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TRENDMACRO LIVE!

On the May FOMC

Wednesday, May 1, 2024

Donald Luskin

Markets were braced for the worst. The sharp deceleration in QT was a bullish surprise.

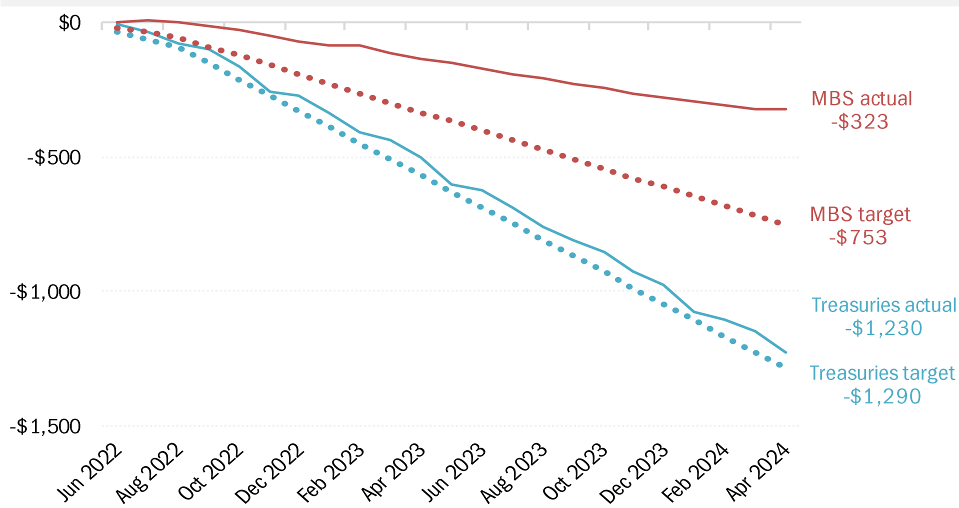
It's no surprise that today's FOMC statement: reiterated that "Inflation has eased over the past year but remains elevated," but added a new cautionary sentence: "In recent months, there has been a lack of further progress toward the Committee's 2 percent inflation objective" (see "Data Insights: FOMC" May 1, 2024).

Markets came into this FOMC meeting at maximum hawk, with very low expectations for rate cuts. Before the meeting, futures markets were discounting only 1.4 rate cuts all the way out to the January 2025 FOMC. They've trivially eased to expecting 1.8 cuts as of this writing.

- *Perhaps it's something of a relief that the characterization of recent inflation was merely "lack of progress," rather than something more freighted – such as "re-accelerating."*
- And in the post-meeting press conference Fed Chair Powell characterized the possibility of any future rate hikes – something clients ask us about every day – as "unlikely."

It's not exactly a surprise that the Fed followed through on its strong hints about reducing the pace of asset run-off on its balance sheet by non-

Change in Fed balance sheet holdings during normalization (so-called QT – USD billions)



Source: FRB, TrendMacro calculations

Update to strategic view

FEDERAL RESERVE, US MACRO: Higher inflation in Q1 is characterized as "lack of further progress," not "acceleration." Markets were already braced for fewer than two rate cuts this year, and this language rules out any rate hikes. As hinted, the deceleration of run-off of balance sheet assets was announced, with onset in June. The cap for run-off of Treasuries will be lowered from $60 billion to $25 billion per month. The new cap is lower than we expected – the closest thing to a bullish surprise from this meeting – even lower than the $30 billion cap when QT began. The $35 billion cap for MBS remains in place, but since onset it has never even been close to binding. Stocks are higher than they were in December when seven cuts were expected, now with fewer than two. Markets see the neutral rate is higher than previously thought, so the Fed is not excessively tight. Deceleration of QT is good for sentiment, but in reality QT isn't really tightening.

[Strategy dashboard]

reinvestment of maturities. In the press conference following the March FOMC (see "On the March FOMC" March 20, 2024), Powell said it would come "fairly soon." The very next meeting is as "fairly soon" as you can get. But we suppose the only surprise there is that Powell didn't disappoint.

