Economic Alert

FOMC likely to point to slower future pace of hikes

- **Powell will likely maintain that the Fed needs to assess the impact of the fast pace of policy rate moves**
- **He will likely be hopeful but noncommittal on a terminal policy rate below 5%**
- **We see markets reacting positively to an indication of a slower pace of hikes**
- **But there could be reassessment down the road if it becomes clear that 5+% rates will be needed**

“Pivot. Pivot. Piv-ot. Piv-ot. PIVOT!” (Friends)

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We expect the FOMC on 2 November to signal that the pace of hikes is likely to slow at the coming meetings, barring upside surprises on inflation and activity. However, the Fed is more likely to suggest that it wants to give the economy time to catch up to the move in policy rates, rather than indicate that it sees a need to reverse policy.

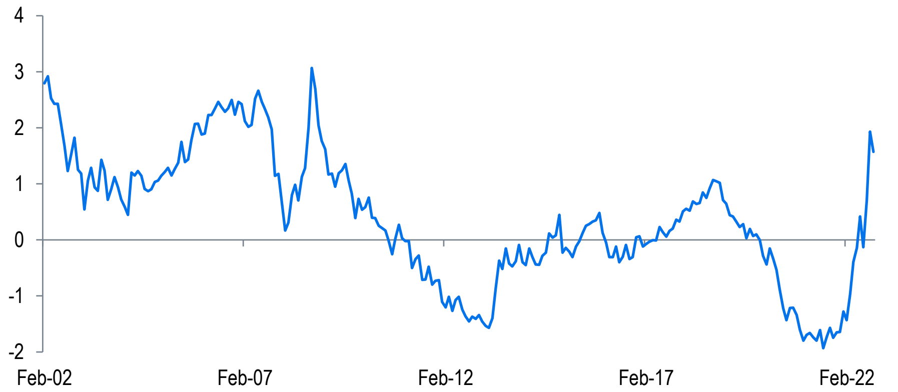
While the term ‘pivot’ often seems to have a dovish connotation, we expect the Fed to characterise the slower pace of hikes in more neutral terms, emphasising the need to gauge the impact of hikes to date while stressing that rates could subsequently go up, down or sideways depending on how the economy and inflation respond. So the pivot will be presented as a technical adjustment to allow the economy to catch up to front-loaded hikes rather than as a policy shift.

Our forecast is that the Fed raises by 75bps in November, 50bps in December and 25bps in January. Money markets are currently pricing 75bps, 60bps, and 36bps over these three meetings. If Fed Chair Powell raises the possibility of a pause, we could see market expectations for the December and January meetings ease towards our forecast.

Despite our view that the Fed will characterise any prospective slowing of policy rate hikes as technical rather than dovish, we still expect money market yields to come off and asset markets to rally if a slowing of the hiking pace is indicated. Investors would see the discussion of slower hikes as an indication of where the Fed expects and wants policy rates to go. The USD would likely follow US yields downward, but leadership in any weak USD move could alternate between high-yielding EM currencies and low-yielding G10 currencies that have been heavily sold.

Figure 1: Fastest increase in real interest rates in 20 years

% (5Y UST nominal – 5Y inflation breakeven)



Source: Bloomberg, Standard Chartered Research

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There has been a lot of dovish discussion of pivots and pauses, but June 2023 fed funds futures are less than 10bps off their cycle highs and end-2023 fed funds futures are only about 25bps off their highs. Market commentary has been more dovish on pivoting so far than market pricing.

Powell will likely be hopeful but noncommittal on a terminal rate below 5%

Powell will probably argue that fed funds at 4.5-5.0% represents a significant degree of tightening that plausibly could restrain inflation. The increase in real interest rates has been the fastest in the last 20 years and rates are now higher than any level since 2008 (Figure 1). If we make reasonable assumptions on the path of inflation expectations before inflation breakevens became available, the increase in real yields over the last six months is probably the fastest since the early 1980s.

Investors will likely be cheered by an indication that policy hikes will pause

However, Powell will probably make it clear that the Fed will go further if it turns out that inflation does not turn down fast enough. Investors may have to balance the risk that terminal rates are higher than expected even if there is a pause or major slowing of rate hikes in early 2023. We think that initially the pause will be the dominant market driver and hence be seen as supporting asset markets, but this could flip quickly if it becomes clear that the 4.5-5.0% range is unlikely to do the job on inflation.

The Fed's focus is inflation but it likely sees a slowing economy as an important part of inflation deceleration. However, Powell is unlikely to emphasise the link between inflation and economic deceleration with midterm elections on 8 November, and some Democratic senators having questioned Fed policy tightening.

50bps a meeting is 400bps a year

So far, neither hard economic data nor inflation has turned down enough to justify a dovish pivot. This could happen in coming weeks if hard economic data deteriorates. But the Fed is still balancing soft economic surveys and earnings guidance against labour markets that are slowing but not really close to recession levels. Fed officials are probably getting an earful from their business contacts on deteriorating prospects, but there are also anecdotes on full flights, restaurants and hotels. When real interest rates were deeply negative, it was easy to argue for a fast pace of hiking. Now, hikes of 50bps seem like a dovish downshift, but by historical standards 50bps per meeting hikes from current levels would be very hawkish.

Powell will probably maintain that the QT impact is small

Fed Chair Powell will likely be questioned on quantitative tightening (QT). The FOMC probably still hopes that QT can proceed behind the scenes without being seen as a major contributor to policy tightening. Powell will probably argue that the QT impact thus far is modest, while admitting that the impact is difficult to quantify.

Asset-market, and especially Treasury market, liquidity is a plumbing issue that the FOMC would prefer to disengage from monetary policy. If asked, Powell is likely to indicate that the Federal Reserve Board is monitoring liquidity conditions, but we doubt he will provide concrete proposals or a timetable for any regulatory changes.

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