Daiwa Capital Markets

U.S. FOMC Review

- FOMC minutes: monetary policy currently restrictive; “almost all” participants anticipate a lower federal funds rate in 2024
- The economic outlook: inflation risks tilted to the upside; growth risks to the downside
- Quantitative tightening: possible end in sight

Lawrence Werther
Daiwa Capital Markets America
212-612-6393
lawrence.werther@us.daiwacm.com

December FOMC Minutes

The minutes from the December meeting of the Federal Open Market Committee noted that the current stance of monetary policy was “restrictive and appeared to be restraining economic activity and inflation.” Additionally, noting gains made in the fight against inflation, the minutes affirmed that the peak target range for the federal funds rate had likely been reached and that a pivot to a lower policy rate was likely in coming months. Indeed, “almost all participants indicated that…a lower target range for the federal funds rate would be appropriate by the end of 2024.” That said, participants pointed out that their collective outlooks “were associated with an unusually elevated degree of uncertainty,” which could warrant “further increases” in the target range for the federal funds rate. Moreover, “several” argued that economic conditions could develop in a manner that would require “keeping the target range at its current value for longer than they currently anticipated.” Furthermore, “many participants” indicated that easing in financial conditions beyond that observed in the intermeeting period “could make it more difficult for the Committee to reach its inflation goal.” Therefore, while the potential for a pivot in 2024 was acknowledged – and is indeed very likely – we view market projections for the first cut coming in the spring as premature.

Regarding inflation specifically, “all” meeting participants acknowledged “clear progress,” but they observed that it remained above their two percent objective and that additional evidence was needed to assure a return to target. They cited supply chain normalization, increased labor supply, faster productivity growth, and increased domestic oil production, along with restrictive monetary policy restraining aggregate demand, as factors contributing to the improvement in inflation. However, “several participants” emphasized that “healing in supply chains and labor supply was largely complete” and that “continued progress in reducing inflation may need to come mainly from further softening in product and labor demand, with restrictive monetary policy continuing to play a central role.” Furthermore, “global geopolitical developments, a potential rebound in core goods prices following the period of supply chain improvements, or the effects of nearshoring and onshoring activities” could cause inflation to accelerate again. Thus, while the Committee viewed risks to inflation and employment as coming into better balance, participants nonetheless remained “highly attentive” to inflation risks.

While Fed staff and the FOMC expected the economy to remain on a growth track in 2024, they anticipated a slowdown from the firm pace of activity in 2023 and “participants generally perceived a high degree of uncertainty surrounding the economic outlook.” The minutes suggested that reports from business contacts were “mixed” and that meeting participants noted increased usage of credit by households (including buy-now-pay-later borrowing and payday loans) and a pickup in delinquency rates. Moreover, “several” participants expressed concern about developments in commercial real estate, as many properties would need to be refinanced in 2024 amid higher interest rates and challenging market conditions. Additionally, with regard to broad market variables, some meeting participants emphasized the weakness in growth of gross domestic income (GDI) relative to GDP as suggesting that underlying momentum in the economy could be less firm than believed.

Although seemingly preliminary in nature, and with no indication of a timeframe offered, meeting participants opened the door to winding down the quantitative tightening program. Participants emphasized that QT has thus far “proceeded smoothly,” with several highlighting additional declines in usage of the overnight reverse repo facility amid continued balance sheet runoff. Those participants noted that the Committee’s balance sheet plans called for a slowing and ultimate cessation of QT with reserves “somewhat above the level judged consistent with ample reserves.” In light of this, they argued that it would be “appropriate” for the Committee to start discussing the “technical factors that would guide a decision to slow the pace of runoff…” Given these comments, we suspect that QT is on the Committee’s radar, and that an orderly slowdown in portfolio runoff could be on the horizon.