Preview: FOMC Rate Decision due Wednesday 31st January 2024 at 19:00GMT/14:00EST; Powell Presser /Q&A at 19:30GMT/14:30EST

The FOMC is set to keep rates unchanged at 5.25-5.50% on Wednesday and is expected to tweak the statement to signal an increasing balance towards rate cuts vs further hikes. There are no new SEPs ("Dot Plot") at this meeting after the December release saw three rate cuts pencilled in for 2024. Thus, markets will be honing in on the statement and Powell's messaging for clues on the path ahead. The March meeting is likely to remain an open question after Powell concludes this week, given the Fed is walking the tightrope of a faster-than-expected fall in inflation against the resilient economic backdrop, causing debate amongst policymakers on how fast to move ahead with rate cuts despite the level of real monetary restrictiveness continuing to drift higher amid concerns the growth strength could keep inflation buoyed moving forward. On the balance sheet, no decision is expected to be made on the pace of the runoff at the January meeting, although it is expected to be an active discussion.

RATE EXPECTATIONS: All 123 economists surveyed by Reuters expect the Fed to keep rates unchanged on Wednesday, with money markets also priced for no change. The central bank is expected to begin cutting rates in Q2, according to 86 of 123 surveyed (55 thought June was more likely, while 31 see a reduction in May) - money markets are pricing a 50% chance of a first cut in March with more than one 25bp cut priced for May. Additionally, the Reuters poll shows that most economists (72 of the 123) believe the Fed will cut rates by 100bps or fewer this year - that compares to money market pricing, which currently sees five 25bps rate cuts fully priced, with a good chance of a sixth.

STATEMENT: There are expectations for another dovish tweak to the statement guidance after the December statement's adjustment: "In determining the extent of ANY [new word] additional policy firming that may be appropriate...". WSJ's Timiraos writes, "Fed officials are likely to take a symbolically important step this week by no longer signalling in their policy statement that rates are more likely to rise than fall." That is a view held by many analysts too. Using the 2006-07 guidance history as a benchmark, BofA suggests the following, "in determining any future policy rate adjustments that may be appropriate...".

POWELL: Fed Chair Powell, in his Presser/Q&A, is unlikely to go into specifics on rate cuts beyond acknowledging that they are on the horizon, likely retaining the optionality for a March cut via "data dependence". Powell may also temper aggressive expectations around policy easing by framing any future rate cuts as "gradual" or "methodical"/"technical". Powell is also likely to give a nod to discussions over tapering the Fed's balance sheet runoff.

INFLATION: Core inflation, as measured by the Fed's preferred index (PCE), rose at 2.9% Y/Y in December, the lowest since early 2021 and beneath the Fed's December SEP forecast of 3.2%. There is even more focus on the three-month and six-month annualised figures, which have fallen beneath the Fed's 2% target; the three-month annualised rate now at 1.5% and the six-month annualised rate is now at 1.9%. The large inflation decline through year-end has seen the level of real restrictiveness (Fed policy rate minus inflation) drift higher, with the Fed Funds Rate having been on hold at 5.25-5.50% since August, causing some policymakers to bring forward their discussion and calls for rate cuts as they look to avoid excessive tightening. The pushback against this view is that the disinflation has been heavily led by the decline in goods inflation, whilst services inflation has been much more sticky, which could leave the headline inflation readings above target if the goods disinflation fades.

GROWTH: A major conundrum of rushing into rate cuts is that GDP and the consumer have remained resilient, while there have been little signs of a material breakdown in the labour market despite its gradual rebalancing, leaving inflation at risk of reacceleration, or at least suppressing the chances of returning to 2%. The flash Q4 real GDP reading printed at 3.3%, well above the analyst forecast for 2.0%, which would see 2023 GDP at 2.5%, which is actually a tenth less than the Fed's SEP forecast of 2.6% but likely above what is required for the aggressive rate cut cycle priced by markets.

BALANCE SHEET: No decision is expected to be made on the pace of the runoff at the January meeting, although it is likely to be an active discussion, as the December meeting minutes and recent Fed Speak have indicated. That was also suggested by WSJ's Timiraos, "Fed officials are to start deliberations on slowing, though not ending, [QT] as soon as their policy meeting this month". The WSJ summarised the rationale in three points: 1) The current USD 60bln/month pace is twice as fast as its prior QT period, raising the risk that reserves drain too quickly vs the money market's ability to redistribute reserves, so a cut could allow the Fed to continue the runoff for longer; 2) The RRP, a proxy for cash surplus, is falling faster than expected, and once that is completely drained, forecasting demand for reserves becomes uncertain; 3) Officials have expressed a preference for retaining more reserves than the prior QT period. Analysts have been pencilling in forecasts for a QT taper to begin between March and June.