FOMC – March pause now the focus

- **We expect the FOMC to hike by 25bps on 1 February and touch on the possibility of a pause in March**
- **The FOMC view on a March pause is likely to be 'possible but not yet likely'**
- **FOMC policy and market pricing are increasingly data dependent**
- **We think ongoing QT can coexist with rate cuts**
- **Markets will likely see the FOMC stance as slightly dovish and USD negative**

Seven key FOMC questions

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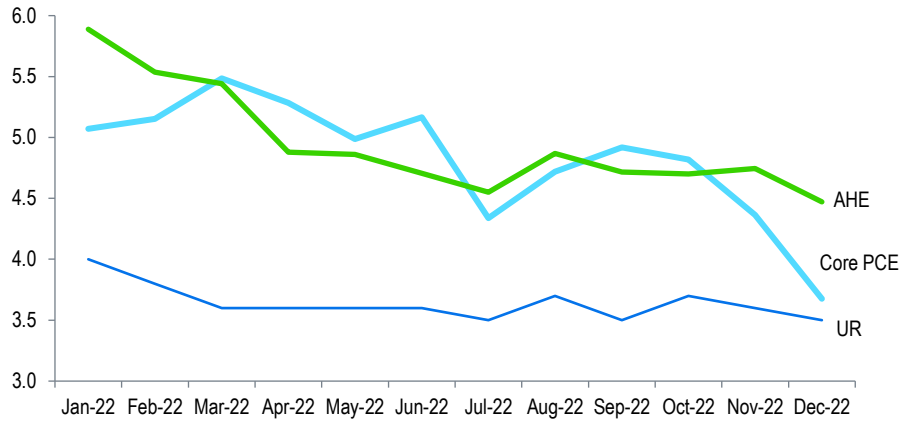
How likely is a March hike? Rates markets are pricing 46bps across the 1 February and 22 March meetings, with 25bps the strong consensus for 1 February. We think the incoming data will be soft enough for the Fed to pause in March. However, this week, the FOMC and Fed Chair Powell will likely signal that there is not yet a conclusive case for a March pause, even though both inflation and activity are slowing. Chair Powell will not foreclose the possibility of a pause, but will avoid endorsing it, in our view. The FOMC also is likely to make clear that any pause is intended to allow more time to assess incoming data, not as a definitive signal that the hiking cycle is over. However qualified the opening to a March pause, we would expect March fed funds pricing to shift to 15-20bps and be highly sensitive to incoming data.

How far will the FOMC ultimately raise policy rates? The market is pricing 4.90% as the effective fed funds peak, roughly 25bps above our expectation and below the FOMC's December projections. If the FOMC opens the door to a pause, we expect this peak to trade lower. In practice, slower is lower, because investors anticipate a slump ahead. The more stretched out the Fed hiking calendar, the more likely that incoming data will deter future hikes. We see a 55% probability that the Fed stops after February, 25% that it stops with one more hike in March or May, and 20% that it hikes more than 50bps in the coming meetings. Pricing will be sensitive to incoming data, so the 3 February labour release could be more important than FOMC commentary.

Figure 1: Two of three key indicators pointing to easing inflationary pressures
% (UR, core PCE 6m annualised, AHE 6m annualised)



Source: Macrobond, Standard Chartered Research

The Fed is unlikely to signal that the hiking cycle is over

What would convince the FOMC to signal a peak in rates? The Fed is looking both at the evolution of inflation and economic slack. As a rule of thumb we think the Fed needs two out of average hourly earnings (AHE), CPI/PCE inflation and the unemployment rate (UR) to be pointing to lower inflation or added slack (Figure 1). That is why the tone of comments changed dramatically when January consumer inflation and hourly earnings pointed to inflation deceleration. However, we highly doubt that a signal that policy rates have peaked will be given at the February FOMC. From a Fed viewpoint, signalling this would be premature and pointless.

Some 2023 easing is possible if the unemployment rate rises

Under what circumstances would policy easing in 2023 or 2024 be warranted? We expect the upper end of the fed funds policy target range to end 2023 at 4.25% and end 2024 at 3.5%. The market is pricing 4.5% for end-2023 and 3.0% for end-2024. We see a qualitative difference between fed funds at 4.25% and below 4.0%. At 4.25% the Fed foot is still meaningfully on the brake, so if inflation goes down and unemployment goes up, as we forecast, we think the Fed will be comfortable with some easing, although the risk is probably skewed to less than more easing, relative to our baseline. Below 4% the degree of disinflationary pressure is less clear.

