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# Research US

## Fed preview: Near-term bloom, long-term gloom?

- **We expect the Fed to remain on hold in the November meeting, in line with consensus and market pricing. As financial conditions have tightened significantly, we doubt the Fed will opt for hikes at a later stage either.**
- **Rise in term premium suggests higher yields are driven by other factors than the Fed's forward guidance, which could spark more cautious tone from Powell.**

**With market fully priced for an unchanged rate decision and no updated economic projections, all eyes will be on Powell's forward guidance**. Over the past weeks, increasing number of FOMC participants (incl. Powell) underscored that the recent tightening in financial conditions reduces the pressure to continue hiking the policy rate and that the Fed has more room to continue monitoring the lagged effects of past tightening.

**And we would agree**, even if the recent macro data releases on labour market, private consumption and consumer inflation expectations have inarguably been much stronger than we have anticipated. Our in-house 'growth tax' model of financial conditions (6M change in short rates, mortage rates, equities, credit spreads, USD and oil) has shown a level of tightening only seen in 2022 and during the GFC over past 20 years.

Recently, the tightening has increasingly been driven by higher term premium. Irrespective of the driver (whether it is debt sustainability worries, uptick in UST supply, lower foreign demand, QT or something else), the rise seems uncorrelated with the latest Fed guidance. The fact that the Fed is no longer fully in control of financial conditions **could tilt Powell to take a more cautious stance**, even if he is unlikely to outright push against the move.

**Tight financial conditions are clearly restricting credit growth**, as new mortgage applications have hit a 28-year low and bank lending growth has stalled significantly this year. This will be reflected in the next round of SLOOS data as well, which will be available for the Fed ahead of the meeting, and is due for public release 6th of November. That said, both effective interest rate on outstanding mortgage stock and corporate net interest costs suggest that **tight monetary policy is not yet markedly affecting household disposable income or corporate profits**. This does not mean that monetary policy transmission is not working, but helps explain resilience in private consumption and labour markets.

Simply put, the transmission lags might just be longer than in the past, but **as yields rise higher above the neutral rate, the risk of hard landing increases down the line.**

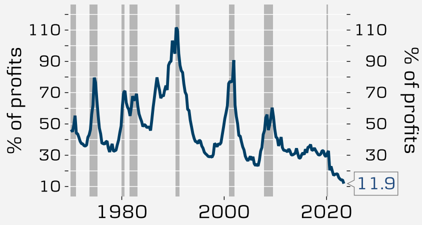
**QT is set to provide passive tightening well into 2024**. Since the debt ceiling was lifted in early June, approximately USD 1200bn of liquidity has been drained from the Fed's ON RRP facility. Reduction of Fed's Treasury holdings accounted for USD 270bn, and MBS for USD 90bn. Issuance to refill the Treasury General Account (TGA) drained USD 715bn, with the small negative residual lifting bank reserves. We estimate that a total of around USD 2200bn can still be drained from ON RRP and bank reserves before liquidity falls to uncomfortably low levels. As we do not anticipate the Treasury to rebuild TGA to significantly higher levels, QT can likely run at least until late 2024 with the current average pace of around USD80bn per month, even considering the downside risks to the economy.

### Our Fed call summarized

- The Fed's hiking cycle is over. Quarterly 25bp rate cuts from March 2024, as nominal rates are adjusted to slower inflation.
- QT continues past the first rate cut, likely at least until late 2024

**Corporate net interest costs have not risen like during past tightening cycles**

US, Non-Financial Corporates, Net Interest Costs, % of Net Profit




*Sources: Macrobond, U. S. BEA*

**Our discussion papers on potential drivers of higher US long-end yields**

- Term premium: *Research US - Yields not bound to remain high for long*, 5 October
- Neutral rate: *Research US - Could investment boom pave the way for a soft landing?* 22 August

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## Markets: Cautious tone unlikely to turn the course for long-end yields

**If we are right about the Fed opting for a cautious tone, EUR/USD could rise upon the announcement**, in line with our expectation of near-term topside risk in the cross, as the probability of another hike is likely to decline (currently around 30%). On the longer horizon, we forecast EUR/USD at 1.06/1.03 in 6/12M. The short end of the UST curve will likely react the most to any signs of softening. The long end will probably be less impacted, as a more cautious Fed in the short run could mean an even longer way for policy rates to come down.

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