Scotiabank

GLOBAL ECONOMICS

SCOTIA FLASH

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Contributors

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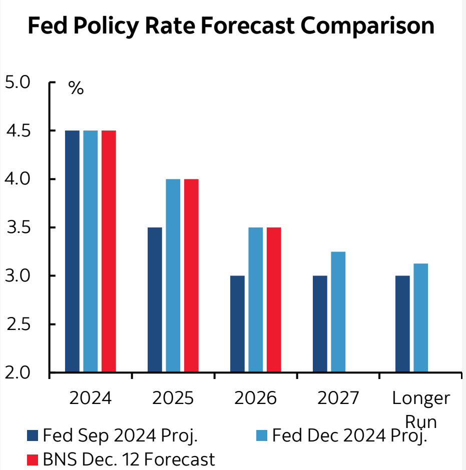
Chart 1



Sources: Scotiabank Economics, Federal Reserve Summary of Economic Proj. (Dec. 18, 2024).

The FOMC's Hawkish Cut Slams Risk Appetite

- **The Fed followed the BoC…**
- **…as it delivered a hawkish 25bps policy rate cut…**
- **…while guiding fewer projected cuts than previously**
- **Powell pinned this partly on recent data…**
- **…and on partially incorporating the incoming administration's policies**
- **Stocks tumbled, bond yields soared, USD strengthened**
- **Central banks and markets were simply getting ahead of themselves**

The FOMC took a page from what its northern neighbour did last week and delivered a hawkish 25bps cut. Birds of a feather I say, as clearly central banks in this neck of the woods are getting a little more nervous about multiple uncertainties like the tone of data and the risks surrounding the incoming US administration.

The effects drove higher market-driven borrowing costs, a stronger dollar and a sharp drop in stocks. CAD, for example, depreciated by over a penny to the USD and stands at 1.4447 on a USDCAD basis (69.2 cents US). The US 2-year Treasury yield moved up about 13bps and so did the 10-year yield. Markets trimmed pricing for cumulative rate cuts next year by about 15bps to a year-end 2025 level of 4%. Markets are pricing no move at the January 29th meeting and less than half of a quarter point cut at the March meeting. Bitcoin fell by over 3% post-Fed. The S&P500 fell by 3½% following the communications. The TSX fell by 2¼% and is down 4½% since the BoC meeting last week and the intensification of Canadian political risk. Watch for more bleeding across Asian equities in the overnight session. Equities were priced for perfection on policy easing.

STATEMENT CHANGES

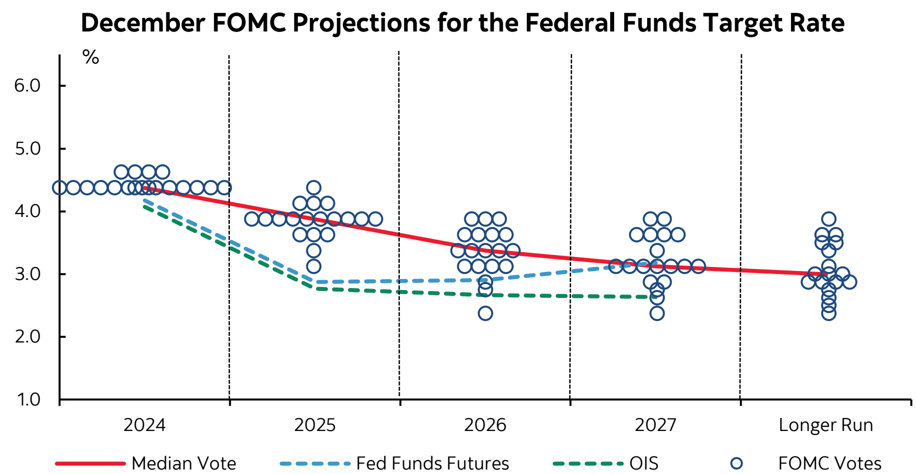
There were only two notable changes to the statement compared to the prior one as flagged in the statement comparison at the back of this publication.

Key is that language around forward guidance shifted. They now say:

"In considering the extent and timing of additional adjustments to the target range for the federal funds rate…."

Instead of:

Chart 2



Note: OIS & Fed Fund Futures as of Dec, 18, 2024.
Sources: Scotiabank Economics, US Federal Reserve.

"In considering additional adjustments to the target range for the federal funds rate…."

This is material in that it injects fresh uncertainty into how much further the Committee thinks they will be cutting, and how over time.

