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Fed Thoughts: Playing with Blocks

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Establishing a call on the monetary policy of the Federal Reserve (Fed) is akin to playing an extended game of Jenga, the tower-building enterprise. Procedural precedent, previous official statements, the economic outlook and financial market prices form a precarious edifice, arising to a forecast of the policy rate at the top. World events, data releases and Fed speak pull out one block at a time from below and the structure wobbles.

Sometimes it falls.

As of this writing, we think that ours most likely will come down in a heap. We thought that the Federal Open Market Committee (FOMC) would use its upcoming meeting on April 30th to May 1st to set up the onset of easing in June. This was shaped by our sense of the Fed's management of two sets of risks.

The familiar one is about the outlook. Our view is that aggregate economic activity retains momentum and resources are already stretched. The easy wins in disinflation are behind us given the healing of pandemic dislocations, recent disruptions to infrastructure and the reigniting of global tensions. Financial conditions, which are easier than when firming commenced, continue to support spending as investors front run the eventual pivot in policy.

The risk of them going too slow and letting the economy weaken seems low given that employment retains momentum and financial conditions support spending. Moving quickly and seeing disinflation stall out is a more considerable problem given recent disappointing consumer price prints. If the Fed is behind the curve with accommodation, markets would price aggressive easing with each weak data point, similar in manner to when the Fed was slow on the uptake in 2022. A premature turn would likely feed an abrupt swing in financial markets and sow doubts about the Fed's commitment to its price-stability goal.

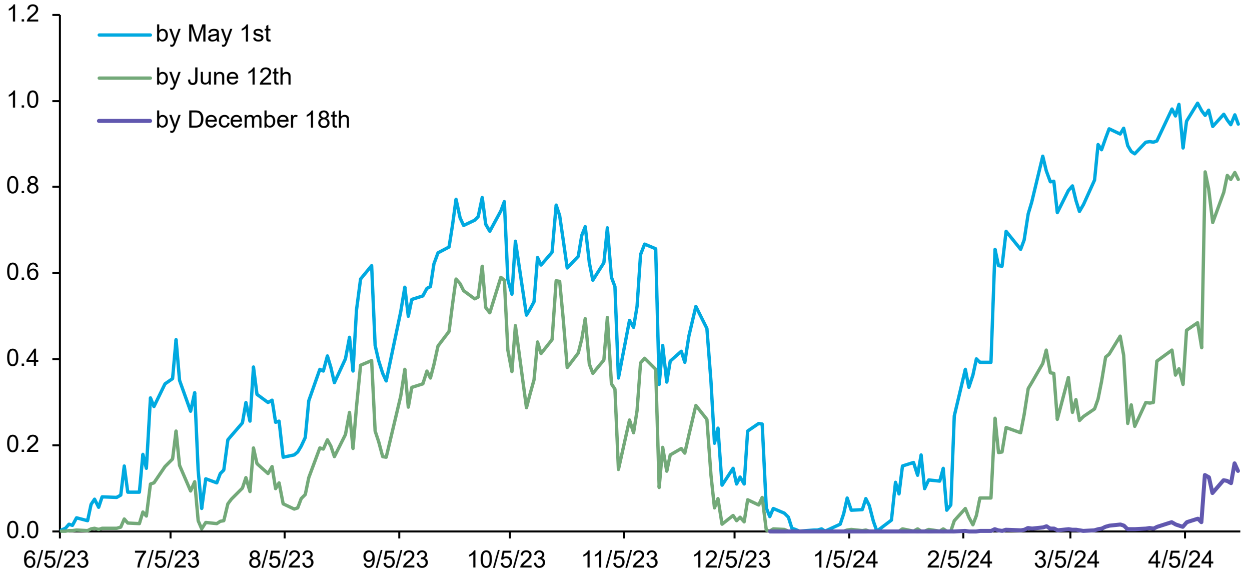
This traditional balancing of risks favors slow-walking accommodation, as it is less costly and an easier mistake to rectify than easing too soon. Indeed, this logic argues for delaying action until the fall.

A second risk consideration intrudes because this year is evenly divisible by four. Almost all observers would agree that the presidential campaign will be toxic. The closer a monetary policy action is to the election, the more likely it will be judged in terms of which candidate benefits. Our view is that the Fed—being politic, not partisan—prudently prefers a relatively calm corner of the calendar to grab headlines starting an easing spell so as not to confuse the public about its intent. The least-worst option to slip action into the political current would therefore be the FOMC meeting on June 11th to 12th.

Some of the blocks pulled out from our tower since the last FOMC meeting were inconsequential. Hating surprises, the Fed has historically leaned into future action with its words at the prior one. They didn't in the statement in March, the subsequently published minutes of that meeting, or any public comment from officialdom. Indeed, consistent Fed communication has kept market expectation of action in May lifeless for longer than Liz Truss was prime minister of Great Britain (as in the top line of the chart on the following page). We are confident, then, that the meeting will come and go with the lower bound of the target rate set at 5¼ percent.

Probability of the Policy Rate (lower bound)

At or above the 5¼ percent rate, in percentages



Source: CME, FedWatch Tool, accessed 4/14/2024.

