FOMC – Hike, then wait and see

- **The case for either a pause or a 50bps hike is likely to look weak to FOMC participants**
- **Impact of equity-market weakness on consumption should be low, barring a much sharper drop in equities**
- **The Fed put faces a lot of headwinds when inflation is above target and possibly rising**
- **Equilibrium real interest rates may also be higher than 1.2% of the FOMC projections**

Reasons not to pause in December

Market pricing of c.23bps for the December FOMC looks about right. All of the inflation data is in, and it points solidly to the need for a hike. We think it would take a lot more equity-market weakness to deter the Fed from a 25bps hike, despite market talk of a hold. However, current weakness does seem to take a 50bps hike off the table, with Governor Waller a possible exception. The small gap between market pricing and a full 25bps therefore reflects the possibility that equity prices could drop so rapidly in the run-up to the 9 December FOMC that risks to financial markets or the economy justify a pause. Market participants can assess whether that risk is 5% or 25%.

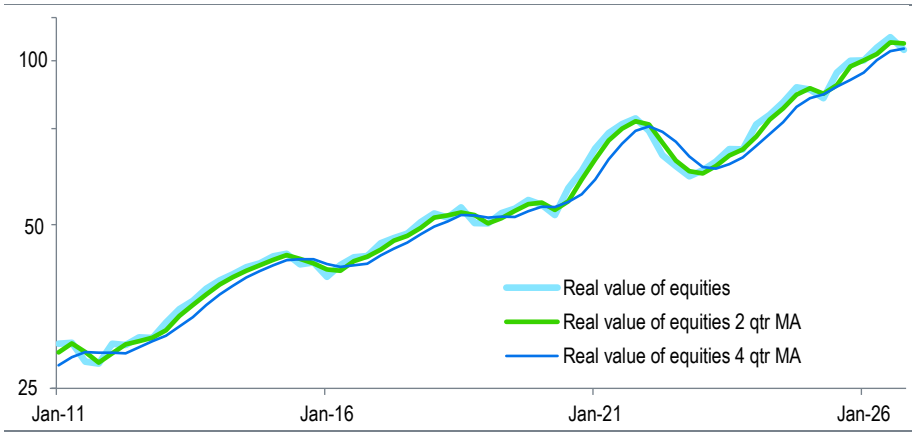
We see a 25bps December hike and a possible bias to cautious hiking, unless inflation comes off sharply before the January FOMC. The FOMC is likely to indicate that it remains concerned about inflation, but is cognisant of financial-market risks. To us, this is still a very far-out-of-the-money Fed put. However, with the risk of a 50bps hike essentially zero, a full 25bps is unlikely to be priced prior to FOMC, unless financial markets rebound unexpectedly.

We are less confident in our forecast of flat FOMC policy rates in 2027, given the likely pick-up in core PCE inflation over the last two months. But both inflation and economic data could soften, making further hikes unnecessary. The two CPI and PPI releases between the December and January FOMC meetings will give FOMC participants a firmer basis to assess whether underlying inflation is stable, rising or falling.

Steve Englander
+1 212 667 0564
Steve.Englander@sc.com
Co-Head of FX Research, ex-China, and
Head, North America Macro Strategy
Standard Chartered Bank NY Branch

Dan Pan
+1 212 667 0647
Dan.Pan@sc.com
Economist, Americas
Standard Chartered Bank NY Branch

Figure 1: Real equity wealth not heavily damaged yet
S&P 1500 Index, Q4-2024=100



Source: Macrobond, Standard Chartered Research

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The drop in equity prices will most likely have a modest effect on consumption

There is much discussion of an FOMC response to the drop in equity prices. However, we doubt the current drop is a limiting factor for Fed hikes. The S&P 1500 market capitalisation is a pretty broad measure of equity-market wealth (Figure 1). We use quarterly data on real equity-market capitalisation, as we doubt anyone makes restaurant choices based on the daily ups and downs in the value of their portfolio. If equity prices stay at the 20 November level and PCE rises around 3.5% annualised in Q4, the real value of equity markets will be less than 1% below the four-quarter average through Q3 and 3% below the two-quarter average through Q3. This would have modest effects on consumption, in our view.