The second change was the introduction of a dissenting voice. Cleveland's Hammack preferred to hold at this meeting.

A MORE HAWKISH DOT PLOT

First, picking up on the last point is the observation that there were actually four dots that preferred a hold today, yet only one voting dissenter. That probably says that the other three Committee members are regional Presidents who aren't in this year's voting line-up but some of them may be when that changes in January.

In teeing up the subsequent points, charts 1 and 2 show the new dot plot of Committee rate projection and compared to our forecasts for the policy rate.

Second, the Committee's rate projections point to about 50bps less easing next year than the prior projections in September such that the year-end 2025 Fed funds target rate is now expected to end at 4% with a 3.875% range mid-point.

Third, note the strong coalescing of opinions around where the policy rate will end 2025. For a Chair who said the word 'uncertainty' over and over in the presser, this seems like a somewhat more certain committee than he let on! 10 participants (one more than half) are in the –50bps more cutting camp for the year, 3 want 75bps, 1 wants 100bps, 1 wants 125, while 3 wants only a quarter point and 1 wants no further easing,

Fourth, the Committee also carried through this bias toward less easing into subsequent years. They now see another 50bps of easing in 2026 ending at 3.5% (3.375% mid-point) which is up from 3% previously (2.875% mid-point). The 2027 projection was raised a quarter point to show another 25bps of easing that year, ending at 3.25% (3.125% mid-point).

Chart 3

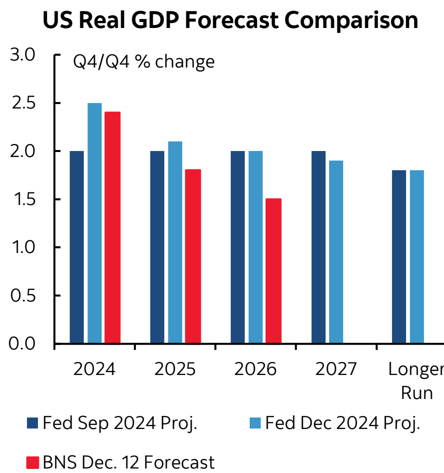


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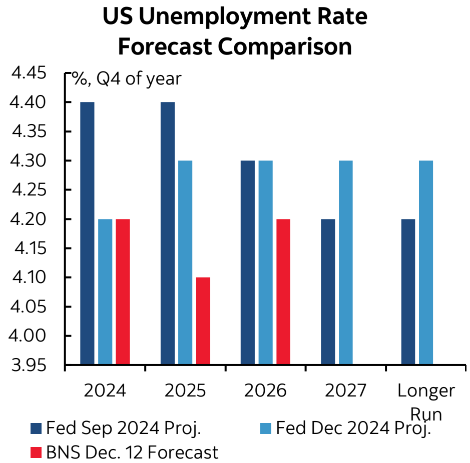
Chart 4



Sources: Scotiabank Economics, Federal Reserve Summary of Economic Proj. (Dec. 18, 2024).

Chart 5

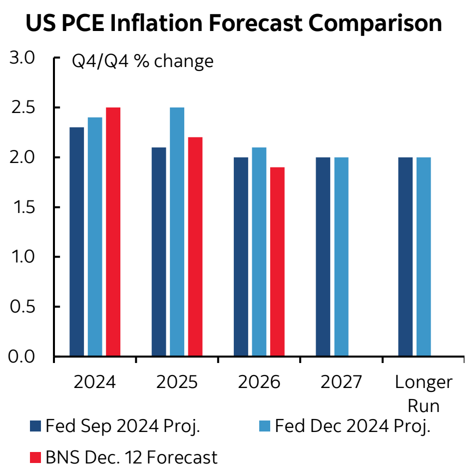


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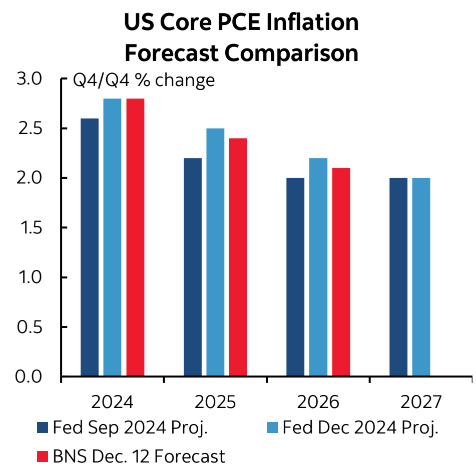
Chart 6



Sources: Scotiabank Economics, Federal Reserve Summary of Economic Proj. (Dec. 18, 2024).