It's something of a surprise, to us at least, that starting in June, *the pace of Treasuries run-off will be capped at $25 billion, down from $60 billion. $25 billion is lower than the $30 billion that capped the first three months of run-off when it started in June 2022*.

The cap for mortgage-backed securities is unchanged at $35 billion a month. But that doesn't matter. Since onset in 2022, MBS maturities have never hit the cap.

- Run-off – or "normalization, as we prefer to think of it – began in June 2022 with a cap of $30 billion per month for Treasuries, and $17.5 billion for MBS. Starting in September 2022 the caps were doubled to $60 billion and $35 billion.
- In reality, these caps have behaved more like targets. For Treasuries, there were months when the run-off was below the cap, only to be followed by others in which it was above. Cumulatively, $1.23 trillion in Treasuries has run off, versus the target of $1.29 trillion (please see the chart on the previous page). For MBS, maturities have been nil, and pre-pays have been sluggish, with the cap undershot literally every month. Cumulatively, $323 million in MBS has run off, versus the target of $753 million.
- As possible, proceeds from MBS pre-pays or maturities will be reinvested in Treasuries – steps down the long road to a traditional Treasuries-only portfolio for the Fed.
- *Powell made no suggestion that MBS would be sold outright.*

How does any of this matter for growth prospects?

- As to rate cut expectations, *the 1.8 cuts discounted in the futures curve as of this writing is even more hawkish than the curve structure at the previous nadir of expectations, October 18, 2023, when 2.2 cuts were discounted* (please see the chart on the following page). And it's a far cry from the dovish expectations that climaxed on December 22, right after Fed Chair Jay Powell's supposed dovish "pivot" at the December FOMC (see "On the December FOMC" December 13, 2023) – then 7 cuts were expected.
- *But astonishingly, the US equity market is up 17.6% on a total return basis since the prior max hawk in October*, even though expectations are more hawkish now. More astonishingly, *stocks are up 10.6% since max dove in December*. And it hasn't just been the Magnificent Seven, or even just the S&P 500. It's a broad vote for improving growth prospects, even as hopes for rate cuts that are generally seen as stimulative have evaporated.

