Economic Alert

Global Research
30 January 2024

# FOMC – ‘Tightening’ could become ‘easing’

- **The FOMC statement’s language will likely be more dovish on inflation and policy easing**
- **Market pricing is underestimating the potential impact of an FOMC shift to an easing bias**
- **Markets may be focusing too little on potential for guidance to induce asset market volatility**

## Cuts coming, even if not in March

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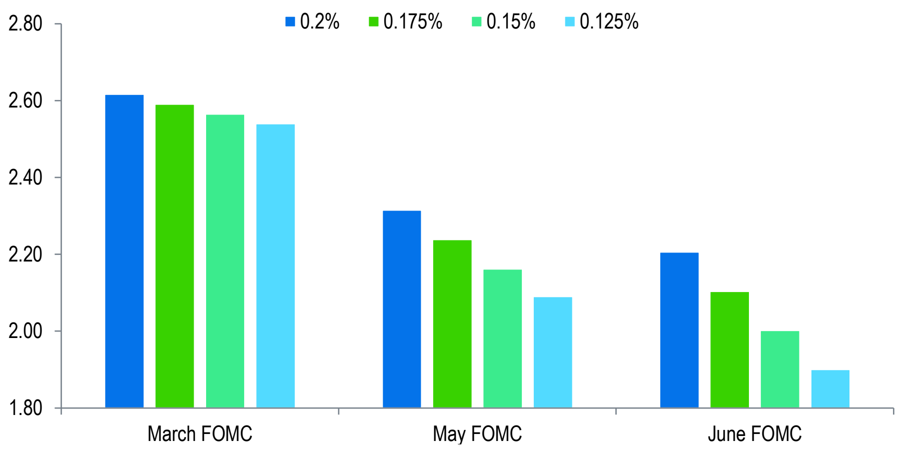
We think Fed Chair Powell will convey that the FOMC will readily cut if it has to but doesn’t yet feel it has to. The tone of the 31 January FOMC may be set by changes in the statement. We expect ‘in determining *the extent of any appropriate easing*’ instead of ‘in determining *the extent of any further policy tightening*’ and ‘Inflation … *has made progress to our target*’ instead of ‘Inflation … *remains elevated’*. The activity description will likely be updated to ‘growth of economic activity remains moderate’. This should convince the market that the Fed will cut as soon as inflation or activity slows sufficiently, even if March is too soon.

While downplaying March easing risk, Powell will likely indicate that softer activity could lead to a March cut. This would be a concrete step towards easing in market terms. Earlier, the market was speculating on and the Fed pushing back against cuts. With ECB dovishness now priced, Fed dovishness would lead to another bout of USD softness.

Our baseline remains no March FOMC cut absent weaker activity, but a cut at the 1 May FOMC meeting looks increasingly possible. By our reckoning, if m/m core PCE growth remains 0.15-0.20%, the FOMC will be looking at c.2.6% y/y core PCE at the March meeting, c.2.25% at the May FOMC and c.2.1% at the June meeting (Figure 1). The most recent annualised six-month growth in core PCE is just over 1.9%. If rents break to the downside, y/y core inflation could be below 2% by the June meeting. The Fed could give very dovish guidance even if it disappoints on March.

**Figure 1: The FOMC may face 2% core PCE inflation in coming months**




Note: Core y/y PCE at indicated meeting based on indicated m/m PCE from January 2024 onwards. Source: Macrobond, Standard Chartered Research

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*The market may underestimate the volatility that could emerge from the 31 January meeting*

The conclusion that investors draw from the FOMC's and Powell's medium-term guidance can induce asset market volatility, even if the risk of a policy rate move at the 31 January FOMC meeting is very small. It's true that there are two CPIs and employment releases before the 20 March FOMC, so a March easing is unlikely to be fully wiped out or fully priced based on FOMC comments at the 31 January meeting. However, guidance on how the Fed will react to incoming data could affect cutting risks for March and beyond.

If activity remains firm and inflation approaches 2% gradually, the Fed will likely cut slowly, wary of overstimulating an economy that is doing fine. If growth shows signs of slowing sharply, the FOMC will likely cut quickly, hoping to prevent an unnecessarily pronounced slowdown. The Fed may likewise accelerate the pace of cutting policy rates if core inflation breaks through 2% y/y.

One hawkish risk is that the statement or Powell throws very cold water on the possibility of early cuts. If the FOMC cites a need for 'compelling' evidence that inflation is 'sustainably' at target before easing, that could push cutting risk into late Q2 or early Q3 rather than March or May. The hawkish buzzwords would convey hiking reluctance.

*We assign a 25% probability of a strong hawkish outcome*

The second risk is that the FOMC makes it clear that activity has to slow significantly to make a case for sharp cuts beginning sooner, rather than gradual cuts beginning later. We would assign these risks together about 25% probability.

The dovish risk is that the FOMC makes the case for bringing real rates closer to neutral quickly. This would leave around 200bps of cutting potential, making it hard to argue that the FOMC should wait. However, we doubt the FOMC would condition policy so heavily on real rates alone.

Another risk is that the FOMC gives a more explicitly negative view of the economy, seeing the strength as being in the rear-view mirror and assessing prospects as softer than in recent quarters. We assign these risks a 25% probability as well.

*We don't expect new comments on QT*

We doubt that much will be said on quantitative tightening (QT) beyond the need to begin to think about optimal levels of reserves and a slowing of the pace of QT as that level is approached. It would be a hawkish twist if Powell indicated that slowing does not mean stopping any time soon and a dovish twist if Powell indicated that there was not much downside to reserves being a bit higher than the minimum needed.

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