Fifth, the Committee also slightly raised the long-run neutral policy rate to 3% even but on this measure there is a wide dispersion of opinions ranging from about 2.5% to 4%.

FORECAST CHANGES

Charts 3–6 show the forecast changes and compared them to the recent Scotiabank Economics projections. The Committee revised up GDP growth this year to 2.5% Q4/Q4, but his is mostly a marking to market exercise that shops like ours had already done. The projection for next year was revised up a tick to 2.1% and is slightly faster than ours. The growth projection for 2025 was left unchanged at 2% and 2027 was revised down a tick to 1.9%. There was a quite wide dispersion of views around the 2025 GDP projection.

Inflation forecasts were marked up this year in what is largely a marking to market exercise where the FOMC lags the street. Next year's headline and core PCE inflation forecasts were revised up by several tenths to 2.5% Q4/Q4.

The unemployment rate forecast was revised down for this year to 4.2% as a Q4 average which is a marking to market revision. Next year's UR was revised down a tick to 4.3%, the following year is left unchanged at 4.3%, 2027 was revised up a tick.

What I find curious is why the Committee bothered to slightly raise the long-run neutral rate without changing any other long-run forecasts. They still see potential growth at 1.8%, long-run inflation at 2% and the long-run UR at 4.2%. I would treat the uptick in neutral as a data quirk in calculating the slight change in the median without much of a supporting forecast narrative.

O/N RPP SPREAD CHANGED

The overnight reverse repo rate was cut by 30bps, 5bps more than the fed funds cut such that the o/n RRP rate now sits on the bottom of the fed funds target range of 4.25–5.5%.

Only a minority of Committee members (though probably the savvier market ones) said in the November minutes that this would occur at a "future meeting" and yet here we are. Most forecasters expected this to occur in January or later. Powell rightly explained this is just a technical adjustment that restores the spread to where it used to be and does not signal anything in terms of the conduct of monetary policy.

MY TAKE

Before getting into the press conference banter I'll share my take on why the FOMC pivoted today. I think all of this is conforming to my narrative that central bank easing was getting far too ahead of itself and so were markets. Data is showing more resilient pressures against central bank policy goals and the incoming US administration poses high risk to the outlook that is making central bankers—and markets—considerably more nervous.

Like the BoC, the FOMC jumped the gun in its judgement that dual mandate pressures were sustainably subsiding in support of an aggressive amount of easing in a short period of time. What both central banks are seeing is that inflation and a generally resilient job market are more persistent.

Chair Powell is correct to flag recent data as a reason to be more careful going forward, though in fairness I think he overreacted in September so that's more about him than data imo. Had he stuck by what he said about looking at full-year inflation data when he spoke in July about SA distortions then he wouldn't have been fooled by a temporary soft patch. But on incorporating potential policy shifts by the incoming US administration, his answers were one part reasonable, one part highly political.

But when probed about incorporating potential policy shifts by the incoming US administration, I thought Powell's responses were one part reasonable, one part highly political. Maybe they have to be given the mixed role. The difference between the FOMC's projections and perhaps more reasonable ones that make a greater attempt at incorporating potential policy changes by the incoming administration may shine through a little more clearly when we see what the Fed staff are willing to incorporate in their projections we get with the FOMC minutes to this meeting in three weeks, versus what Powell & Co did. Staff may go further as they've done in the past.

PRESS CONFERENCE Q&A

What follows is an attempt to provide a rough transcript of key parts of the press conference.

Q1. Why do officials think it's appropriate to cut at all in 2025 if inflation is expected to be resilient? Can you comment on timing including January, whether a cut or a pause?

A1. Let me start with today. I would say today was a closer call. We see the risks as two-sided. On balance we decided to go ahead with a further cut. The labour market is rebalancing and cooling further and we don't think we need further cooling to achieve 2% inflation. The job fill rate is cooling and so are other measures. Inflation is still broadly on track. We've made a good deal of progress. The slower pace for 2025 reflects the expectation that inflation will be higher and so will uncertainty around inflation. Nonetheless we think we are still on track for further cuts.

Q2. Why would you make those cuts? What would be the trigger?

A2. We're significantly closer to neutral but believe policy is still meaningfully restrictive. As long as the economy and labour market are solid we can be cautious toward further cuts.

Q3. This seems similar to the tighter policy in anticipation of the fiscal policy stance seen evolving ahead of the 2016 election. How much of this was accounting for inflation data to date versus expected policy adjustments and their impact on inflation?