As the intermeeting period rolled on, payroll gains in March—at 303,000 workers on net—blew past expectations, and there were no asterisks attached in the details to cast doubt on the vigor of economic expansion. Chair Powell, however, had already pre-emptively inoculated us against the result, asserting in his March press conference that "…in and of itself, strong job growth is not a reason, you know, for us to be concerned about inflation." We knew, and that block slipped out without shaking the edifice of our expectations.

The release of consumer prices for March, however, was seismic for the structure. Monthly headline and core inflation, both at 0.4 percent, exceeded market expectations, energy prices continued to run hot and service prices moved stubbornly higher. The translation of the price data to the Fed's preferred price index for personal consumption expenditure may yet temper the bad news, but that's the thing with feathers. The Chair didn't offer much hope on that score in his last remarks before the blackout curtain on Fed talk dropped. Markets got that message, and the probability the funds rate holds steady through June climbed, but not to near certainty (the green line in the chart).

If our hopes took flight for a time, we suspect Chair Powell had gained more altitude. After all, his comments before the March consumer price release consistently leaned into a June action, and he's likely most attuned among the FOMC of reputational risks in the neighborhood of November. Thus, he'll probably emphasize the sunny side of data in coming months and may work to put an earlier move back on the table.

While the blocks are not completely in disarray as a non-zero weight remains on action in June, that's not the way to bet. ***Absent a surprising turn of events on the world stage or sudden and unlikely news from economic data, we think that the FOMC will take a pass in June. This implies that there will be no new guidance on rates in May. We stick, however, to the logic of our call that the election calendar matters and that the funds rate is at the top of this policy cycle.***

The FOMC's central task is to realign the nominal federal funds rate lower to the prevailing lower rate of inflation to sustain economic expansion while bringing inflation more assuredly into the zone of price stability. As opposed to most prior easing cycles, the Fed is directing the path of the short rate, not forced by the data, and has discretion as to the timing. Because easing is a plan rather than a response to weak data, and, as long as market participants are convinced of the general direction of policy, the exact date of action isn't that important—provided it is delivered in the promised window. The real fed funds rate, at 2⅞ percent, is well above all FOMC participants' assessments of its neutral level. They should all be willing to ease a bit if they can also signal through the Summary of Economic Projections (SEP) about how long the real rate will stay firm.

We think that a revised view of the macro risks will lead the Fed to commence easing in December. Indeed, even if the data could justify action sooner and absent a surprising turn of events, once past the June meeting, the next safe harbor on the political calendar is the last one of the year. That meeting offers the FOMC the opportunity to shape rate guidance with the SEP, which will be one-and-done for 2024.

There's another topic on the agenda for the upcoming FOMC meeting. Since the inception of Quantitative Tightening in June 2022, $90 billion monthly net redemptions of securities have pared $1½ trillion from the Fed's balance sheet. Fed officials don't put much stock in economic or market effects of its holdings of assets, aside from in its announcement of the program. Fed officials are much more focused on the liabilities, reserves, that keep the target rate in its declared range. The runoff in assets has been matched by a decline in overnight repurchase agreements, providing them the assurance that reserves remain well north of ample. That's why the tapering of quantitative tightening (QT) is on a slow train. Staff provided a study of alternative strategies at the March meeting. According to the minutes from that meeting, "participants broadly assessed it would be appropriate to take a cautious approach to further runoff. The vast majority of participants thus judged it would be prudent to begin slowing the pace of runoff fairly soon."

FOMC participants "…generally favored reducing the monthly pace of runoff by roughly half from the recent overall pace. With redemptions of agency debt and agency mortgage-backed securities (MBS) expected to continue to run well below the current monthly cap, participants saw little need to adjust this cap." ***We believe that the FOMC will announce the change at its May meeting, most likely to start then or, at the latest, in June.*** A month here or there doesn't matter for the footprint of the Fed on the national economy, which remains huge.

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Vincent is the firm's Chief Economist and Macro Strategist. In this role, he is responsible for developing views on the global economy and making relative value recommendations across global bond markets, currencies and sectors.

Previously, Vincent served as the Chief US Economist and a managing director at Morgan Stanley. For the prior four years, he was a resident scholar at the American Enterprise Institute (AEI). Vincent also spent 24 years at the Federal Reserve, holding several roles including Director of the Division of Monetary Affairs and Secretary and Economist of the Federal Open Market Committee (FOMC). His responsibilities at the Federal Reserve included directing research and analysis of monetary policy strategies and the conduct of policy through open market operations, discount window lending and reserve requirements. Prior to these roles, he was the principal liaison with the domestic desk at the Federal Reserve Bank of New York and was responsible for preparing a document outlining policy alternatives for each FOMC meeting. He was Deputy Director in the Division of International Finance and Associate Economist of the FOMC and spent five years at the Federal Reserve Bank of New York in both the domestic and international research departments.

His academic publications primarily concern the conduct of policy and issues related to the monetary transmission mechanism as well as an analysis of alternative auction techniques and Treasury debt management. After an undergraduate training at Fordham University, he received graduate degrees in economics at Columbia University.

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