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**Rates Alert**

Global Research
27 January 2025

# FOMC – Four risks around a bland baseline

- **Little is priced in for the 29 January FOMC amid low expectations that Powell will rock the boat**
- **However, we see risks to asset markets from FOMC indications of its medium-term stance**
- **Asset markets may be so focused on Trump's policies that Fed risk is underestimated**

## A sunny look of his would soon repair

Money markets have nothing priced in for the 29 January FOMC, 7bps of cuts for the 19 March meeting, and 25bps cumulatively for H1. We would characterise the Fed's stance on cuts as 'show me'. The FOMC would need a visible slowing of activity or inflation to justify resuming a sequence of cuts. We expect both activity and inflation to slow in H1, but that shift is not yet visible in incoming economic data.

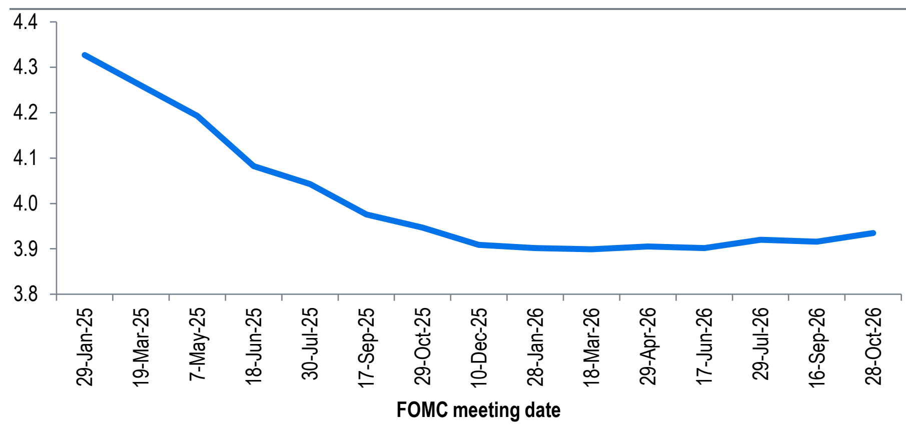
We see four risks from the upcoming meeting:

1. Even a small opening of the door to two-way risk on future policy rate moves would be taken as very hawkish by the market
2. Small tweaks to the FOMC statement may indicate a firming of labour markets
3. Conversely, if Fed Chair Powell echoes Fed Governor Waller's optimism on disinflation in coming months, markets may add a few bps to March or May rate-cut probabilities
4. Any reference to ending or slowing quantitative tightening (QT) could take some pressure off long-end rates, even though it is unclear how much impact QT has had on rates

Of these, (1) would have the biggest market impact, in our view. Even a tiny opening of the door to 'the next move could be a hike' could have a major impact on asset markets. Money markets currently price in falling or stable rates through 2027. The possibility of hikes could unwind the residual cutting risk that is now priced in, and even have a few bps of hiking priced for mid-2025. We would expect the yield curve to steepen, the dollar to strengthen and equities to sell off, reversing asset market moves of the last two weeks.

**Figure 1: Markets are pricing in an uneventful fed funds policy rate path**

*%, fed funds futures*




Source: Bloomberg, Standard Chartered Research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*The Fed has leaned hawkish recently*

We doubt that Powell would like the FOMC to add further hawkishness at this stage, but comments from FOMC participants (other than Waller and Goolsbee) have been more hawkish than dovish. There may also be a desire to manifest the Fed's monetary policy independence at the start of Trump's term. This is the same FOMC (albeit with somewhat different voters) that risked offending Trump by cutting rates by 50bps at the meeting before the election. Even if Powell tries to avoid discussion of hiking, journalists may ask (as they frequently do at ECB press conferences) whether any participant expressed a preference for hiking, and it may be difficult for Powell to completely avoid the question. Even if he says that no one advocated hiking at this meeting, investors could conclude from a limited response that the issue arose.

A hawkish FOMC stance might engender some comment from President Trump, exercising his right to comment on Fed policy choices, even if such comments increase market uncertainty. As with comments on FX intervention, the market may initially react to such comments, but the impact may diminish over time if there is no follow-through.

