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GLOBAL ECONOMICS

SCOTIA FLASH

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Why Did Markets Rally on the FOMC's Piv-not?

- **Policy rate held at 5.5% as expected**
- **The FOMC projected fewer cuts than markets were pricing…**
- **…yet bonds and equities rallied, dollar sold off**
- **Markets may have reacted this way on positioning away from more hawkish fears…**
- **…and/or because of sentiment the Fed tends to chase inflection points**
- **Time will tell if a further easing of financial conditions is appropriate**

The Fed had already shown 2024 cuts in its prior projections and so this was no grand pivot, but they added a touch more easing that nevertheless continues to fall short of market pricing into the communications and afterward. Statement changes make it appear more likely that they are at a terminal rate of 5½%. Macroeconomic forecast changes generally reinforce the pattern of projected rate cuts. The press conference alluded to a greater discussion on easing in the minutes three weeks from now. Full coverage follows.

MARKET REACTION

Markets lapped it up from beginning to end and there will be more reaction through the Asian overnight session. The USD softened on a DXY basis by almost 1% including moves like just under a penny's depreciation relative to CAD. The two-year Treasury yield fell by 24bps. The 10-year Treasury yield fell by about 14bps. The S&P rallied by 1¼%.

There was spillover into Canada as well. The Canada two-year yield fell by about 22bps and the 10-year yield fell by 11bps after the full suite of communications.

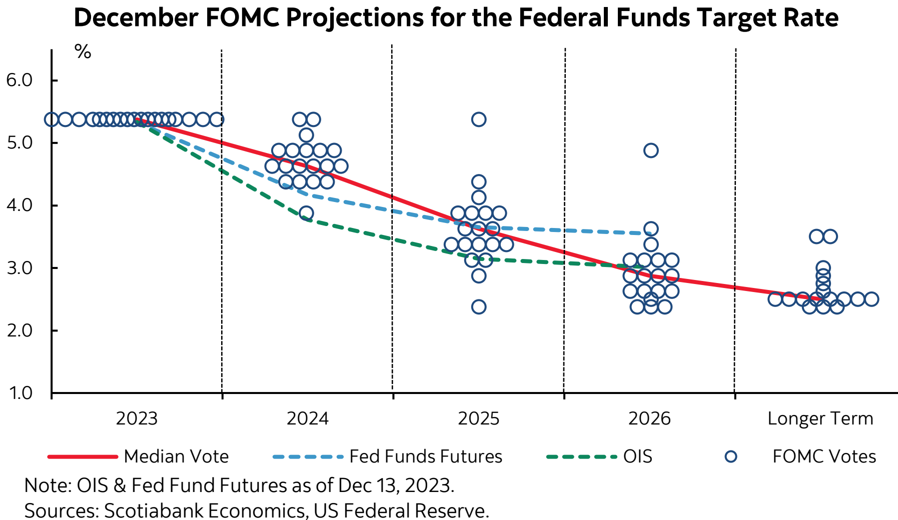
The market reaction was resoundingly positive. We'll all take it I'm sure. The reaction was more than what I had expected, notwithstanding the main point about how what they did to the dots etc was largely what had been expected but it remains less than markets were pricing for cuts during 2024 going into the communications and afterward.

STATEMENT CHANGES

There were very few, but impactful statement changes. Please see the appendix for a full statement comparison.

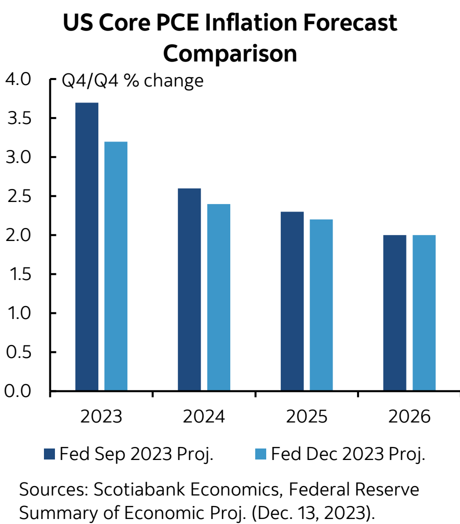
One tiny three-letter word was impactful. They inserted "any" in now saying "In determining the extent of any additional policy firming that may be appropriate to return

Chart 1



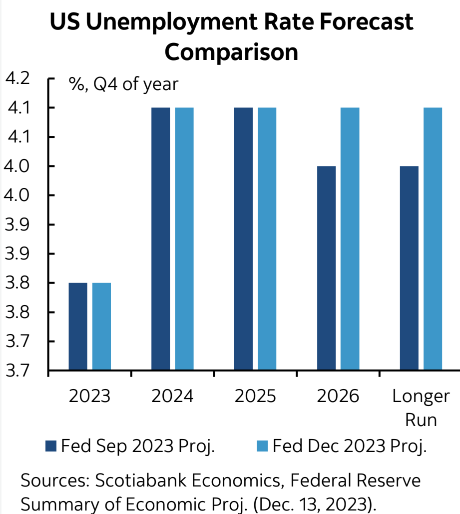
Note: OIS & Fed Fund Futures as of Dec 13, 2023.
Sources: Scotiabank Economics, US Federal Reserve.