A3. The slower rate cut path is being driven by stronger growth in 2024H2 and is expected to remain above our prior expectations. Unemployment is lower. Inflation is higher. We're also closer to the neutral rate which is another reason to be cautious toward further moves. Uncertainty around inflation is also higher. Some people did take a very preliminary step and start to incorporate highly conditional effects of policy changes in their forecasts. Some people said they didn't do so. Some people didn't say. But some did identify policy uncertainty as a reason for more uncertainty around inflation. When the path is more uncertain you go a bit slower.

Q4. The measures of inflation uncertainty have jumped and the only thing that has changed is Nov 5th. Is it fair to say this is driving things?

A4. Actually that's not the only thing. Inflation recently has been higher of late. That might be the single biggest factor.

Q5. In September 2018 the Fed staff argued to look through tariffs as long as inflation expectations were anchored and a one-off. Can you comment?

A5. I do think that's a good stating point to go back to the six-year old teal book. There were two simulations, one was seeing through and one was not. They named some conditions that could make it appropriate to see through and some that may not. In any case that's not what we're facing now. We're looking at the pathway through which tariffs can affect inflation. It puts us in a good position when we do see the actual policies to make an appropriate policy response.

Q6. Does recent inflation date mean you have to respond more quickly to inflation threats like tariffs than in prior years?

A6. There are many factors that can go into determining how tariffs can impact inflation. We don't know the policies. It's very premature to conclude. We don't know what tariffs, for how long, how broadly, whether there will be retaliation, and what pass throughs into inflation may occur. There are differences now than the last stress scenarios in 2018. We need to take our time and not rush but only when we see the actual policies and how they are implemented.

Q7. what would compel the Committee to be cutting given core inflation only falls to 2.5 next year?

A7. 2 1/2 would be further progress. That would be a little better than this year that would be 2.8 or 2.9. We also have to think about the labour market. It is still very gradually cooling in an orderly gradual way.

Q8. Someone could say this could be the last rate cut for some time. Would they be mistaken?

A8. That's not any decision we made at all. The "extent and timing" comment speaks to being closer to neutral while timing just suggests we are at a place where we can slow the pace of adjustments. We'll have a much clearer picture when we see the policy changes.

Q9. Mortgage loans, auto loan rates etc haven't changed much this year. Are the markets fighting against you and you may be at greater risk of a slowdown than you anticipate?

A9. Longer-run rates have gone up since September and are affected by other things than Fed rate policy. The outlook is pretty bright for our economy. It continues to outperform expectations. [ed. when he says job creation is below break-even rates, where he could be dead wrong would be if our assumed population shrinkage reduces the break-even rate by slowing the pace of growth in the labour force. Trump's immigration policy is assumed to start to hit in 2025H2.] We still think we're on a path to get down to 2% inflation and I'm reasonably confident.

Q10. The UR is near the concerns in the summer before you cut 50bps. Now the Committee feels comfortable skipping. What changed? Is there less concern, or more upside risk to inflation?

A10. The UR is now the same as it was in July. Job creation is lower than it has been, but it has been steady but below the level that would hold the UR constant but is not so far below. You'd get a tenth to the UR every other month if we're right on the break-even rate [ed. again, wait until migrants start being shown the door….].

Q11. I did not hear you use the word recalibration today. Is that phase over? Is the criteria for changing rates higher or lower than before?

A11. We are in a new phase in the process. That's because we reduced our policy rate but it is meaningfully restrictive and it is appropriate to more cautiously.

Q12. Are you or the Committee looking through some of the inflation? Cars due to hurricanes, eggs due to avian flu etc.

A12. We always have to be careful about throwing out the numbers we don't like. We try to look not just at 2 or three months of data. We have a long string of data showing inflation coming down. It's way better than where we were but we still have some work to do.

Q13. Is the Committee comfortable with where financial conditions are? Or could they undermine your goals?

A13. A lot of things move financial conditions around but we see the effects we're hoping to see on the goal variables.

Q14. Do you see any virtue to building a bitcoin reserve?

A14. We're not allowed to hold it and we are not looking to a law change.

Q15. Why is inflation proving to be more stubborn than you expected?

A15. It has been a little more recession. Many folks were saying you would need a high UR and recession to get inflation down to where it is. That has not happened. One reason it hasn't come down is a technical issue around how we calculate housing services and how market rents show up. People now are feeling the effect of high prices, not high inflation. [ed. It's sticky in part because the US is in excess aggregate demand with a positive output gap and expected about to add more stimulus.]

