FOMC – Unintentional surprises unlikely

- The FOMC does not have to diverge from recent policy comments
- Projecting two cuts is well anticipated; downshifting to one could roil markets
- An AM CPI surprise could be more market moving than an as-expected PM FOMC
- The press conference could focus on immigration and r-star rather than immediate policy moves

You want for nothing but patience

Both June and July FOMCs are about as flat as flat can be so there is little drama likely to emerge from Wednesday’s FOMC. We think the FOMC will project two rate cuts in 2024 versus three in March and that is close to market expectations, in our view. We think it is very unlikely they will keep three cuts. Downshifting to one has about a 30-40% probability, in our view, and would be a major hawkish shock. Many in the market would see a single cut as backing away from the ‘policy rates have peaked’ view, opening the door to serious discussion of the possibility of further policy rate hikes.

The increase in May average hourly earnings and nonfarm payroll employment growth makes a July cut less likely than we thought. We cautiously pencil in a September cut in place of July. We doubt the FOMC is enthusiastic about cutting policy rates just before the election but think it has earned some credibility by its patience to date.

Retaining both two cuts and optimism that disinflation is still in place would be slightly dovish relative to market pricing, in our view, but not by enough to make it tradable. The distribution of dots is likely to suggest that the two cuts were kept by a small margin.

Normally when the CPI comes out on FOMC day, the FOMC meeting gets almost all the market weight. We are not so sure this time; we and the market expect core CPI to grow 0.3% m/m. With limited expectations for both June and July FOMC meetings, a downside surprise to core CPI to 0.2% could reopen hope for a July cut. If core surprised on the high side at 3.7% y/y, that would be the first y/y acceleration since March 2023. If this occurred, speculation that inflation had bottomed could emerge, along with concerns that the next move could be a hike. In our view, a core CPI surprise in either direction could be a bigger market mover than FOMC.

Figure 1: SOFR futures contracts pricing fed funds trough around 3.75%

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Source: Bloomberg, Standard Chartered Research
The FOMC statement can remain largely unchanged, in our view. It is possible that they will cite immigration as a qualitatively significant factor driving robust nonfarm payroll (NFP) gains. At the press conference, Fed Chair Powell is very likely to be asked how much immigration is contributing to the employment and GDP gains in staff forecasts. The Fed staff approach is likely similar to ours, but Fed staff may make different assumptions than we do on the employment rate of immigrants and their NFP contribution (see US – Immigration leading to labour-market surge).

Year-to-date NFP gains have averaged 248k; the 12-month average is 230k. It is material for policy whether the FOMC sees these gains as reflecting underlying demand in labour markets – if so, the case for cuts would be weak. If these reflect a significant contribution from a surge in immigration, then the headline NFP numbers would not necessarily deter rate cuts if disinflation were on track.

The edging up of the UR may lead to questions on whether the FOMC considers the UR or NFP to be the more reliable labour market indicator. If the UR reflects the gap between labour supply and demand, then it is less distorted by supply shocks. Even if the UR reflects conditions only among established workers, it is still of value.

Powell is likely to be questioned on r-star. The market now prices a fed funds trough around 3.75%, well above the FOMC’s long-term projection of 2.6% (Figure 1). Long-term inflation expectations remain close to target, so there is an implicit questioning of the FOMC’s long-term real interest rate projection. Powell has frequently expressed discomfort with unmeasurable concepts such as r-star, so journalists may put the question in terms of the divergence between where the Fed thinks long-term rates can go and what the market is pricing.

The statement will likely shift the language on quantitative tightening from initiating to maintaining the reduced pace of QT, but that is unlikely to be market moving.

The projections could provide other surprises, but we are reluctant to see them as first-order market drivers. The FOMC can change the projections the next quarter and they probably should be regarded as soft guidance rather than as a commitment. With that caution, we see FOMC projection changes as most likely pointing to hawkish rather than dovish:

- We expect fed fund target rate projections to be 25bps higher in each of 2024, 2025 and 2026. The long-term fed funds rate may also be nudged up another 25bps to 2.9%
- Core PCE forecasts are likely to remain unchanged
- The projected UR could be adjusted upward slightly in 2024 and 2025
- GDP projections are unlikely to be changed much

Central banks almost always project that they will hit their targets within the forecast horizon. The adjustments that we expect reflect a Fed view that slightly more restraint may be needed to get to the inflation target.
Disclosures appendix

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Recommendation structure – Rates

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<th>Issuer recommendation</th>
<th>Standard Chartered terminology</th>
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<th>Definition</th>
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*See https://research.sc.com/research/api/application/static/forecasts#rates for our full rates coverage universe and current recommendations.

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IB% - Percentage of investment banking clients in each rating category

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