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SHORT THOUGHTS

December 17, 2024

FOMC Preview – Last Cut for a While

More cautious tone, less aggressive dots, RRP rate cut

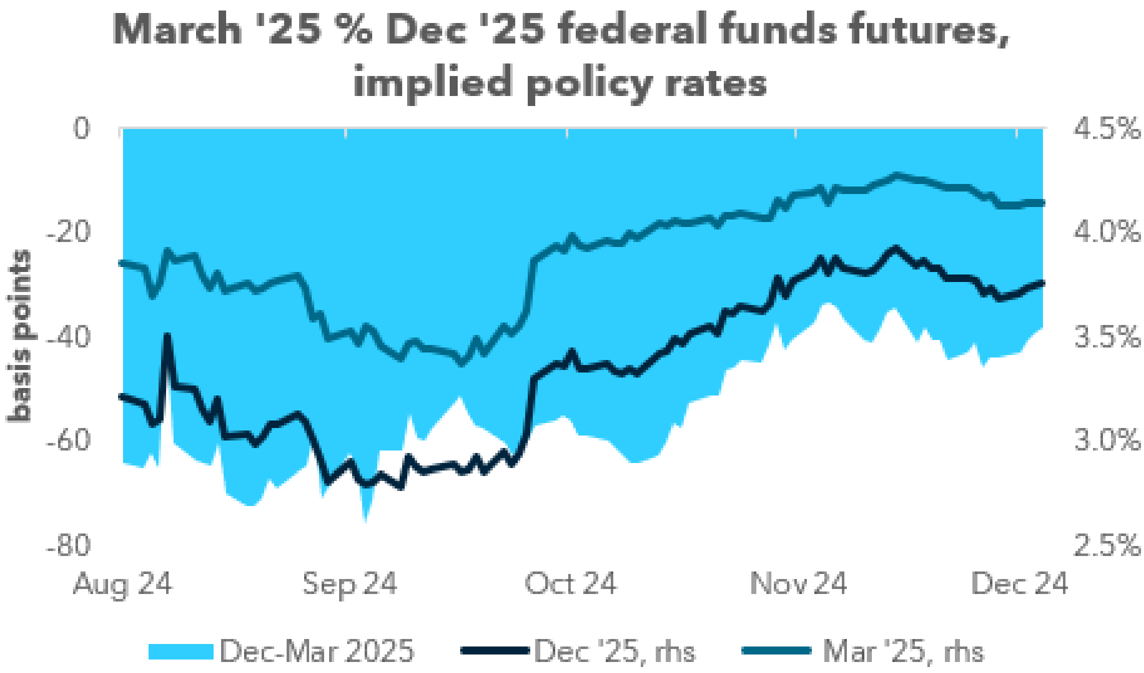
- 25bp cut on Wednesday; Powell will sound cautious on outlook, as will dots
- Inflation progress has stalled; upcoming policy shocks still uncertain
- We also expect the RRP rate to be lowered to the bottom of fed funds target band

We expect the Federal Open Market Committee to lower the federal funds rate by 25bp on Wednesday this week. This is likely to be the last cut for while – if not for good, as the inflation and economic policy outlook are both murky going into 2025. We don't think the Fed will see things differently – and we expect Chair Powell to sound a very cautious note alongside the announcement. We also expect the rate on reverse repos (RRP) to be lowered by 30bp, bringing it in line with the lower bound of the fed funds rate target band, or 4.25%.

Given the uncertainties ahead, the Summary of Economic Projections (SEP) due alongside the rate announcement will likely reflect wide differences of opinion on the FOMC. Nevertheless, we do expect them to indicate a much slower pace of easing in 2025 than we saw in the last set of dots, back in September, when the Fed kicked off the easing cycle with a 50bp cut. At that time, the median dot for the end of 2025 indicated 100bp of rate cuts. We think that will fall to 50bp or even less with the December release of the SEP.

Market expectations for 2025 have made a steady and notable reversal since that September 18 FOMC meeting. Exhibit #1 plots the evolution of the implied federal funds rate from the OIS market since the beginning of August. We show the March and December 2025 contracts, as well as the spread between them. The December contract, on September 19, a day after the meeting, showed a market expectation that rates would be well below 3% by the end of next year. The March contract implied a rate below 3.5%, which was remarkable considering rates were lowered to 5% on the 18th. 150bp by March was an aggressively dovish expectation.