Q16. What is the biggest challenge to the economy next year for the administration?

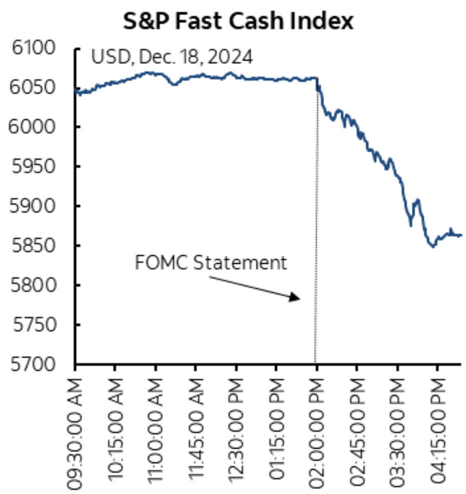
A16. I expect another good year next year.

Q17. Can you rule out a rate hike next year?

A17. You don't rule things out in this environment but it's unlikely.

Finally, here is a collection of the intraday market charts.

Chart 7



Sources: Scotiabank Economics, Bloomberg.

Chart 8

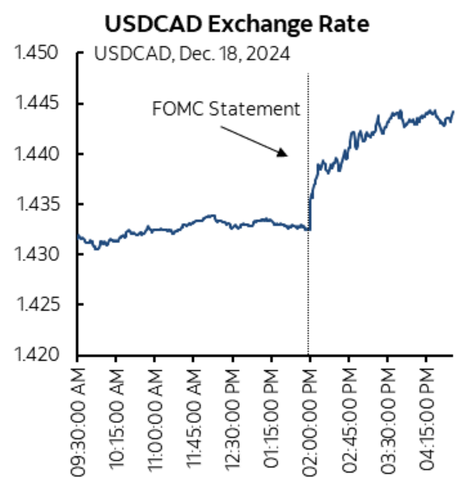


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Chart 9

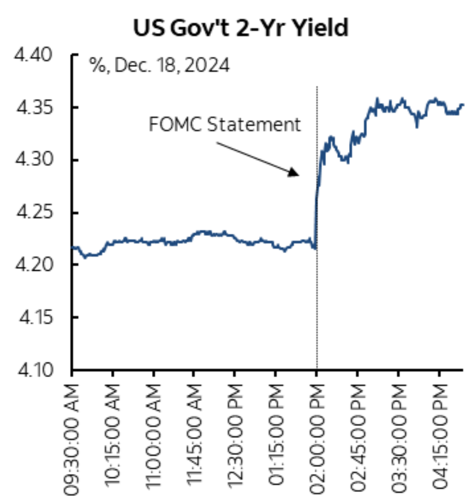

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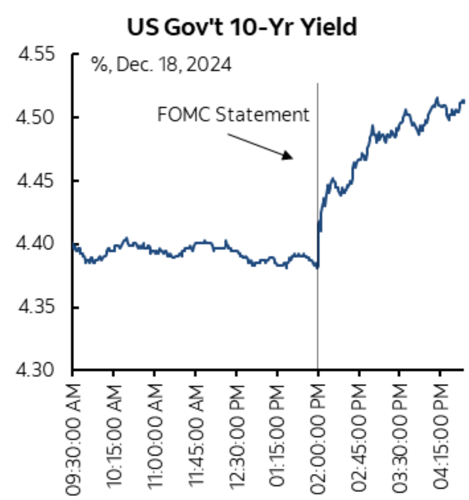
Chart 10



Sources: Scotiabank Economics, Bloomberg.

RELEASE DATE: December 18, 2024

Recent indicators suggest that economic activity has continued to expand at a solid pace. Since earlier in the year, labor market conditions have generally eased, and the unemployment rate has moved up but remains low. Inflation has made progress toward the Committee's 2 percent objective but remains somewhat elevated.

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 roughly in balance. The economic outlook is uncertain, and the Committee is attentive to the risks to both sides of its dual mandate.

In support of its goals, the Committee decided to lower the target range for the federal funds rate by 1/4 percentage point to 4-1/4 to 4-1/2 percent. ***In considering the extent and timing of additional 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 will continue reducing its holdings of Treasury securities and agency debt and agency mortgage-backed securities. The Committee is strongly committed to supporting maximum employment and 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; Mary C. Daly; Philip N. Jefferson; Adriana D. Kugler; and Christopher J. Waller. ***Voting against the action was Beth M. Hammack, who preferred to maintain the target range for the federal funds rate at 4-1/2 to 4-3/4 percent***

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