Financial Markets Update

ATB CAPITAL MARKETS

ATB FMG: Fed January Policy Decision

Jan 31 2024

Summary:

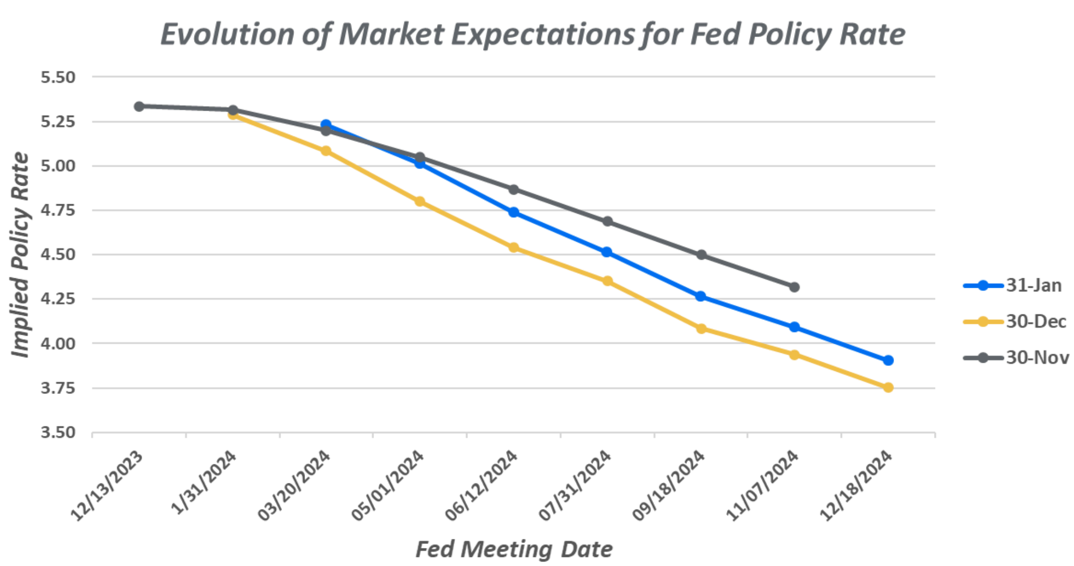
- The Fed left rates unchanged with a target band of 5.35%-5.50%
- However, the tone of their position has changed
- They now feel more balanced about the risks moving forward
- Meaning that they are moving towards accepting that rate cuts are likely ahead

Takeaways -

There was enormous pressure on the Federal Reserve ("Fed') and Chair Jerome Powell to deliver a message that would balance the need for the markets to feel confident that interest rates could be lowered this year, with the need for the Fed to fulfill their mandate on price stability. They just about achieved this:

- *"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 towards 2%"*
- *"We are in risk management mode" (*balancing the need to not cut too early but also not wait too long)
- *"The vast majority of the committee believe that rate cuts will be appropriate"*
- *"There is confidence" that inflation is continuing to fall towards target - but they want to see more*

As you can see below, the market has accepted that it got carried away at the end of last year with aggressive expectations that, no doubt, the Fed felt obligated to push back against. However, current pricing is still lower than where the market sat at the end of Nov'23 so it's fair to conclude that the Fed is comfortable with this: **The market expects 150bps of cuts by Dec'24, while the Fed's official projections from Dec'23 are for just 75bps of cuts - one would expect more pushback if they felt the market was too far ahead.**



