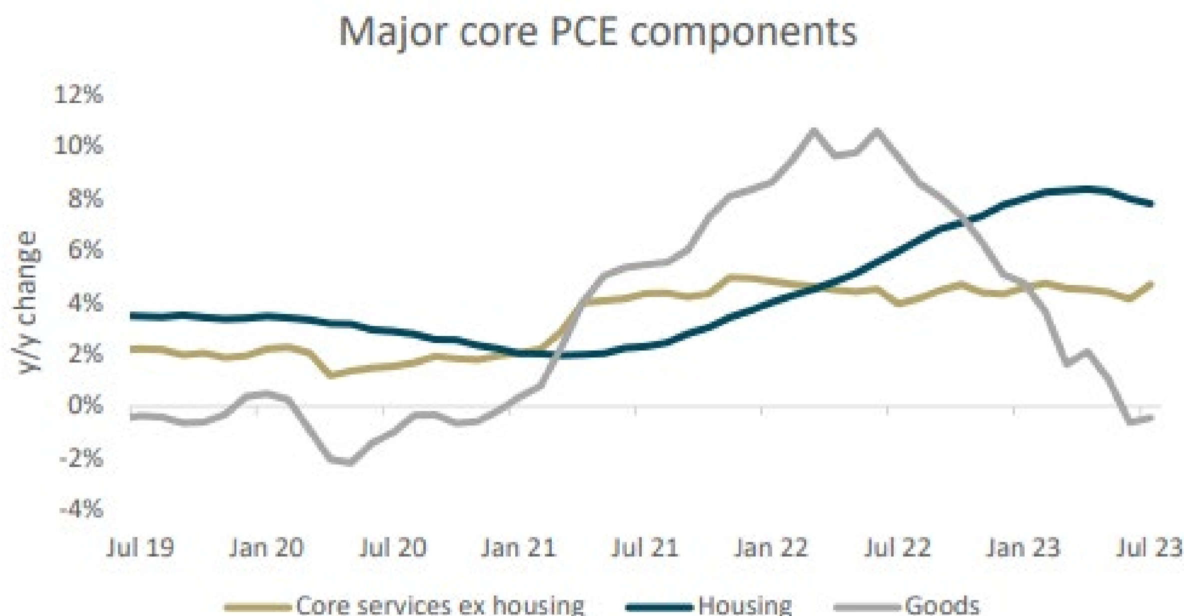
rental prices, but with a considerable lag. Now that rents are starting to fall (the Zillow US rent index for all homes in August was 3.3% y/y, compared to 16% in February), it is expected that the housing PCE measure will start to attenuate. Indeed, we can see from the chart (blue line) that this sub-aggregate has started to turn in recent months.

As for the remaining key component, core services ex housing, concern remains. Since April of 2021, this measure has been stuck around – and usually slightly above – 4%, which is too high and too sticky for the Fed's comfort. We expect Chair Powell to make much about the lack of progress here and to use this to argue for rates to stay elevated well into 2024.

Exogenous factors will likely influence the FOMC's view on the economic outlook and should be reflected in an ambiguous or even cautionary tone. The UAW strike, a looming government shutdown, and higher energy prices all are relevant, even if their impacts on the economy and inflation remain uncertain at this point. Yesterday we wrote that WTI oil prices around $90/bbl will probably not impact core PCE to such a degree that the Fed would be more hawkish than we think it actually is at the moment.

Nevertheless, risks to the economy are mounting. We would expect those to weigh somewhat on the FOMC and to induce Powell to couch slightly hawkish SEP dots in a more cautionary outlook on the economy and, ultimately, the final stages of the policy cycle.

Goods Good, Housing Better, Services Sticky



Source: BNY Mellon Markets, Bureau of Economic Analysis

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

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