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MARKET COMMENTARY

The Fed: rate cuts are coming, but not in March

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- **The Fed acknowledged the sharp improvement in the inflation outlook but stepped up the efforts to push back against expectation of rate cuts as early as in March. Six months of good inflation data are not yet enough for the FOMC to declare victory.**
- **The almost painless disinflation owes much to the unwinding of the bottlenecks caused by the pandemics. Once they are completely over it is not yet clear how the economy will behave, and this further suggests caution n loosening policy.**
- **We still think that, by the May meeting the Fed will have enough evidence to start cutting rates, and we expect a total of 100bps loosening this year. The evolution of Quantitative tightening will be discussed in the next meeting. We see the balance sheet runoff to end around the turn of the year.**

The almost immaculate deflation the Fed has been busy advertising since early 2023 looks increasingly likely, also thanks to the ongoing unwind of the legacy from COVID. The Fed will lower rates this year - the vast majority of FOMC members is in favour- but it is still unsure on the timing. The only certainty is that the first cut will not happen in March.

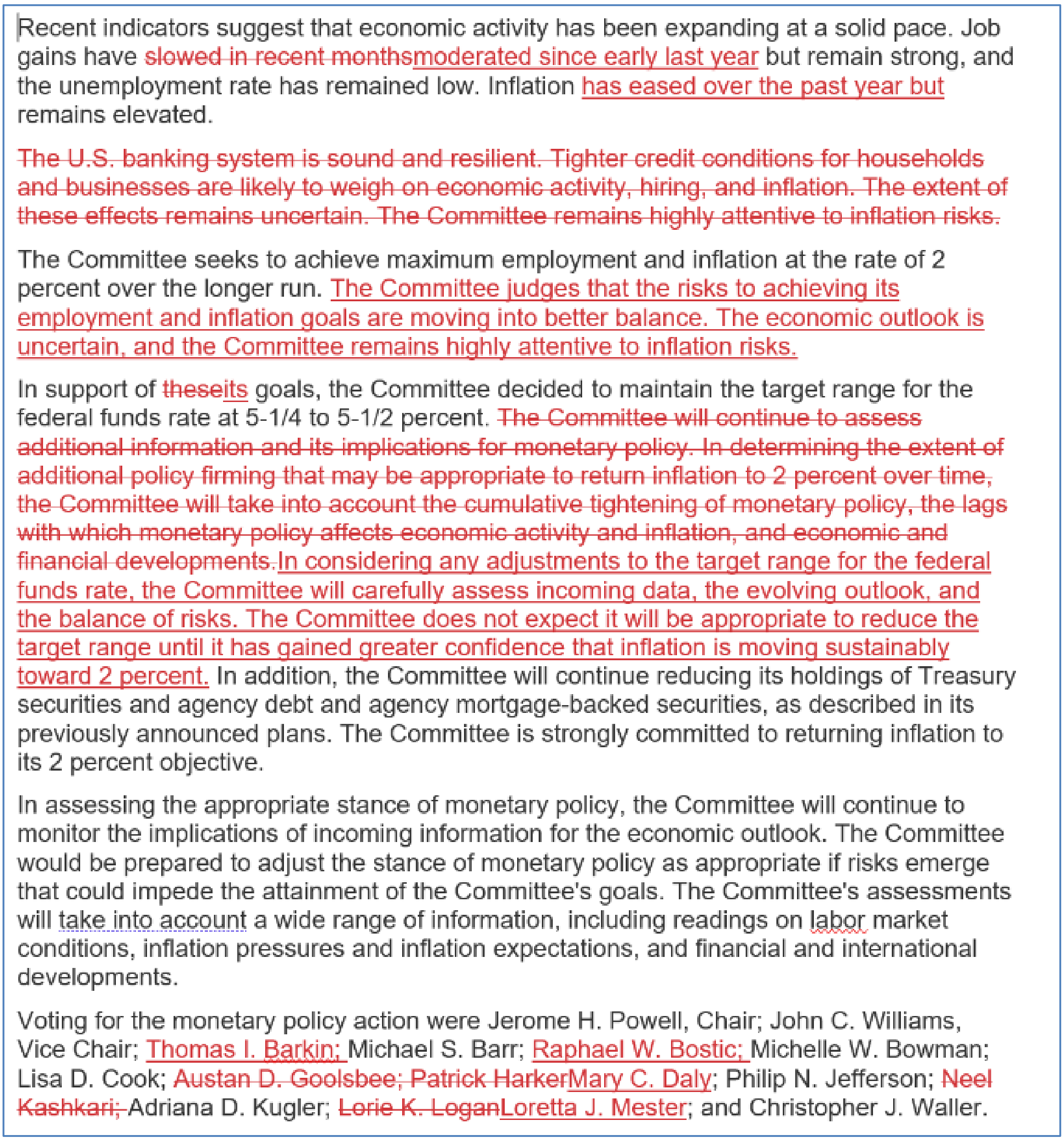
The extensively changed press release listed the favourable evolution of inflation the cooling of labour market and removed any reference to tight financial conditions but, in an unusual twist, explicitly stated that the FOMC is not yet comfortable to cut, given the still high level of inflation (the press release can be found at the end of this commentary). Powell added that that to him and many other committee members March remains too early for the FOMC to be confident enough that the progress on inflation seen over the last six month are durable.