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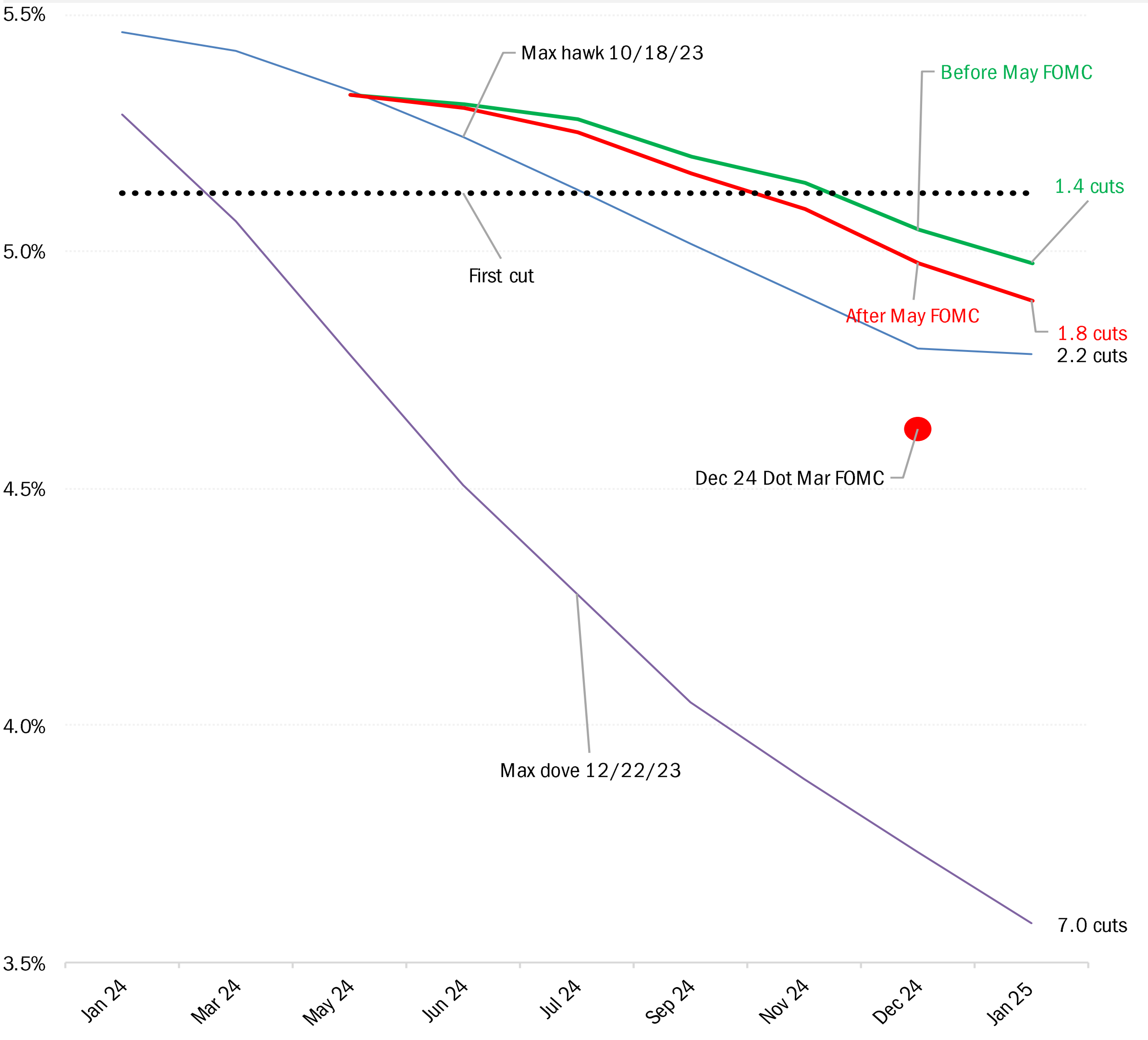
Futures-implied funds rate, by FOMC meeting, before and after today's FOMC meeting



Source: Bloomberg, TrendMacro calculations

- *This is what we've been saying for months – it doesn't matter very much when the Fed cuts rates, because the present funds rate is nowhere near as restrictive as Powell and other Fed officials say* (see ["Video: What you're not hearing about why it doesn't matter when the Fed cuts rates"](#) February 26, 2024). *It seems clear that the evidence shows the neutral rate in the post-pandemic productivity-led boom to be much higher than we've been conditioned to expect in the post-GFC era of "secular stagnation."*
- As to the deceleration of balance sheet run-off, *in an important sense that, too, doesn't really matter that much* – at least not in reality, while we acknowledge it might weigh importantly in sentiment. *Central bank asset purchases in times of emergency are a maturity transformation that de-risks the banking system when risk is critical. Unwinding those purchases in normal times restores risk to the banking system, but at a time when risk isn't especially important.*

- *We think QE is easing. But we don't think QT is tightening.*

Bottom line

Higher inflation in Q1 is characterized as "lack of further progress," not "acceleration." Markets were already braced for fewer than two rate cuts this year, and this language rules out any rate hikes. As hinted, the deceleration of run-off of balance sheet assets was announced, with onset in June. The cap for run-off of Treasuries will be lowered from $60 billion to $25 billion per month. The new cap is lower than we expected – the closest thing to a bullish surprise from this meeting – even lower than the $30 billion cap when QT began. The $35 billion cap for MBS remains in place, but since onset it has never even been close to binding. Stocks are higher than they were in December when seven cuts were expected, now with fewer than two. Markets see the neutral rate is higher than previously thought, so the Fed is not excessively tight. Deceleration of QT is good for sentiment, but in reality QT isn't really tightening.