Scotiabank
GLOBAL ECONOMICS

**SCOTIA FLASH**

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# FOMC Eases Financial Conditions

- **The Fed kept its policy rate on hold and balance sheet plans unchanged as expected**
- **Minor statement changes added reference to tightened financial conditions…**
- **…which just repeated Powell's remarks from two weeks ago**
- **Each meeting remains 'live' but not very convincingly**
- **The effects eased financial conditions at a curiously vulnerable point for inflation risk**

The market theme of the week appears to be to react twice to the same information. That's true in terms of the Treasury issuance statements on Monday afternoon and this morning's repeated guidance that volumes will be lower than feared. It's once again true in the reaction to the Fed as they statement-codified Chair Powell's earlier warnings on tightened financial conditions. The result was to send a signal that they wish to rein in some of the bond selloff in terms of the overall mixture of policy measures.

The Federal Reserve kept its fed funds upper limit rate unchanged at 5.5% as universally expected and waffled on the bias in deference to the next meeting that is still described as 'live' but not in terribly convincing fashion. I think it was a misstep.

## MARKET REACTION ADDED TO THE DAY'S EASING BIAS

The day's first big move lower in bond yields was after weaker US data (ADP, ISM-mfrg) and the Treasury refunding announcement that largely repeated Monday's guidance.

Powell added a bit more to this reaction (charts 1–4). The two-year yield fell a further 6bps throughout the Fed's communications and is down 13bps on the day. The 10-year Treasury yield is down 17bps on the day mostly after this morning's developments with the Fed's communications adding about 4bps to the drop. The dollar modestly weakened throughout the Fed's communications and is little changed throughout the day as a whole. Stocks liked it with the S&P 500 up by just over ½% post-Fed.

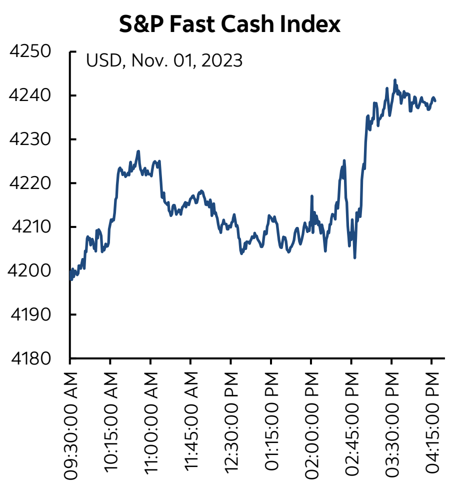
Markets are now pricing the first cut by June and almost a full percentage point of cuts over the next year which is double the guidance offered by the Fed in its last dot plot.

There is a lot of waffling and two-sided speak here which reflects a need to acquire a lot more information before arriving at any next phase whether higher or lower.

## STATEMENT CHANGES BOILED DOWN TO ONE SINGLE WORD MATTERING

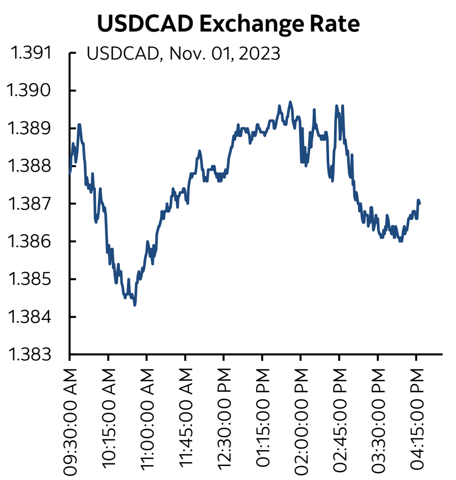
There were very few statement changes in a unanimous decision and only one of them seemed to matter to markets whether justified or not. The statement comparison is available at the back of this publication.