Chart 2



Sources: Scotiabank Economics, Federal Reserve Summary of Economic Proj. (Dec. 13, 2023).

Chart 3



Sources: Scotiabank Economics, Federal Reserve Summary of Economic Proj. (Dec. 13, 2023).

inflation to 2 percent over time…." which indicates greater skepticism toward any further need to hike again.

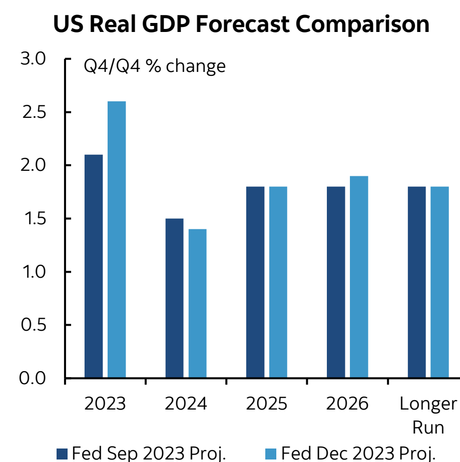
The statement revisions flagged softening growth by now saying growth "has slowed from its strong pace in the third quarter" which shouldn't surprise anyone's tracking.

The opening paragraph also changed from saying inflation "remains elevated" to now statement-codifying that "inflation has eased over the past year."

Also notable is that they did not change what they could have. They did not soften reference to 'tighter financial and credit conditions' despite the moves we've seen. Today's market reaction added to the financial market easing in a significant way.

There were no dissenters but that doesn't mean there isn't a wide spectrum of opinions on the likely magnitude of easing next year and beyond, a point that is addressed below.

Chart 4



Sources: Scotiabank Economics, Federal Reserve Summary of Economic Proj. (Dec. 13, 2023).

DOTS—MORE, BUT LESS

Enter the dot plot of what the Committee thinks might happen to the policy rate (chart 1).

The FOMC's 'dot plot' lowered the end point for the fed funds target rate for this year to 5.375% as expected by removing the hike they previously showed in September's dot plot.

They then added 75bps of cuts next year down to 4.625%. That indicates 75bps of cuts from the present 5½% policy rate.

They also lowered 2025 by 25bps to 3.625% at year end.

The breadth of the dots in 2024 does not show a whole lot of conviction toward -75bps. Six participants expect -75bps and define the median estimate for the magnitude of easing next year. Four participants expect -100bps. One expects -150bps. But 5 expect just -50bps, 1 expects only -25bps and two expect no cuts next year. There is a tail skewness in the distribution toward less than 75bps of cuts in 2024.

PROJECTIONS—SLIGHTLY FASTER EXPECTED PROGRESS ON INFLATION

Charts 2–4 show updated macroeconomic projections.

The GDP growth forecast was raised to 2.6% from 2.1% for this year as expected, but next year's growth was revised down a tick to 1.4% and there were minimal changes thereafter.

The unemployment rate was left at 3.8% this year and left unchanged at 4.1% over the next two years.

Core PCE projections were revised down a half point this year to 3.2% which is just marking to market, but next year was revised down two-tenths to 2.4% and the year after that was revised down by one-tenth to 2.2%.

There were no changes to the neutral rate as expected, and minimal changes to the longer run guideposts other than a 0.1 up-tick to the long-run UR at 4.1%.

PRESSER—KEY IS THAT THERE IS MORE TO COME ON THE EASING DIALOGUE IN THE MINUTES

Additional remarks during Chair Powell's press conference reinforced the market's initial reaction and here are the most salient points that were made during the Q&A.

Q1. What does 'any' in front of additional firming mean? Are you done hiking?

A1. We added it as an acknowledgement that we are likely at or near the peak rate for the cycle. Participants didn't put down additional hikes but didn't want to take the possibility off the table.

Q2. Governor Waller said that the FOMC could be cutting interest rates in the next several months if inflation keeps falling. Comment?

A2. I don't comment on any other officials. The first question was how fast to hike. The second question is how high to hike. We think we're at the peak but don't want to take the option off the table. The next question is when it will become appropriate to begin easing. We are seeing strong growth that appears to be moderating. We are seeing a labour market coming back into balance. We are seeing inflation

progress. **These are the things we want to see but we still have a ways to go. When will it begin to become appropriate to begin easing? That was a discussion point in our meeting today.**

Q3. What was the nature of that discussion on when to begin to ease?

A3. This will be a topic of discussion going forward. I can't do a head count for you today in terms of who said what.

Comment: This last question was a strong hint at the importance of watching for the meeting minutes in three weeks time when additional colour on the criteria and potential timing of easing may be provided.

Q4. What motivates the projection for a lower fed funds rate next year? Are you simply calibrating it in relation to the inflation forecast as opposed to stimulating the economy?

A4. It's nothing that mechanical. We're very conscious of real rates and monitor them but it's broader financial conditions that matter and it's so hard to know what the real rate is and exactly how tight policy is. You can't follow that as a rule. The expectation is that the real rate will fall.