Exhibit #1: Less Dovish Market Pricing

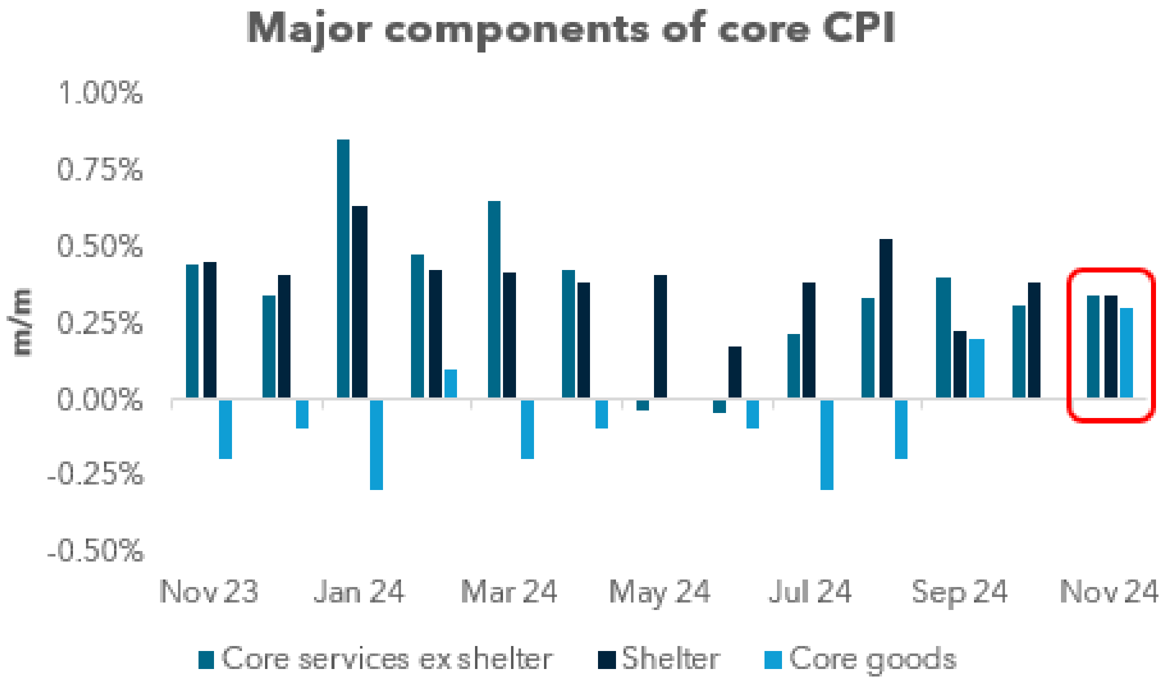


Source: BNY Markets, Bloomberg

The current inflation picture is less encouraging than it was back in late summer this year. Recent CPI and PCE prints have indicated steady inflation, with little improvement in the main drivers of core inflation. Exhibit #2 shows these main components of core CPI, indicated in the legend of the graph. All three drivers have been rising in recent months. Shelter inflation remains stubborn, and core services ex shelter have begun to pick up again. Even core goods inflation has started to rise after months of disinflation or even mild deflation. Nevertheless, the implications from the most recent CPI and PPI prints indicate a better picture for the November PCE inflation figure, due to be released well after the FOMC, likely allowing the Fed to execute this final cut of the year.

We had been in agreement with the September dots indicating 100bp of cuts next year, however, we're changing our view to just two 25bp cuts, both relatively early in the year – say, March and June. This reflects both the stalled inflation picture as well as the implementation of policies that are likely to be inflationary.

Exhibit #2: Inflation Progress Stalling



Source: BNY Markets, Bureau of Labor Statistics

As we mentioned above, in addition to lowering the range for the federal funds rate from 4.5%-4.75% to 4.25%-4.5%, we also expect the rate on the Fed's RRP facility to be lowered from 4.55% to 4.25%. This would represent a 30bp move in this administered rate. Since 2021, it has sat 5bp above the lower bound of the fed funds target range, and this move would bring it equal to the very lower limit of that range.

