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Fed Notes

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January FOMC preview: And now for something completely different

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- The January FOMC meeting should serve to confirm that the FOMC has left behind its tightening bias and has more intensely begun the discussion around rate cuts. We expect this transition to be reflected in a meaningful overhaul of the post-meeting statement, which will likely drop the reference to "the extent of additional policy firming" and re-focus attention on how long rates will remain at current levels.
- Chair Powell's press conference will focus on the Committee's discussion around rate cuts. We expect Powell will echo comments from his colleagues that policy is in a good place, that a restrictive stance will have to be maintained for some time, and that officials do expect to cut rates this year. However, the timing and pace of those cuts will be data dependent and determined on a meeting-by-meeting basis. In this way, Powell would leave open the potential for a rate cut in March, but would not intend to add to those probabilities at this time.
- With officials recently sending mixed signals about the urgency to slow QT, we will look for Powell to provide an update on any discussions. While we believe it is too early for officials to agree on a revised set of balance sheet plans, an update to this guidance is likely to arrive at coming meetings.

New year, new meeting statement

We expect substantial revisions to the January FOMC statement that will reflect the Fed's gradual pivot from a soft hiking bias toward the next phase of the policy cycle.

Starting with the opening paragraph, the first line can remain the same. It is possible they add further language to acknowledge the strong growth rate of final sales to private domestic purchasers, which slowed by only a tenth in Q4. The remainder of the first paragraph should remain unchanged.

The second paragraph should be excised from the statement entirely - especially with the Fed recently announcing the BTFP will be closed in March. What may replace the second paragraph is a more detailed message on the Committee's inflation outlook. The March 2007 meeting statement provides a good template for how the Fed's messaging evolved at that time as they gained confidence that inflation was moving back toward target. Hence, we expect the second paragraph to state:

"Although inflation pressures seem likely to moderate over time, a tight labor market and supply disruptions could sustain those pressures. The Committee remains highly attentive to inflation risks."

Revisions to the forward guidance language in the third paragraph will then cement this transition from a tacit hiking bias to opening the door for rate cuts. Thus, we expect the Committee to remove "*the extent of any additional policy firming*" and replace it with "*any future policy adjustments*".

In summary, the rewrite of the meeting statement should reflect the clear shift in the balance of risks evident in the December SEP. The Committee would also convey the need to see more data to gain sufficient confidence that inflation is on the right track but that assuming the data continue to evolve in line with expectations, a rate cut will likely be appropriate at some point.

Press conference

Chair Powell's press conference will no doubt focus on how the Committee is thinking about rate cuts this year. We expect Powell will echo comments from his colleagues – particularly Governor Waller – that policy is in a good place, that a restrictive stance will have to be maintained for some time, and that officials do expect to cut rates this year. However, the timing and pace of those cuts will be determined on a meeting-by-meeting basis based on incoming data. In this way, Powell would leave open the potential for a rate cut in March, but would not intend to add to those probabilities at this time.

In terms of details around rate cuts, we suspect that officials will have a somewhat more extensive discussion around this topic, possibly accompanied by a staff presentation on considerations related to different paths. With a March rate cut on the table, continuing these discussions would be prudent policy planning. The key question will be how Powell frames these discussions. Rather than suggesting they are well advanced with hints that the Committee is leaning towards a March cut, we expect Powell to not express urgency around cutting rates. Instead, he should indicate that these discussions progressed and leave open the timing about when rate cuts will be delivered.

In discussing the reasons for cutting rates this year, we expect the Chair will build on the notion that these reductions would be to normalize policy in a soft-landing scenario. That is, as inflation continues to moderate, officials would like to ensure that policy does not passively over-tighten by risking a sharper rise in the real fed funds rate. We wrote about how abruptly the real Fed funds rate could rise over the coming months without cuts as inflation moderates (see "The real deal about rate cuts"). Powell is likely to keep this discussion broad and not detail specific targets for the real fed funds rate as it cuts rates.

Inflation is likely to remain the key driver of the timing of rate cuts. Powell should continue to express optimism around recent progress, likely highlighting again that core PCE inflation is below 2% on a six-month annualized basis. The fact that this progress is not entirely due to core goods prices is also encouraging, as super core inflation has moderated as well, even if it remains above pre-Covid run rates. Powell could, however, indicate that officials are closely watching shelter inflation to ensure it moderates too. He could also note that there are potential upside risks to core goods inflation, including from disruptions to global supply chains emanating from developments in the Red Sea or other geopolitical events.

Despite this progress, officials want to gather more evidence that inflation is trending sustainably to 2%. That will require corroborating evidence in the coming months. Indeed, Powell could echo Waller by name checking the Feb 9th revisions to the CPI seasonal factors as an important hurdle. Ultimately, if these revisions do not lead to higher recent prints, and core PCE continues to print 20bps or lower, a March rate cut would become likely.

Powell should also be able to express optimism around the economy, with recent developments adding to evidence that soft-landing prospects are building. He should continue to emphasize evidence that the labor market is coming into better balance, including through lower job openings, quits and hire rates. While recent data showed a surprising reversal of recent progress on the labor force participation rate, we expect Powell to downplay this move and instead emphasize that, overall, improving labor supply has contributed to the easing of imbalances in the labor market.

On the growth front, recent data suggest that GDP growth remained elevated in Q4 2023. Moreover, while business sentiment indicators remain subdued, a number of developments suggest that growth could well remain resilient in the coming quarters: consumer confidence is rising; retail sales were firm; housing demand is getting a boost from lower mortgage rates; and the easing of financial conditions should begin to support growth conditions. While the December minutes indicated that some officials were concerned easy financial conditions could risk reversing progress on inflation, we suspect Powell will be more sanguine about these developments and speak generically about financial conditions. He could also provide an update on the takeaways from the latest Senior Loan Officer Opinion Survey (SLOOS), which showed some notable improvements the previous quarter despite conditions remaining tight. In short, Powell should be more confident about achieving a soft landing.

Regarding the balance sheet, Fed staff could brief the Committee on technical considerations around the potential to slow the pace of QT this year. Officials have sent mixed signals on the timing of these decisions, with Dallas Fed President Logan expressing some urgency around slowing QT as ON RRP reaches "low levels", while NY Fed President Williams and Waller indicated greater complacency with how QT is evolving. It is possible officials release updated balance sheet plans, but this would be faster progress on these discussions than in our baseline. An update at coming meetings appears more likely. Nonetheless, we will look for Powell to provide an update on any discussions.

Appendix 1

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