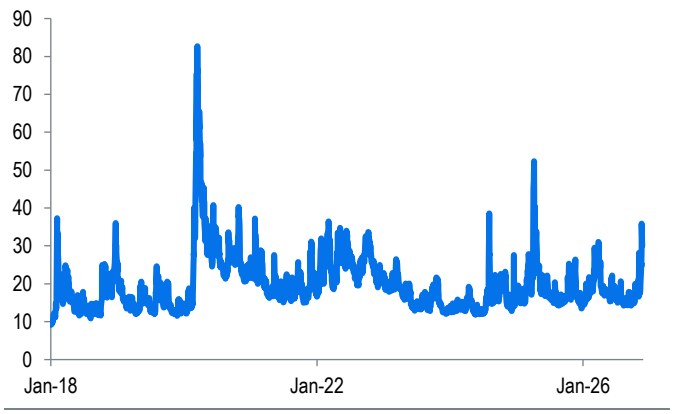
There is considerable uncertainty on how much and how fast consumption responds to equity prices and what inflation will do based on that response. There are models (and Warsh has been highly critical of existing Fed models), but all of these models are very rough, and at best give guidance on what to look out for. Insofar as equity wealth is concentrated among the wealthy, the marginal propensity to consume out of stock market moves may be low – wealth effects driven by stock market rather than housing gains may operate on different spokes of the 'k'.

Corrections of this magnitude are not unusual – comparable drops and subsequent rebounds have occurred several times in the last few years. Moreover, on several occasions in recent decades, an equity-market correction seemed to lead the Fed to ease rates or put off hikes, only for the market to rally thereafter. These rebounds raised questions on whether the dovish shift had truly been needed.

Not every bout of uncertainty has long-term consequences. The VIX has been at current levels eight times since 2022, and equity markets were at record highs a few weeks ago (Figure 2).

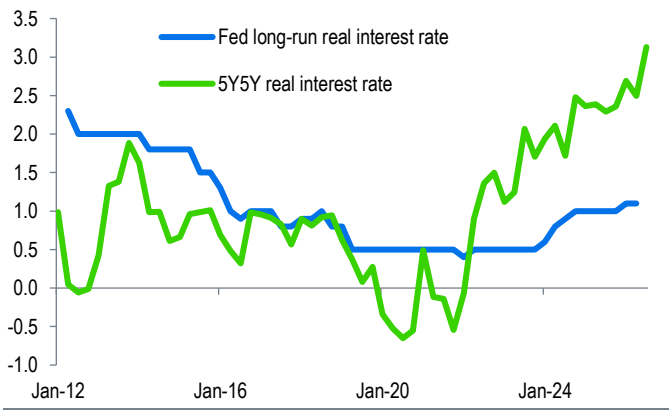
The Fed put is probably less operative when inflation is above target. With core inflation above target and possibly rising, the need to react immediately to weaker equities is limited. Ignoring incoming inflation data because of somewhat weaker asset prices would require considerable confidence on the Fed's part. There is always a Fed put at some level of financial-market stress, but the Fed may be more reluctant to trigger it when inflation is above target than below.

Figure 2: The VIX has hit current levels multiple times
VIX



Source: Bloomberg, Standard Chartered Research

Figure 3: Higher market expectations of long-run real interest rates *(%)*



Source: Macrobond, Standard Chartered Research

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‘Do a little bit and see what happens’ is pretty much the formula – like taking medicine when you are not sure of the correct dosage. The Fed could hike, and then wait a meeting or two to see what happens. Do equities collapse or rebound, and what does the new inflation data show? Is inflation rising so fast that further hikes are unavoidable, or do firms become more careful about trying to expand profit margins?

In our view, the Fed must be cautious about both tightening too much and doing too little, which argues for moving slowly. If the equity market keeps falling, the inflation problem is probably solved, but we do not know how large a decline would be needed. A modest policy move, along with a willingness to do more if necessary, therefore makes sense.

There is another layer of uncertainty. The FOMC’s estimate of the long-run equilibrium real interest has been very stable in the dot plot, remaining near 1% (Figure 3). But it looks as if market expectations of long-run real rates have shifted more sharply, with the 5Y5Y estimate of real UST rates rising above 3% in recent years. The increase may be benign if it reflects productivity growth (see *US – Faster productivity growth is already here*), but it could still mean that policy rates have to rise to keep the economy from overheating.

FOMC officials have been reluctant to link real interest rates and productivity growth. Some, including Fed Chair Warsh, sound sceptical on near-term productivity gains. We think the productivity pick-up is already here, although we would not attribute it as much to AI as some do. If we are correct, this pick-up will likely be reflected in a rise in nominal as well as real rates. We calculate real rates as the difference between nominal and breakeven inflation rates. With breakevens close to 2%, there seems little room for them to fall, making it likely that a real rate increase would be accompanied by a rise in nominal rates.

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	Neutral	Perform in line	
	Defensive^	Underperform	

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