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Semi-Annual Monetary Policy Testimony

Chair Powell stresses patience. The Fed remains on track to cut "at some point" this year, more flexible than the previous "mid-year" message. Inflation does not need to be at 2% before cutting, but the Fed needs "a bit more evidence". We think core PCE at 2.5%Y is a good level to signal a June cut.

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Key Takeaways

In the prepared remarks delivered to the House Financial Services Committee, Powell reiterated the Fed's plan to cut rates this year but there is no rush. "We believe that our policy rate is likely at its peak for this tightening cycle. If the economy evolves broadly as expected, it will likely be appropriate to begin dialing back policy restraint at some point this year." This is a change in communication on timing of the first cut. In his 60 Minutes interview, he had described the first cut as likely "mid-year," instead of "some point this year."

In line with recent commentary from the January FOMC – "The Committee does not expect that it will be appropriate to reduce the target range until it has gained greater confidence that inflation is moving sustainably toward 2 percent."

Powell balanced the risks of cutting too soon vs too late: "Reducing policy restraint too soon or too much could result in a reversal of progress we have seen in inflation and ultimately require even tighter policy to get inflation back to 2 percent. At the same time, reducing policy restraint too late or too little could unduly weaken economic activity and employment."

While risks to achieving its "employment and inflation goals have been moving into better balance", the Committee "remains highly attentive to inflation risks" and still sees the labor market as "relatively tight."

In the Q&A, Chair Powell pointed to inflation setting the bar for a rate cut. He noted that the Committee needs "just a bit more evidence," which would include "good, relatively low inflation readings", "not looking for better inflation readings than we've had, just more of them."

On recession risks, Powell said "there's no reason to think the economy is in some kind of a short-term risk of falling into a recession", and "I don't think the possibility of recession is elevated right now." In turn, "solid growth" and "past progress" on inflation means they can approach rate cuts carefully.

Other thinking on inflation: He was asked specifically about property insurance and brought up car insurance prices as well—both are areas where inflation has been sticky, limiting the improvement in services inflation.

FAIT is dead. The Fed had rolled out a Flexible Average Inflation Targeting in August 2020, when inflation was low and recent history showed the risks of undershooting the FOMC's 2% inflation target. **Chair Powell pointed out this is no longer an issue the Fed is facing and said they will revisit their framework starting later this year.**

There was substantial focus on financial regulation. On Basel III, Powell does expect broad and material changes to the capital proposal, but it will be a thoughtful and deliberate process of rule making.

Looking ahead to the March SEP. Since the January FOMC meeting, measures of core inflation have run hot, which may limit downward adjustments to inflation in the SEP, perhaps at most a 0.1pp markdown of the Fed's core PCE forecast from 2.4% 4Q/4Q this year, to 2.3%. Coupled with a likely upgrade to GDP growth and downgrade to the unemployment rate, the median "dot" is likely to remain at 3 cuts this year.

Before the January inflation data, the Fed was sounding increasingly confident. Powell had said that their inflation forecast for this year was likely on track to be trimmed by a couple of tenths at the March FOMC. (Perhaps this year's median rate forecast would have moved in line.) The January inflation data undid that, and in all likelihood, encourages inertia in the March dot plot.

While we expect the median dot to remain at three cuts this year, we expect some convergence in the outlier dots (both high and low), that will move the average dot up 2bp from 4.70% to 4.72%. Exhibit 1 provides our subjective placement of FOMC participants according to their views on 2024 policy at the March FOMC meeting (voters are "members" whereas "participants" includes all policymakers on the FOMC). Based on commentary since the December FOMC meeting, we expect the lowest dot, which we believe belonged to Governor Waller (V), to move from 3.875% in the December SEP to 4.125% in the March SEP. We expect SF Fed President Daly's (V) dot to move from 4.375% to 4.625%, in line with the median. We expect KC Fed President Schmid's dot to move from 4.625% to 4.875%. Lastly, we expect Minneapolis Fed President Kashkari's dot to move down from no cuts (5.375%) to two cuts (4.875%). We are uncertain who was the lowest dot, at 3.875%, in December but think it's likely they're not as low now.

Exhibit 1: Our subjective take – policymakers' expectation for rates in the March SEP dot plot

Policymakers Expectation for Appropriate Federal Funds Rate by the End of 2024						
	3.875	4.125	4.375	4.625	4.875	5.125 5.375
Presidents			Goolsbee (Chi, '25) Harker (Phil, '26)	Williams (NY, V) Daly (SF, V)	Logan (Dal, '26) Mester (Cle, V) Bostic (Atl, V) Barkin (Rich, V) Collins (Bos, '25) Schmid (KC, '25) Kashkari (Min, '26)	Paese (StL, '25)**
		Waller (BOG, V)	Cook (BOG, V)	Jefferson (BOG, V) Powell (BOG, V) Barr (BOG, V) Kugler (BOG, V)		Bowman (BOG, V)
Board of Governors						
2024 Meetings:						
	Jan 30-31	April 30-May 1	Jul 30-31	Nov 6-7		
	Mar 19-20*	Jun 11-12*	Sep 17-18*	Dec 17-18*		

Source: Federal Reserve, Morgan Stanley Research forecasts; Notes: *Indicates meetings with a Summary of Economic Projections; **Musalem will take over as St. Louis Fed President April 2, 2024. "V" indicates a current voter. "BOG" identifies members of the Board of Governors. The New York Fed President is always a voting member. For non-voting members, the next year in which they rotate into voting is provided. Committee membership changes at the first regularly scheduled meeting of the year.

Overall, we think it will take until June for a data-dependent Fed to have clear and convincing evidence inflation will return to the 2% target, and therefore begin cutting rates. In our monthly inflation forecasts, core PCE hits 2.5% in April, which we think is a comfortable level for the Fed to signal it will soon be appropriate to cut. We look for 25bp cuts at the June, September, November, and December meeting this year, and an additional 200bp in easing in 2025.

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