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TRENDMACRO LIVE!

On the January FOMC

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Donald Luskin

The pivot is affirmed. Now Powell will watch inflation to see if there is any inflation. Brilliant.

There were more changed words and sentences today's FOMC statement than we've seen in a long time. But there's nothing here we weren't expecting, or for that matter markets weren't expecting (see "FOMC Preview: Groupthink is Dead, Now It's Just Lies" January 19, 2024 and "Is Quantitative Tightening Over?" January 29, 2024). After December's dovish pivot, markets have taken on board a great deal of confidence that the hiking cycle is over and that cuts are coming. That's not a set-up for a dovish surprise at today's meeting, and we didn't get one. *What we did get was affirmation of the pivot.*

- *As of this writing, the market-implied probability of the first cut coming in March has fallen to 37%, down from 42% this morning and 60% just before the meeting* (please see the chart on the following page).
- *We still think the first cut will come in March – despite Chair Jerome Powell saying in the post-meeting press conference that this is "not the base case" – on the heels of two disinflationary if not downright deflationary CPI reports to come.*

Generative AI token: "Jay Powell says I really want to be a dove, but I have to deal with all these damn hawks everywhere"

Source: DreamStudio running SDXL 1.0

Update to strategic view

FEDERAL RESERVE, US MACRO: Today's FOMC reaffirms the December pivot by dethroning inflation as the only risk, saying it is in balance with risks to full employment. The exclusive focus on rate hikes as the only possible policy change is gone – it's now the directionally neutral concept of rate "adjustments." Cuts won't come until there is "greater confidence" that inflation is heading back to target. Powell wouldn't define how many months at what low level of inflation would give him that confidence. However, in a slap to Waller, he ruled out using growth or labor market tightness as a causal variable: he will simply look at inflation itself. In the first-ever question about the possibility of deflation, he said he is not expecting it, but if it comes "we'd have to do something about that." He said there was some discussion about slowing balance sheet run-off, but that serious discussion will come in March. There are two more CPI reports before the March meeting. They will be deflationary, and we think the Fed will have to cut rates then – though this meeting reduced the market-implied probability.

Futures-implied funds rate, by FOMC meeting, before and after today's FOMC meeting

Source: Bloomberg, TrendMacro calculations

Compared to [the December 2023 statement](), *the most important changes* [*in today's*]() *reveal the collapse of the inflation-fighting and rate-hiking biases of the Committee*.

- The keys are these two passages. The first is an entirely new sentence was [*emphasis ours*]:

  "The Committee judges that the risks to achieving its employment and inflation goals are *moving into better balance*."

- The second is a change of phrasing. In December, it was [*emphasis ours*]:

"In determining *the extent of any additional policy firming* that may be appropriate to return inflation to 2 percent over time…"

- Today it is [*emphasis ours*]:

  "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."

- *"Firming" rules out rate cuts. "Adjustments" rules them in.*
- Pretty dovish, but on the other hand today's statement adds an entirely new sentence cautioning against too-aggressive assumptions about the timing rate cuts [*emphasis ours*]:

  "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."

- Early on in the post-meeting presser Chair Jerome Powell was asked what it would take to give him that confidence. He said, in essence, that inflation data has been excellent for the last six months, and he just wants to see more of it.
- *And critically, he began his answer by saying, first and foremost, "We're not looking for a weaker labor market." He went on to acknowledge that throughout this tightening cycle the Committee has looked to economic growth and so-called tightness in the labor market as the causal agent for inflation. But now, he says, "It hasn't been the case."*
- This is a strong slap at Governor Christopher Waller who continues to imagine, and speechify, that growth causes inflation (again, see "FOMC Preview: Groupthink is Dead, Now It's Just Lies"). *For the moment at least, and according to Powell at least, the Phillips Curve is dead. Instead, now we're on some kind of "price rule" in which we can tell if there is inflation by looking at inflation statistics.* Not much of a forecasting model, but there you are.
- And don't worry. *There will be two CPI reports before the next FOMC meeting in March, and they will be somewhere between very disinflationary and somewhat deflationary*.
- Powell was asked in the presser how the Fed would react if inflation started printing below the Fed's target. *We think this is the first time Powell has been asked about outright deflation. That itself is rather astonishing evidence of a pivot in market expectations about what used to be considered an axiom: that inflation would be "sticky."*
- *He noted that the last couple months of inflation data have, in fact, been deflationary!* Of course, he's not expecting that to continue (but he didn't give a reason). *If below-target inflation does continue, he said, "We'd have to do something about that."* We believe that will prove to be quite an understatement. We'll find out before mid-year.
- Finally, today's statement removed these two sentences:

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[About us]

"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."

- Well, we suppose it is hard to say the banking system is sound and resilient after today's news that New York Community Bancorp, a large regional bank, had to take unexpectedly large loan loss reserves and cut its dividend. Maybe especially hard considering that the Fed just last week terminated the Bank Term Lending Program designed to bail out banks just like that one (see "In the Dead of Night, the Fed Ends the Bank Term Lending Program" January 25, 2024).
- But then why go silent on concern about tighter financial conditions in the face of news that makes them tighter?
- There is one topic on which not one syllable changed in today's statement. The FOMC disappointed the Fed-watchers who were expecting a deceleration of the run-off of the Fed's balance sheet – that is, a reduction in so-called quantitative tightening (again, see "Is Quantitative Tightening Over?"). The same old sentence was there again:

  "…the Committee will continue reducing its holdings of Treasury securities and agency debt and agency mortgage-backed securities."

- In the presser Powell was asked whether it was discussed. *Interesting way of framing the question*, because, in the prior press conference in December he said it *had not* been discussed, but then the meeting minutes revealed that it *had* (again, see "Is Quantitative Tightening Over?"). After a weirdly long pause, he said, "We had some discussion, but we intend to discuss it in depth at the March meeting."
- We continue to believe that QT is not in fact tightening, and that this ought not to be an important concern for markets.

Bottom line

Today's FOMC reaffirms the December pivot by dethroning inflation as the only risk, saying it is in balance with risks to full employment. The exclusive focus on rate hikes as the only possible policy change is gone – it's now the directionally neutral concept of rate "adjustments." Cuts won't come until there is "greater confidence" that inflation is heading back to target. Powell wouldn't define how many months at what low level of inflation would give him that confidence. However, in a slap to Waller, he ruled out using growth or labor market tightness as a causal variable: he will simply look at inflation itself. In the first-ever question about the possibility of deflation, he said he is not expecting it, but if it comes "we'd have to do something about that." He said there was some discussion about slowing balance sheet run-off, but that serious discussion will come in March. There are two more CPI reports before the March meeting. They will be deflationary, and we think the Fed will have to cut rates then – though this meeting reduced the market-implied probability.