**Chart 1**



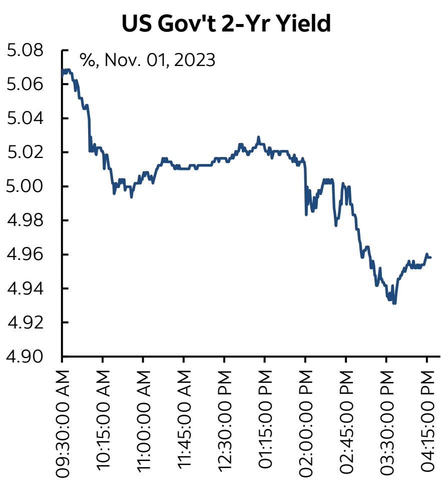

Sources: Scotiabank Economics, Bloomberg.

**Chart 2**



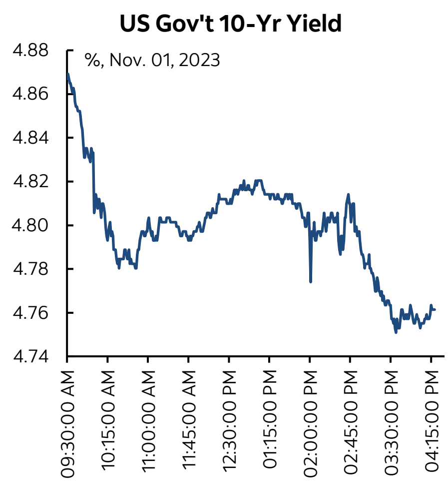

Sources: Scotiabank Economics, Bloomberg.

**Chart 3**




Sources: Scotiabank Economics, Bloomberg.

**Chart 4**




Sources: Scotiabank Economics, Bloomberg.

One word seemed to rock the boat and that was the statement-codification of the reference to how tighter financial conditions are likely to weigh on the economy. The statement did this by inserting “financial” alongside tighter credit conditions. That’s a clearer nod to how they view the impact of higher bond yields along with a strong dollar and equity market developments.

That’s basically what Powell had already told us in his comments before the Economic Club of New York on October 19th. Recall his full quote at the time when asked to comment on developments in bond markets up to that time and with bolded emphasis upon the most material part of that:

> “It's hard to say what's exactly going on. It's not about expectations about higher inflation or shorter-term policy moves. The move is in longer-term bonds and term premiums and not principally looking at shorter-run matters. Markets are seeing the resilience of the economy to high interest rates and revising their views on longer-term rates. There may be heightened focus upon fiscal deficits. And QT. Also, if markets think we're going through rolling supply challenges. Then the question is does it matter to us? Actual and expected changes in our policy affect financial conditions. **Persistent changes in financial conditions affect the economy. Are we seeing these higher longer-term bond show through financial conditions and yes, I think they are. Financial conditions indices are showing tightening and a lot because of longer-term rates. Then the question is whether it is endogenous, in other words if it's because they expect us to do more and that doesn't seem to be the case. We need to see evidence over time. It's clearly a tightening in financial conditions and we have to watch it carefully."**

Other than that issue, the rest of the statement changes were fairly minor. The opening paragraph’s depiction of current conditions tweaked some of the language by upgrading recent growth to “strong” from “solid” and saying job gains have “moderated” instead of “slowed” which is a slight upgrade given how the Fed’s vernacular works.

## PRESS CONFERENCE ADDED TO THE EASING OF FINANCIAL CONDITIONS

Powell’s press conference was basically about buying time to assess more data and developments while warning in somewhat unconvincing fashion that they stand prepared to tighten further if necessary.

He said that risks to inflation are “more two-sided now” and inflation expectations are expecting inflation to come down toward target.

Powell repeated references to “how far we have come” and that “the Committee is proceeding carefully” and that “We will make decisions on potential further tightening based upon the totality of the evidence.”

While saying labour demand still exceeds labour supply, he repeated that supply and demand in job markets continue to come into better balance with strong job creation accompanied by a rise in the participation rate alongside rebounding immigration to pre-pandemic levels. He nevertheless repeated that labour demand still exceeds the supply of available workers.

Powell also repeated caution that inflation still remains "well above" 2% and that “the process of getting inflation sustainably down to 2% has a long way to go.”

