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FOMC December Meeting Preview: Markets jumping the gun on US rate cuts?

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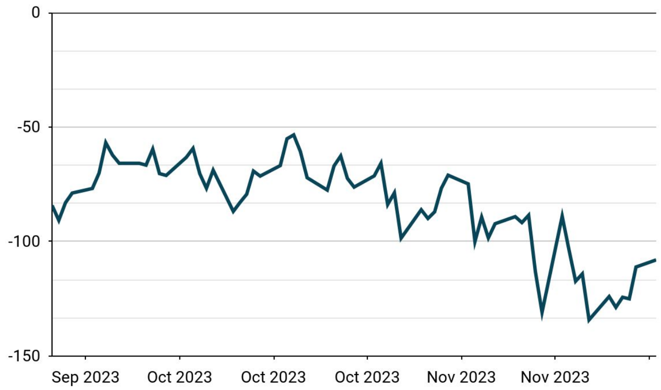
Markets jumping the gun on US rate cuts?

We expect the Federal Reserve to strike a cautious tone during its policy meeting on Wednesday, while pushing back against market pricing for US rate cuts in 2024.

Investor expectations for Fed interest rates have shifted dramatically since the FOMC's latest policy announcement in November, as US inflation continues to ease and the jobs market shows early signs of a slowdown. At the time of writing, futures markets are largely pricing in a first rate reduction in May (from July), and see a total of 110 basis points of cuts through the end of 2024 (from 65bps). Recent communications from FOMC chair Powell have remained largely hawkish, however, and there appears to be a rather sizable disconnect between futures pricing and Federal Reserve rhetoric. Clearly, something will have to give.

Figure 1: US Interest Rate Cuts Priced In [bps] (end of 2024)



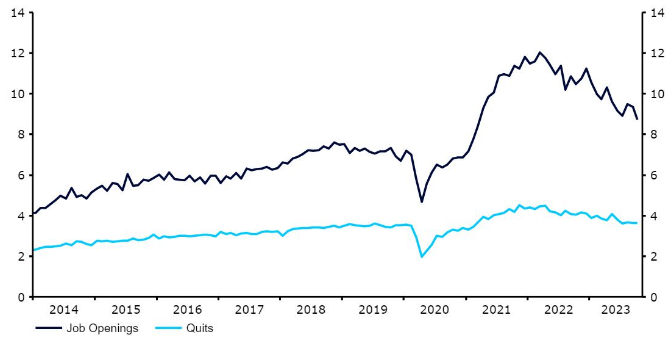
Source: Bloomberg Date: 11/12/2023

During his last public appearance before the Fed's customary blackout period, chair Powell not only poured cold water over the possibility of looser policy any time soon, but also failed to rule out additional hikes. According to Powell, it would be 'premature' to conclude that the Fed has raised rates high enough to defeat inflation, and that it was not time to speculate on when policy easing may begin, with the bank set to move forward 'carefully'. These remarks were almost entirely shrugged off by markets, with futures continuing to set an extraordinary high bar for Federal Reserve cuts in 2024.

In our view, the aforementioned market pricing for US rates is excessive, and investors are getting carried away about the possible extent of policy loosening next year. This view is based largely on the following arguments:

1) The US labour market remains tight, and has only shown modest signs of cooling thus far. FOMC members will no doubt be encouraged by the recent deterioration in the jobs market, but signs of progress have been limited so far. Job creation remains robust at around 200k, job openings are still well above pre-pandemic levels, job cuts have fallen, while initial jobless claims remain low, with the four-week moving average of claims hovering around the 220k level.

Figure 2: US Job Openings (2014 - 2023)



Source: LSEG Datastream Date: 11/12/2023

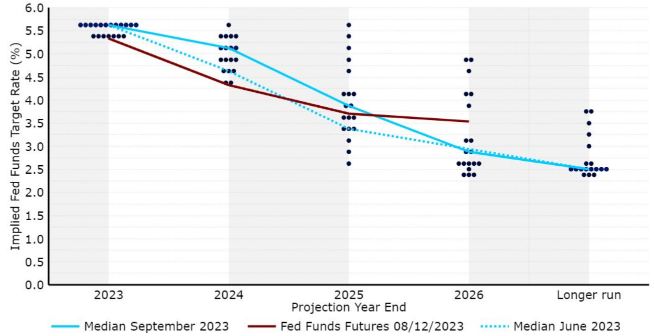
2) Consumer spending continues to hold up very well. Clearly, the Federal Reserve's tightening cycle has not yet been fully reflected in macroeconomic data, given the economy's low interest rate sensitivity and large time lags in policy transmission. Consumer spending, in particular, remains robust, and will need to show far clearer evidence of a slowdown before the Fed can be confident of a return to 2% inflation in a sustainable manner.
3) The 'final mile' in the inflation fight will take time, with households and businesses adapting to the inflationary environment by demanding higher wages and setting higher prices respectively. Worker strikes remain common-place, as do labour shortages, which should act to prop up wage growth and keep inflation elevated.

In light of the above, we expect the Fed to deliver a hawkish set of communications relative to market expectations on Wednesday. Powell will likely stress patience, and say once again that it is too early to declare victory over inflation, and that a period of below-trend growth and a cooling in the labour market will be needed for the bank to express confidence in achieving its price mandate. He will also probably say that further tightening remains possible should progress on inflation be put at risk, albeit this will be viewed by markets as no more than a thinly veiled caveat, rather than anything that could be constituted as forward guidance.

In our view, the most important aspect of the Fed's communications this week will be the bank's 'dot plot' of interest rate projections. In its most recent interest rate projections in September, the FOMC upped its view on longer-term rates. The median dots for 2024 and 2025 were raised to 5.1% and 3.9% respectively, indicating only very modest policy easing in the coming twelve months.

We suspect that market participants will be anticipating a sharp downward revision to these estimates that brings the Fed's projections closer in line with futures pricing. However, we are not at all confident that the Fed will meet these expectations, and any downgrade to the 2024 median dot could be rather minor.

Figure 3: FOMC Dot Plot [September 2023]



Source: LSEG Datastream Date: 11/12/2023

The Federal Reserve will probably wish to keep a low profile on Wednesday, and refrain from rocking the boat too much during its final meeting of the year. Chair Powell may not deviate too much from his 1st December communications, stressing that the beginning of policy easing is not on the horizon just yet. A hawkish set of communications from Powell, and a 'dot plot' that shows no more than only a very modest downward revision from September, could provide some fresh impetus for dollar strength in the second half of the week.

The FOMC will announce its latest policy decision at 7pm GMT (8pm CET) on Wednesday, with chair Powell's press conference to follow 30 minutes later.

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