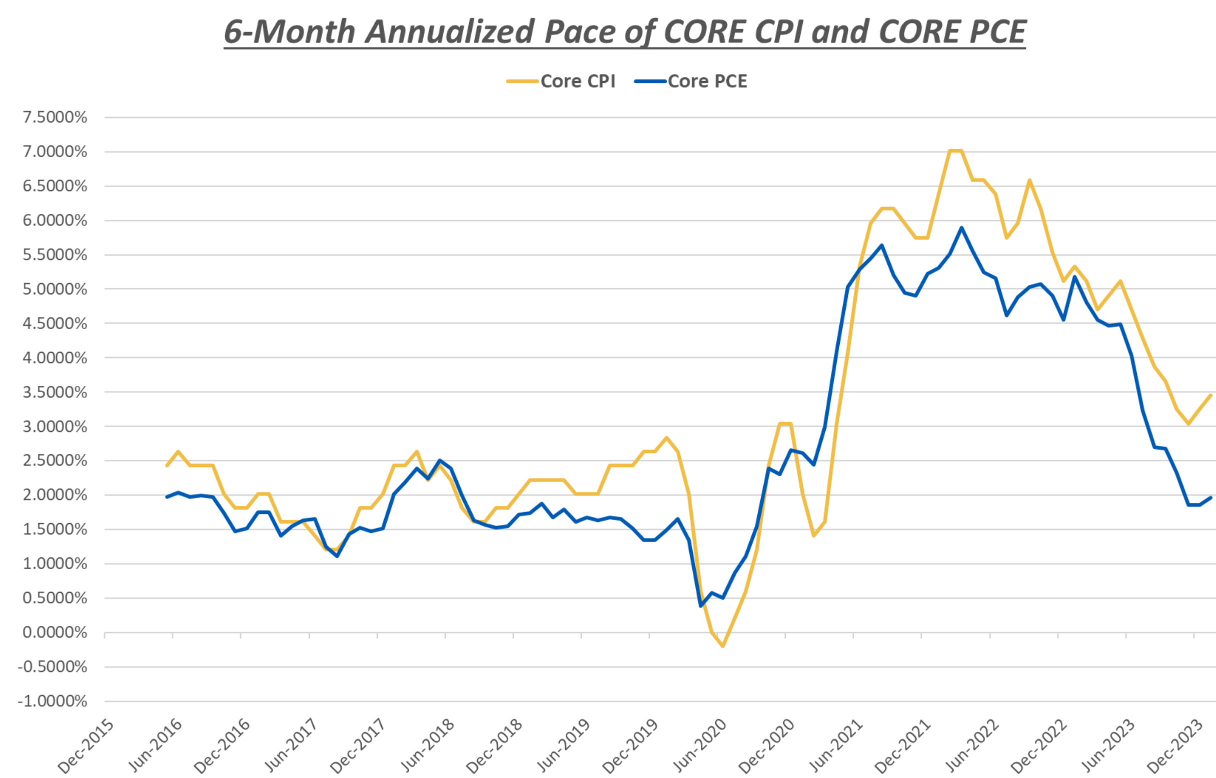
Observations -

Chair Powell's comments that the Fed no longer considers it necessary to lower growth or raise unemployment via lengthy restrictive policy in order to keep inflation falling towards 2% are crucial. (We wrote about this back in December as a conclusion to the changes in their economic projections - higher growth and lower unemployment projections for 2024 which had not led to them raising inflation forecasts for this year). **From now on the Fed expects that we are on a simple "inflation watch".** The risks are binary:

- If inflation keeps falling in a steady enough way - so that 2% by sometime in 2025 looks probable - the Fed will start easing.

How confident are the Fed that this could happen? Pretty confident, it appears.

- Powell said that "*the vast majority of the committee*" believe that rates could be lowered this year. Indeed - he even phrased it at one point as "*the need will be there to lower rates".*
- He said that there was growing confidence given the trend in 6-month annualized inflation readings (chart below).
- However, looked at over a 12 month rolling horizon ("the target"), the picture is not yet as rosy. And so more time is needed.
- He said that the danger was that the 6 month measure "flattered" the trend - and that the committee wanted to avoid reaction prematurely.



Conclusions -

For Powell to so openly discuss the process of deciding to cut rates and what the Fed will need (essentially "more of the same") - plus their confidence that they will get it, is a huge leap forward . It really is now just a matter of "when" and not "if".

So *when* can rate cuts start? Well, Powell said that a cut at the March meeting is "unlikely". That is not a total rejection of the idea - more of an acknowledgement that it is probably too soon.

So, our conclusions:

- This is a divided Fed - it is too early to get the consensus they feel they need to act
- The trend is encouraging but some members need more convincing
- It is likely that the pressure to get it perfectly correct when battling inflation and then exiting the fight - get it wrong and credibility is hurt and the fight gets harder - is weighing on the minds of some members
- Hence the procrastination/more intensive data gathering approach
- **Look at that chart above. If CPI and PCE start turning back up - then it could get quite tough for some members to vote for cuts**
- However, the pace of descent can slow and still provide the comfort that the handful of moderate Fed voting members will need to press the "cut" button
- The reticence to ease when "Higher for Longer" was such a loudly stressed policy in the fight to reduce inflation and boost credibility can be soothed by the fact that April is 9 months after the last hike, which came in July'23. This is a much longer delay to the first cut than the historical average. An ease would not be incongruent with "Higher for Longer" to fight inflation and meet the mandate.

Market Reaction -

Very little, actually. Rates had already fallen aggressively on the day as news broke of disappointing quarterly results, slashed dividends and larger loan loss provisions for the regional Financial Institution, New York Community Bank. This spread fears of another regional bank contagion issue not even a year after the SVB collapse (NYCB is 25% the size of SVB and actually bought some of its troubled portfolio, for what it's worth). The concern is that their bad loans on office properties is perhaps indicative of a broader issue - is this the first of many in the regional banking system?

But the fact that nothing Powell and Co said changed the market trend is significant. This was a day for doves.

US Treasury Bond Yield Summary							1/31/2024
		Last	1w chg (bps)	YTD chg (bps)	3m High	3m Low	% Rank of Current Yld to 3m Range
UST Bond Yields	2y	4.264	-2.88	6.33	5.062	4.144	11%
	5y	3.910	-8.86	29.26	4.684	3.795	23%
	10y	3.982	-13.61	47.54	4.734	3.794	28%
	30y	4.225	-14.56	59.28	4.927	3.953	38%
Curves	2s10s	-28.21	-10.73	41.21	-16.14	-53.18	78%
	5s30s	31.53	-5.70	30.02	37.23	6.44	86%

What Next? -

As we suggested above - we need to see the next couple of months of inflation (especially Core PCE Deflator). If the trend continues, Powell has already revealed that it will start turning their target 12 month rolling measure down towards a level that will get the votes needed to start easing. May? June? The market thinks the former. But nobody - not even Powell himself - sounds like it could be beyond the latter.

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