On the policy rate bias, he said “Evidence of growth persistently above potential or that labour markets are not coming into balance could warrant further tightening” and 'the Committee is proceeding carefully' and will make decisions on a meeting-by-meeting basis.

On higher bond yields, he said “We require persistent changes that are material and that remains uncertain. Secondly, higher longer term rates cannot be just a reflection of higher policy rates but it does not appear that this is the case. These higher Treasury yields are showing through to higher borrowing costs for households and businesses and impacting their decisions.”

When pushed on whether tighter financial conditions are acting as a substitute for rate hikes that are restrictive enough, Powell said “We are not confident yet. We are still evaluating whether policy is appropriately restrictive” and “We haven't made a decision about December“ while also keeping the door open to tightening even after December if they decide to pause at that time.

Finally, when asked whether the Committee's bias is neutral now, he said “I wouldn't say that at all. The language is about determining the extent of additional tightening. The question we're asking is should we hike more. In December we'll write down another forecast.”

In conclusion, it is my opinion that the Fed inappropriately eased financial conditions and egged on financial markets to more aggressively price rate cuts next year. Inflation risk remains pointed higher in my view in an economy that is performing very well. If easing financial conditions continue, then the Fed might have set itself up to behave more erratically next month.

**RELEASE DATE: November 1, 2023**

Recent indicators suggest that economic activity ***expanded at a strong pace in the third quarter. Job gains have moderated since earlier in the year*** but remain strong, and the unemployment rate has remained low. Inflation remains elevated.

The U.S. banking system is sound and resilient. Tighter ***financial*** and credit conditions for households and businesses are likely to weigh on economic activity, hiring, and inflation. The extent of these effects remains uncertain. The Committee remains highly attentive to inflation risks.

The Committee seeks to achieve maximum employment and inflation at the rate of 2 percent over the longer run. In support of these goals, the Committee decided to maintain the target range for the federal funds rate at 5-1/4 to 5-1/2 percent. The Committee will continue to assess additional information and its implications for monetary policy. In determining the extent of additional policy firming that may be appropriate to return inflation to 2 percent over time, the Committee will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, and economic and financial developments. In addition, the Committee will continue reducing its holdings of Treasury securities and agency debt and agency mortgage-backed securities, as described in its previously announced plans. The Committee is strongly committed to returning inflation to its 2 percent objective.

In assessing the appropriate stance of monetary policy, the Committee will continue to monitor the implications of incoming information for the economic outlook. The Committee would be prepared to adjust the stance of monetary policy as appropriate if risks emerge that could impede the attainment of the Committee's goals. The Committee's assessments will take into account a wide range of information, including readings on labor market conditions, inflation pressures and inflation expectations, and financial and international developments.

Voting for the monetary policy action were Jerome H. Powell, Chair; John C. Williams, Vice Chair; Michael S. Barr; Michelle W. Bowman; Lisa D. Cook; Austan D. Goolsbee; Patrick Harker; Philip N. Jefferson; Neel Kashkari; Adriana D. Kugler; Lorie K. Logan; and Christopher J. Waller.

**RELEASE DATE: September 20, 2023**

Recent indicators suggest that ***economic activity has been expanding at a solid pace.*** Job gains have ***slowed in recent months*** but remain strong, and the unemployment rate has remained low. Inflation remains elevated.

The U.S. banking system is sound and resilient. Tighter credit conditions for households and businesses are likely to weigh on economic activity, hiring, and inflation. The extent of these effects remains uncertain. The Committee remains highly attentive to inflation risks.

The Committee seeks to achieve maximum employment and inflation at the rate of 2 percent over the longer run. In support of these goals, the Committee decided to maintain the target range for the federal funds rate at 5-1/4 to 5-1/2 percent. The Committee will continue to assess additional information and its implications for monetary policy. In determining the extent of additional policy firming that may be appropriate to return inflation to 2 percent over time, the Committee will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, and economic and financial developments. In addition, the Committee will continue reducing its holdings of Treasury securities and agency debt and agency mortgage-backed securities, as described in its previously announced plans. The Committee is strongly committed to returning inflation to its 2 percent objective.

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