Q5. Do you want to front-load this easing in 2024?

A5. We're moving carefully. One issue is the assessment over whether we've done enough and we're thinking we have but aren't feeling that strongly. Another hike is no longer a base case. We'll be having a discussion going forward on when to begin easing.

Q6. Markets are pricing a first cut as soon as March. Is this something you are broadly comfortable with?

A6. We focus upon what we have to do and how we use our tools to achieve our goals. People will have different forecasts, but we have to do what we think is right. It's important that financial conditions are aligned with what we will do and in the long run they will. In the meantime there will be back and forth.

Comment: This last question gave Powell the opportunity to confront market pricing even in nuanced fashion and he passed. He could just as easily have slammed the door on early cuts and chose not to do so which may be meaningful.

Q7. Do you believe we're at the point where inflation is coming down credibly?

A7. I welcome the progress. We're still well above 3% on core. We need to see continued further progress toward getting back to 2%.

Q8. How will you decide when to cut rates and how will you determine you are not behind the curve?

A8. We're aware of the risk we hang on for too long. You see our forecasts. We'll be looking at further progress across our dual mandate.

Q9. Will you tie a rate cut to a specific threshold or achievement?

A9. These are things we haven't really worked out yet. We're just at the beginning of that discussion.

Q10. How much closer do you need to be to 2% before cutting?

A10. You need to cut well before. I can't give you a precise estimate. I think in the SEP you'll see a reasonable assessment of the lags in terms of what it would take.

Q11. Has there been any discussion about altering the pace of QT?

A11. No. Powell went on to repeat earlier guidance on their plans and targets for QT and when to tweak them and there was nothing new.

CONCLUSION — WHY SUCH MARKET JUBILANCE?

So what gives? Why such a jubilant market reaction if the FOMC fell short of validating market pricing in line with what was largely expected?

One possibility is market positioning in that markets were cautiously fearing a more hawkish stance that could have only removed the extra hike this year but retained only 50bps of cuts next year instead of 75bps. If so, then this positioning reaction may be vulnerable going forward. We've seen wild reactions only to be shaken off later.

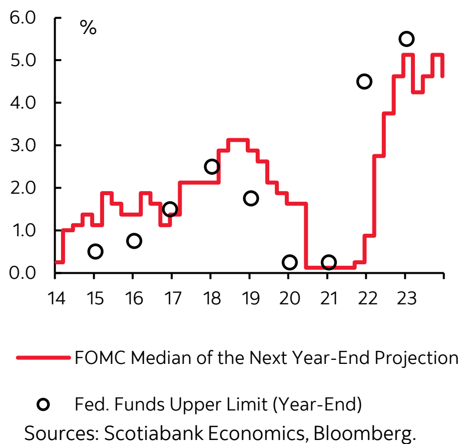
Another possibility is that the market is inclined to discredit the Fed's credibility and thinks ah-hah, if they're thinking and showing -75bps next year, then there will be more than that because the Fed messes up at inflection points.

Unless it's one of those two arguments, then the rest of what they did wasn't really a big surprise.

And finally as a reminder, one should probably always err on the side of dissing the dots as shown in their performance in charts 5–7. Time will tell in which direction the dots may be wrong and whether today's outcome that easing financial conditions further was justified, not enough, or premature.

Chart 5

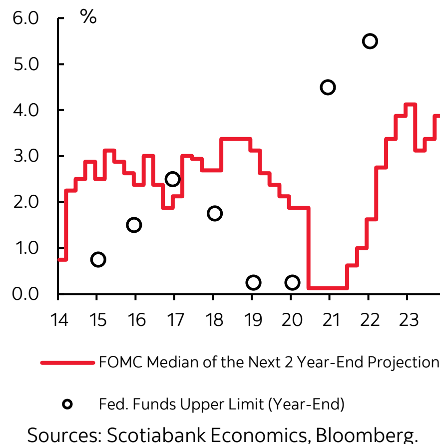
DOTs Perform Poorly in the Next Year



Sources: Scotiabank Economics, Bloomberg.

Chart 6

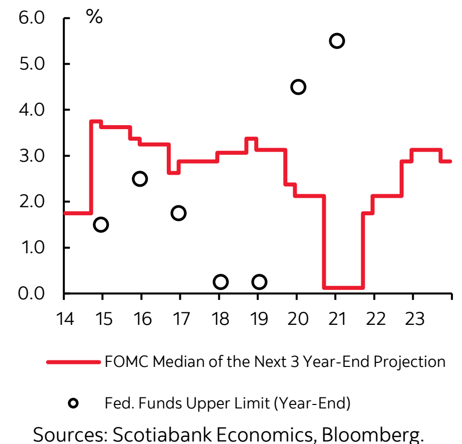
DOTs Are Useless Two Years Out



Sources: Scotiabank Economics, Bloomberg.

Chart 7

DOTs Are Even Worse Three Years Out



Sources: Scotiabank Economics, Bloomberg.

RELEASE DATE: December 13, 2023

Recent indicators suggest that growth of economic activity ***has slowed from its 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 has eased over the past year*** but 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 ***any*** 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: November 1, 2023

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