

### **This Week's Fed Meeting: What Words will Move Markets?**

- As the Fed nears the end of its tightening cycle communication is critical, as words can move markets, but mistakes can be made.
- WSJ journalist and Fed "mouthpiece" Nick Timiraos last Sunday signaled the Fed's intention to slow the pace of rate hikes to 25 basis points this upcoming Wednesday.
- This Sunday however he indicated that this does not imply the Fed is stopping here, instead that the terminal rate is still under debate and may yet end up in the 5.0 - 5.5% range.
- The Fed is likely debating "top-down" factors like unemployment and output, arguing about whether demand is still too high and more hiking is needed to cool the economy.
- But the Fed may also be assessing "bottom-up" data focused on falling wages, layoffs and weak GDP components including retail sales, auto and housing, which may ultimately lead them to end the hiking cycle sooner rather than later.
- All in all, we will be listening closely to the Fed this Wednesday.

**Jim Caron:** Hello everyone. This is a big week for the markets. We have the Fed on Wednesday, the Bank of England and ECB on Thursday and the non-farm payroll number on Friday. Let's start by focusing on this week's Fed meeting and the words they use which may move markets. As the Fed nears the end of its tightening cycle it finds itself in a clash of communications, where words will move markets and I think mistakes can be made. Not surprisingly, Wall Street Journal (WSJ) journalist and Fed "mouthpiece" Nick Timiraos wrote another piece in the WSJ discussing what to expect from the Fed meeting. Remember that in the prior Sunday's WSJ he signaled that the Fed's intention was to slow the pace of rate hikes to 25 basis points, and that's what we all expect for Wednesday's meeting - a 25 basis point rate hike. But this Sunday's WSJ article signaled that the slowing of the pace to 25 basis points does not necessarily imply that the Fed is stopping there. Instead, what Nick indicates is that the terminal rate is still being hotly debated at the Fed and may still end up in the 5 to 5.5% range.

So why signal this? Because the Fed does not want the market to run away with higher equity prices or tighter credit spreads, which ends up easing financial conditions substantially, and ends up working against their goal fighting inflation. It's also because the Fed doesn't want anyone to misunderstand their policy statement or miscommunicate anything during the press conference on Wednesday. It might be that the markets start to think that the Fed agrees with the market and that the Fed will then start to cut rates this year. But the Fed is telling us explicitly that they're NOT looking to cut interest rates, and of course we'll see what happens, but that is essentially what is going on here. So not only will we have a very likely 25 basis point rate hike, but the message around this should be that the Fed is not willing to end its rate hiking cycle. It still may get to a terminal rate of 5 to 5.25%, maybe higher, but it's just going to take a little bit more time. Let's now look at what the Fed may want to communicate at Wednesday's meeting and what we will be listening for.

The first thing is trying to understand whether the Fed is planning to stop or pause the tightening cycle, whether they go 25 basis points or 50 basis points, which is possible, but most likely 25. It really does

matter in terms of signaling. The second question is whether anything has changed with respect to the terminal rate forecast? From the December summary of economic projections, what the Fed told us is that they're likely to end up between 5-5.25% as a terminal rate, but could they say something different and make us think that it's more likely to be between 4.75 and 5% now. This is something that we're going to be listening for. The third question is about whether the Fed now sees sufficient evidence that inflation will reach their 2% target and become durably anchored at that level. If that is the case can they in fact end their tightening cycle or are they considering other factors and if so, what are those factors. All of these questions need to be taken into consideration.

Based on the WSJ article this past Sunday, the Fed may be debating top-down factors like the unemployment rate and output gap, which argues that aggregate demand is still too high and more hiking is needed to cool the economy. On the other hand, they may look more bottoms-up and focus on wages, layoffs and the weak components of the GDP data that we got last week, including weak retail sales, weakening in autos and housing etc. as forward-looking indicators suggesting that the Fed has done enough and may want to end their hiking cycle sooner rather than later. These are the points that are going to be discussed and debated and what the Fed wants is to be very clear that they're not trying to send a signal either way. They only want to communicate that they're slowing their pace of rate hikes from 50 basis points to 25, but still debating where that terminal policy rate will ultimately end up. So let's expand on each one of these questions.

Number one, the stopping versus pausing argument. If the Fed goes to only 25 basis points, that is not stopping their rate hiking cycle. I don't think it's pausing it either. It could be slowing it, but it's not stopping or pausing. What we have to understand is that stopping and pausing are two very different things. A stopping of the rate hiking cycle implies that they've met their inflation goals and are now ready to consider cutting rates, and markets will see this as very bullish, aka risk-on. I don't think the Fed wants that. Now as for pausing, if they decide they're going to slow their rate hiking or they're going to pause at some point in the future, this suggests they're going to adopt more of a wait-and-see approach and consider restarting the hiking cycle. If inflation turns out to be unanchored – and understand that this is my number one risk scenario that we will have to contend with in the second half of the year - it's also something that the markets are not pricing at all at the moment. Markets may nevertheless see this as a less risk friendly event because it concentrates on only a single inflation data point. In other words, we're going to be watching inflation to give us all the information. All of the risk will be on CPI reports and PCEs and things like that. These are important facts to consider when looking at the stopping, slowing, pausing debate.