*The FOMC may characterise labour markets as stable and balanced, rather than gradually slowing*

Risk (2) is that the statement raises the FOMC's assessment of the labour market to a view that it has broadly stabilised near balance. This would probably be seen as mildly hawkish relative to recent statements pointing to a gradual easing of labour-market conditions. Our view is that underlying labour markets are probably not as firm as headline numbers indicate. QCEW points to weaker outcomes beyond the upcoming benchmark revision, and the impact of immigration is consistently downplayed, in our view. However, the FOMC may choose to take NFP numbers at face value and use them as an indication that the supply-demand balance in labour markets is stable or even firming slightly.

This would signal to markets that the FOMC sees no need for cuts anytime soon, flattening the rates curve further. The asset market response would probably be more muted than to risk (1), but we could see the USD stabilise and equities wobble at least temporarily.

*Powell may acknowledge a slightly improved inflation outlook*

Risk (3) is that Powell or the FOMC point to indications that inflation may be resuming its gradual downtrend. Waller recently indicated that he expects "a significant step-down in the 12-month inflation numbers through March [2025]". His speech was before December CPI and PPI came in somewhat below expectations. Fed officials, including Powell, have sometimes given guidance on upcoming PCE releases based on published CPI and PPI data. If Powell were to point to soft core PCE, investors would see this as a sign of FOMC comfort with the inflation outlook. That may not add much to cutting expectations, but it could lower fears of hikes. We share the market's expectation that December core PCE will come in at 0.2% m/m and 2.8% y/y, but if we are wrong, we think inflation is more likely to come in below expectations than above.

Such an indication would likely extend the equity-market rally and further weaken the USD. The reaction would be moderate, in our view, reducing risk premia and volatility in asset markets rather than significantly changing FOMC pricing expectations.

*All signs point to balance-sheet runoff continuing unchanged*

Risk (4) is FOMC commentary that points to slowing or stopping QT. In terms of the outlook for QT, we think the statement is very likely to be unchanged. Key market-based metrics indicate that QT can continue to run at the current pace. New York Fed President Williams recently characterised reserve levels as "abundant" and year-end pressures as transient. However, with reserves approaching levels that might be considered close to 'ample' (rather than abundant), we see a small possibility of the



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FOMC indicating that QT could be curtailed down the road, putting it on the agenda but not on the front burner.

If an end to QT is hinted at, bonds could see a short-term rally, but more as a knee-jerk response than a lasting move. There is considerable uncertainty on the extent of the QE or QT impact on yields. But if bond yields were to fall, they would likely take the USD with them and support equity pricing.

***TGA drawdowns will make gauging market conditions more difficult***

Powell is most likely to be asked about QT in the Q&A session – potentially in the context of the US Treasury's deployment of "extraordinary measures" to avoid hitting the debt ceiling, which muddies the outlook for QT. When deploying extraordinary measures, the Treasury uses cash from its Treasury General Account (TGA) with the Fed – to continue to function without hitting the debt ceiling. This may obfuscate measures of market variables – such as RDE and the TGCR-IORB spread – making it harder for the Fed to tell when underlying reserves have crossed from 'abundant' to 'ample' levels. Powell may simply reaffirm Williams' comments about reserve levels and state that there is little evidence at present to suggest that QT policy needs to be adjusted.

***The Fed may have to choose between two competing philosophies in deciding when to end QT***

More generally, we think the decision to stop QT may boil down to a struggle between two competing philosophies. The first is caution (stemming from Fed officials' desire to avoid a liquidity shortage as in 2019). That may lead Fed policy makers to slow or stop QT before market-based metrics suggest they should – especially considering distortions from the TGA drawdown and the risk of a more volatile market environment this year. The second is a (perhaps ideological) desire to minimise the size of the Fed balance sheet, and thus to continue QT for as long as possible before markets start protesting.

Our view is that the first philosophy will dominate – but we accept that both have their merits. On the whole, we think the Fed is more worried about the consequences of stopping too late than too soon. In this context, there could be some indication at this week's meeting that slowing QT could be considered at upcoming meetings, although Powell is unlikely to specify which one(s). When the January minutes are released, the details of SOMA Manager Perli's presentation to the FOMC may provide more insight into the Fed's current views on QT.



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|---|---|---|---|
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| | Neutral | Perform in line | |
| | Defensive^ | Underperform | |

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