31 January 2024

Research US

Fed review: In a risk management mode

- **The Fed maintained its monetary policy unchanged, as widely expected. Powell signalled optimism on inflation but pushed back on March cut.**
- **We still stick to our call for a first cut in the next meeting, and will focus on labour supply and leading growth data during the intermeeting period. Phasing out QT will also be discussed more in-depth in March, no new signals today.**
- **EUR/USD price action around the FOMC meeting should be viewed in light of the drop in US rates following renewed concerns about the health of US regional banks. In the end, EUR/USD finished close to the 1.08 level and about flat on the day, we still look for 1.07 in 6M and 1.05 in 12M.**

The Fed remains firmly 'in a risk management mode' as it continues to make progress on both sides of the dual mandate. Powell struck an optimistic tone on inflation, stating that data seen so far has been 'good enough' and that the Fed simply needs to see more similar evidence on disinflation in order to initiate the cutting cycle. There are two-sided risks to starting either too late or too early, but the cuts are ultimately on the way in any case.

We stick to our call for a first cut in March followed by gradual quarterly reductions thereafter, as we think the approach still fits well with the Fed's risk management stance. Market prices in around 35% probability for the March cut.

What would be needed for the Fed to opt for a cut already in the next meeting? Powell continued to emphasize recovering labour supply as a key factor balancing the labour market. The flow of workers from outside the labour force and into employment slowed abruptly in December (Chart 1), and we will see if the tide turned higher again in the Friday's Jobs Report. Powell was confident that housing inflation would continue to slow down as past moderation in rental price growth feeds into the official measures. According to the *NY Fed's Multivariate Core estimate*, sector-specific housing is clearly the most important contributor to underlying inflation, while other factors have already eased markedly, suggesting that further positive news on inflation might be on the way.

We will also closely follow early indicators for growth. The uptick in January Flash PMIs rhymed well with the late-2023 easing in financial conditions, recovery in household real incomes and also Powell's comments on anecdotal evidence. That said, some regional manufacturing indices have flashed downside risks ahead of the ISM release tomorrow.

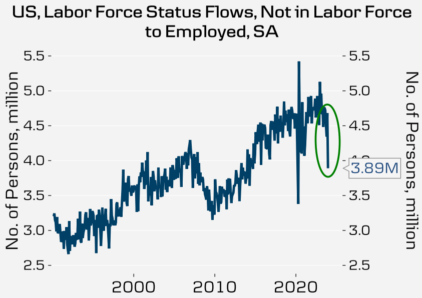
On the balance sheet, Powell gave no concrete signals on the timing of QT endgame, and simply stated that the issue would be discussed more in detail in the next meeting. We still think that QT will likely continue at least until the end of 2024.

EUR/USD price action around the FOMC meeting should be viewed in light of the rally ahead of the meeting triggered by renewed concerns about the health of US regional banks. In the end, EUR/USD finished close to the 1.08 level and about flat on the day as the market and the Fed remain undecided on the prospects of a cut in March. **We keep our forecasts for EUR/USD unchanged at 1.07 on 6M and 1.05 on 12M.**

Our Fed call summarized (no changes)

- 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

Chart 1: Powell emphasized positive recovery in labour supply even if December data was disappointing. Labour market developments will be key to follow for the March meeting.



Sources: Macrobond Financial. The U.S. Bureau of Labor Statistics (BLS)

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