The likelihood of disinflation is more concrete in 2023 than 2024. Special factors such as rent, car prices, other goods prices and some spillover of energy prices into core should exert downward pressure on inflation in 2023. Some of these disinflationary forces are transitory and somewhat independent of the unemployment rate. By late 2023, disinflation may have progressed enough for the Fed to lessen policy rates pressure a little.

The Fed may cut policy rates a bit if activity softens

We are less focused on how fast the Fed cuts rates in a downturn than how far it cuts. The Fed's policy framework is that there is disinflationary pressure as long as fed funds is above neutral (setting aside questions of where neutral is). So given lags in monetary policy transmission, the first cut or two from the peak are unlikely to take policy from contractionary to neutral. These first cuts take it from more contractionary to less contractionary.

But if inflation disappoints in 2024, the pace of cuts may be slower than expected

However, structural factors may be less friendly to 2024 and beyond disinflation and policy rate cuts. If the labour market proves resilient and major disinflationary forces wind down in the course of 2023, the Fed may have to be more cautious on 2024 easing. Moreover, if structural forces such as relocalisation, reduced trade growth, increased military spending, and climate policy transition costs prove powerful, we are sceptical that fed funds will spend much time below 3% in the future. If the unemployment rate is as elevated as our baseline forecast, the Fed is likely to be able to continue easing, but perhaps not as aggressively as markets now price.

A small opening to a possible pause should be enough to take March expectations lower

How will markets react? Markets have been very data dependent in recent weeks and, by our assessment, less reactive to FOMC commentary than in the past. With 21bps priced for March, any possibility of a pause is likely to take yields down slightly and be seen as risk supportive, even if only in a second order sense. We doubt Chair Powell will call a top to the cycle at this point, having shown no inclination to look at the bright side of life in recent months.

We also think Powell has to calibrate any hawkish message carefully. In our view, investors are reading incoming data differently than the Fed, anticipating both slower growth and lower inflation. On any given day, a hawkish Fed tone will move the market, but there is also a risk that overstated hawkishness becomes like failed intervention –

effective in the first instance but reversed on consideration. We do not expect a hyper-dovish surprise, but would be careful about taking a hyper-hawkish stance at face value. There is a risk that markets stop paying attention to a Fed stance that is at odds with incoming data. Our advice to the Fed would be to be very explicit on why its read is pessimistic relative to the market's. Our advice to investors would be to assess carefully whether the FOMC is playing the ball as it lies, or is assuming a hawkish stance because its risk assessment is skewed towards hawkishness.

On the FX side we see a 10bps down-move in 5Y UST yields as pushing BBDXY down 0.5-1.0%. The low end of the response would be driven simply by a reduction in yield differentials, the high end by a risk-on response to softish US economic data. On the whole, we still see bad economic news as good asset market news, supporting our USD smile view (see *Mona Lisa USD Smile* and *SMS – Can't You See*). If the Fed comes across as dovish we would see the JPY and EUR benefiting the most in G10.

We think that maintaining QT while cutting rates slightly is possible

Can the Fed continue QT while cutting policy rates? We think 'yes', but if asked at the press conference Powell is likely to say something like 'under normal circumstances the two should move in the same direction but it is possible that quantitative tightening (QT) will continue while policy rates are cut'. Much depends on how hard the economic landing turns out to be. If the unemployment rate stays, say, under 5% and is fairly stable, the Fed may keep shrinking the balance sheet while easing policy rates moderately. The likely outcome of a somewhat steeper yield curve and less bloated balance sheet would be welcome.

And as we saw in 2022, forward guidance can backfire if it prevents needed policy measures from being implemented. The Fed would have more flexibility with the fed funds rate in the future if it did not commit to stopping QT as a requirement for cutting policy rates. On a deeper-than-expected recession, the usual full court press of policy easing is likely to be applied, but if fed funds is the preferred tool for controlling activity and inflation, the case for flexibility is strong.

The Fed wants to avoid debt ceiling politics but will likely pause QT if there is a breach

What will the Fed do if there is risk of a debt ceiling breach? If asked at the press conference, Powell is likely to be as unspecific as possible on the measures to be taken, while encouraging Congress to avoid such a breach. From a Fed institutional standpoint, the debt ceiling debate reflects politics rather than policy. Previous Fed chairs have suggested that controlling spending be done through the normal appropriations process rather than by risking a US default on debt obligations. Powell would probably indicate generically that the Fed would implement policies to limit the repercussions in financial markets.

Notwithstanding our view that QT could continue if policy was eased moderately, we think the Fed would suspend QT temporarily if it thought that the added liquidity would help financial markets. We believe the Fed is studying multiple policy options to help limit disruption to market function in such an event.

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