The economy has shown very good progress, as inflation has come massively down, while the unemployment rate has remained below 4% for two years and the non interest-sensitive sector of demand have continued to growth at a solid pace. Yet it is too early to call it a soft landing, as a lot of this improvement has to with the unwinding of the bottlenecks the pandemic has created, especially to the labour market. This creates uncertainty, especially on the durability of disinflation once the economy returns to full normality. There have been six months of good inflation data, which are sending a solid signal, but to start cutting rates the FOMC want to see a few months of equally good prints. A lot of disinflation has come from goods as global supply chains restarted working smoothly, but from now on it is the service sector that will have to contribute more. A key risk preventing early cuts is not that inflation may come back up, but that it stabilises at the current, still too high, level (core PCE inflation was 2.9% yoy in December). Moreover, uncertainty surrounds the level of the neutral rate. The current strength of the economy suggests that it may be higher than the 2.5% implicit in the FOMC dots, and Powell himself thinks that it may be higher than the estimates of most models. Therefore, risk management suggest a bit more of patience.

This meeting staged some discussion on the evolution of the balance sheet, but a more in-depth analysis will be conducted in March. Powell stressed against that the balance sheet and the fed funds rate are two independent policy tools, and the cut in rates need not be followed immediately by the end of quantitative tightening.

The outcome of the meeting confirmed our view that the Fed will start cutting rates in May and will ease policy by a total of 100basis points this year. On Quantitative tightening, we expect the March discussion to lead to a reduction in the pace of the balance sheet runoff during the summer, and to a halt around the turn of the year.

Markets took the meeting as not dovish enough: the S&P lost around 1.5%, while the 2-year Treasury yield was flat at 4.3%.



Recent indicators suggest that economic activity has been expanding at a solid pace. Job gains have ~~slowed in recent months~~moderated since early last 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 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. The Committee judges that the risks to achieving its employment and inflation goals are moving into better balance. The economic outlook is uncertain, and the Committee remains highly attentive to inflation risks.

In support of ~~these~~its 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 considering any adjustments to the target range for the federal funds rate, the Committee will carefully assess incoming data, the evolving outlook, and the balance of risks. The Committee does not expect it will be appropriate to reduce the target range until it has gained greater confidence that inflation is moving sustainably toward 2 percent. 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; Thomas I. Barkin; Michael S. Barr; Raphael W. Bostic; Michelle W. Bowman; Lisa D. Cook; ~~Austan D. Goolsbee; Patrick Harker~~Mary C. Daly; Philip N. Jefferson; ~~Neel Kashkari;~~ Adriana D. Kugler; ~~Lorie K. Logan~~Loretta J. Mester; and Christopher J. Waller.

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