Number two, what has changed with respect to the terminal rate since the December FOMC meeting. Now remember, back in December, they were pretty explicit, meaning there was a lot of consensus amongst the Fed voting members that the terminal policy rate was going to that 5-5.25% level. Note that we have to recognize that we're not going to get a Summary of Economic Projections at this meeting. This meeting on February 1 will be just a statement in a press conference with a Q&A session, such that the Fed is not going to be able to lay out a forecast projection. What we also have to recognize is that the Bank of Canada last week signaled an end to their tightening cycle and some are thinking that there's some pressure on the Fed to do the same. My base case is a 25 basis point rate hike in both Feb and March which gives me a terminal rate of somewhere between 5 and 5.25%. The market broadly agrees with this, but it is currently pricing in a terminal rate between 4.75 and 5%, which makes my view slightly different than what the market is actually pricing. Now a dovish surprise would be for the Fed to signal an end to the hiking cycle or just one more rate hike, hinting that the March meeting is still alive and that they're still very data dependent. Although, they may hold steady at that meeting will have to wait and see. It's going to be much more about data dependence and this is perhaps reasonably what

the doves can hope for in the absence of a summary of economic projections (the forecast table the Fed provides on a quarterly basis). The hawkish surprise would be for the Fed to either go 50 basis points or to keep messaging a terminal rate between 5 - 5.25% alive and well, and perhaps this is what the hawks can hope for in the absence of that summary of economic projections.

With respect to point number three, that is whether the Fed is comfortable that inflation will reach its 2% target and remain anchored there. This is something that we're going to be listening for. In my view, the argument is hard to make because the service-sector inflation is still high and wage inflation is still high, falling, yes, but still way above levels that indicate a target or anchored inflation in the future. The latest positive jobs data reinforces this, but let's see if the Fed dismisses this and abandons their former line of thinking or not. We'll have to wait and see, of course, but the Fed could argue that this is all backward-looking data and they need to take their foot off the brakes to fulfill the full employment part of their dual mandate. Let's see if they adopt something like this as a new forward-looking line of thinking.

Now, I think there are six "wild cards" i.e. potential Fed statements that I will be listening for on Wednesday, three dovish and three hawkish. Dovish number one is that concern about excessive job losses could be something that they communicate. This would be viewed as dovish in that they're coming to an end of their hiking cycle. The second dovish point or could be that inventory and goods price declines are more durable and if they mention something along those lines, in my mind that puts them firmly in the end-of-the-hiking-cycle camp. The third dovish wild card could be that they discuss the risk of falling too far below potential growth in 2023, and that it would be hard to recover without excessive easing and risking higher inflation much later on. The worry that we're going to slow too much and not be able to recover, if they start to think about that make that change in their balance of risk assessment, I would view that as dovish.

On the hawkish side there are three as well. Number one is if they mention something about stopping inflation now will it create less economic stress than if we get into a harder to control wage price spiral inflation later. This is something that they've mentioned before, but if they reinforce this at this meeting, that's going to make them lean hawkish. I think that the terminal rate could then go higher. The second hawkish wildcard item could be that they discuss the cost benefit analysis that overshooting rate hikes to control inflation is better for long term growth. Again, this is an argument that they've made in the past, but a reinforcement of that this time around would be viewed as hawkish. The third hawkish wild card would be that we have not yet seen sufficient evidence that inflation will not just fall, but remain anchored at target levels, and that they have more work to do. If they make any one of those three hawkish statements, then that would tilt more towards the camp that the Fed is progressing with terminal rate hikes into that 5 – 5.25% ranger.

One other factor to consider is that the Fed may opt to end the rate hiking cycle sooner as a tradeoff for keeping rates higher for longer, meaning that if they ended the rate hiking cycle at 5%, they may be able to keep the policy rate at 5% for a longer period of time than if they went to 5.25% or above. Then they may be forced to cut sooner and create this pivot in unnecessary volatility in the markets. If they start to weigh this higher for longer scenario, what's the more durable policy rate, and then try to match that up to create jobs? I would view that as the Fed being a little bit political, but also as a tradeoff that if they get to a lower terminal rate that they're going to keep that terminal rate in place for longer. So if they end up at 4.75 – 5% that probably is the signal then they keep that there for longer.

Look, we're going to learn a lot more about this on Wednesday. This is extremely important meeting because this, this is really the beginning of the end of the rate hiking cycle. We just need to see how it

ends. Does it end abruptly, or is it going to end in a more gradual set of 25, 25, 25 basis point rate hikes that gets us to a terminal policy rate of 5.25%. This is very important for the markets and I'll be back Wednesday with a special Caron's Corner to discuss the outcome of the meeting.

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