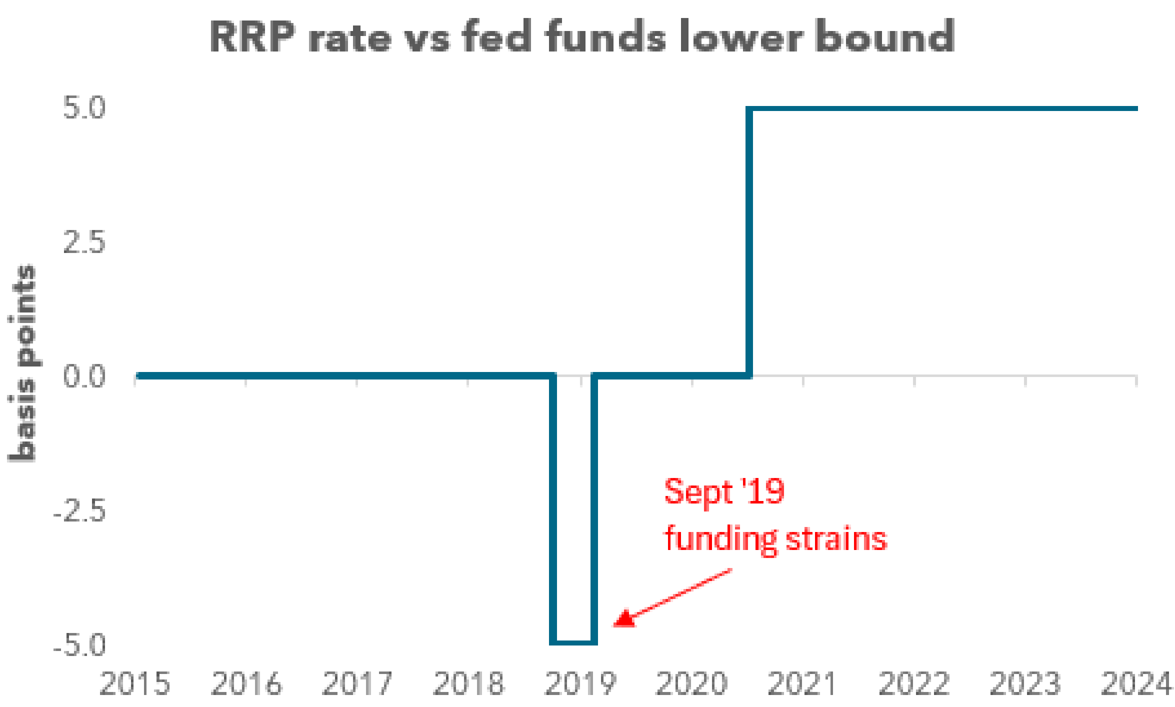
Such a move would reset the RRP rate to where it was until 2021, when it was raised in relation to the lower bound for the first time. There was a glut of cash in the system then, a result of quantitative easing as well as financial market conditions at the time. The move to effectively "raise" the rate was aimed at providing money market mutual funds (MMFs) with an alternative short-term risk-free investment to park this glut of cash. By early 2023, the RRP was drawing over $2trn per day. Of course, before that, in the autumn of 2019, the funding market experienced significant strain, and the Fed temporarily dropped the RRP rate to below the fed funds target band – aiming to incentivize cash to move into repo markets and to lower funding rates during that episode.

There is no need to mop up extra cash any more with RRP balances well below $200bn at present. Moreover, funding markets have seen episodes of stress, with rates elevated and volatile. Going into quarter- and year-end we expect more strain. As we have written about (see here, for example), we think that the Fed sees these more volatile funding market conditions as a symptom of "frictions" in repo markets, rather than scarcity of liquidity.

We tend to agree, and considering reserves are still abundant at approximately $3.2trn, we think that markets are reflecting significant balance sheet constraints by dealer banks. So, lowering RRP might help lower rates across the short-term markets. This is certainly what the Fed thinks, as we documented in a recent note. With RRP balances now so low, however, it's unlikely that moving cash out of RRP into funding markets will increase liquidity significantly.

Still, there is no longer any need to offer such a high rate for RRP. The stated purpose of RRP is to prevent the effective federal funds rate from falling below the bottom of the target band, for it were to do so, higher RRP rates would draw cash to that facility, reducing the incentive to lend at a lower-than-target federal funds rate, bringing that rate back up to the target band.

Exhibit #3: RRP Back to Bottom of Band



Source: BNY Markets, Bureau of Labor Statistics

Please direct questions or comments to: iFlow@bny.com

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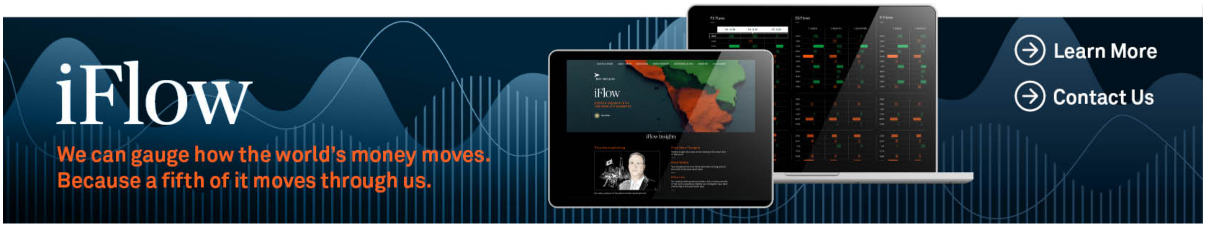
John Velis
AMERICAS MACRO STRATEGIST
CONTACT JOHN



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