Morgan Stanley | RESEARCH

IDEA

March 6, 2024 06:25 PM GMT

US Economics | North America

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.

MORGAN STANLEY & CO. LLC

Ellen Zentner
Chief US Economist
Ellen.Zentner@morganstanley.com +1 212 296-4882

Sam D Coffin
Economist
Sam.Coffin@morganstanley.com +1 212 761-4630

Diego Anzoategui
Economist
Diego.Anzoategui@morganstanley.com +1 212 761-8573

Sarah A Wolfe
Economist
Sarah.Wolfe@morganstanley.com +1 212 761-0857

Lenoy Dujon
US/Canada Economist
Lenoy.Dujon@morganstanley.com +1 212 761-2779

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)	**Williams (NY, V)**	Logan (Dal, '26)	Paese (StL, '25)**	
			Harker (Phil, '26)	**Daly (SF, V)**	**Mester (Cle, V)**		
					Bostic (Atl, V)		
					Barkin (Rich, V)		
					Collins (Bos, '25)		
					Schmid (KC, '25)		
					Kashkari (Min, '26)		
Board of Governors		**Waller (BOG, V)**	**Cook (BOG, V)**	**Jefferson (BOG, V)**			**Bowman (BOG, V)**
				Powell (BOG, V)			
				Barr (BOG, V)			
				Kugler (BOG, V)			

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.

Disclosure Section

The information and opinions in Morgan Stanley Research were prepared by Morgan Stanley & Co. LLC, and/or Morgan Stanley C.T.V.M. S.A., and/or Morgan Stanley Mexico, Casa de Bolsa, S.A. de C.V., and/or Morgan Stanley Canada Limited. As used in this disclosure section, "Morgan Stanley" includes Morgan Stanley & Co. LLC, Morgan Stanley C.T.V.M. S.A., Morgan Stanley Mexico, Casa de Bolsa, S.A. de C.V., Morgan Stanley Canada Limited and their affiliates as necessary.

For important disclosures, stock price charts and equity rating histories regarding companies that are the subject of this report, please see the Morgan Stanley Research Disclosure Website at www.morganstanley.com/researchdisclosures, or contact your investment representative or Morgan Stanley Research at 1585 Broadway, (Attention: Research Management), New York, NY, 10036 USA.

For valuation methodology and risks associated with any recommendation, rating or price target referenced in this research report, please contact the Client Support Team as follows: US/Canada +1 800 303-2495; Hong Kong +852 2848-5999; Latin America +1 718 754-5444 (U.S.); London +44 (0)20-7425-8169; Singapore +65 6834-6860; Sydney +61 (0)2-9770-1505; Tokyo +81 (0)3-6836-9000. Alternatively you may contact your investment representative or Morgan Stanley Research at 1585 Broadway, (Attention: Research Management), New York, NY 10036 USA.

Global Research Conflict Management Policy

Morgan Stanley Research has been published in accordance with our conflict management policy, which is available at www.morganstanley.com/institutional/research/conflictpolicies. A Portuguese version of the policy can be found at www.morganstanley.com.br

Important Disclosures

Morgan Stanley is not acting as a municipal advisor and the opinions or views contained herein are not intended to be, and do not constitute, advice within the meaning of Section 975 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Morgan Stanley Research does not provide individually tailored investment advice. Morgan Stanley Research has been prepared without regard to the circumstances and objectives of those who receive it. Morgan Stanley recommends that investors independently evaluate particular investments and strategies, and encourages investors to seek the advice of a financial adviser. The appropriateness of an investment or strategy will depend on an investor's circumstances and objectives. The securities, instruments, or strategies discussed in Morgan Stanley Research may not be suitable for all investors, and certain investors may not be eligible to purchase or participate in some or all of them. Morgan Stanley Research is not an offer to buy or sell or the solicitation of an offer to buy or sell any security/instrument or to participate in any particular trading strategy. The value of and income from your investments may vary because of changes in interest rates, foreign exchange rates, default rates, prepayment rates, securities/instruments prices, market indexes, operational or financial conditions of companies or other factors. There may be time limitations on the exercise of options or other rights in securities/instruments transactions. Past performance is not necessarily a guide to future performance. Estimates of future performance are based on assumptions that may not be realized. If provided, and unless otherwise stated, the closing price on the cover page is that of the primary exchange for the subject company's securities/instruments.

The fixed income research analysts, strategists or economists principally responsible for the preparation of Morgan Stanley Research have received compensation based upon various factors, including quality, accuracy and value of research, firm profitability or revenues (which include fixed income trading and capital markets profitability or revenues), client feedback and competitive factors. Fixed Income Research analysts', strategists' or economists' compensation is not linked to investment banking or capital markets transactions performed by Morgan Stanley or the profitability or revenues of particular trading desks.

With the exception of information regarding Morgan Stanley, Morgan Stanley Research is based on public information. Morgan Stanley makes every effort to use reliable, comprehensive information, but we make no representation that it is accurate or complete. We have no obligation to tell you when opinions or information in Morgan Stanley Research change apart from when we intend to discontinue equity research coverage of a subject company. Facts and views presented in Morgan Stanley Research have not been reviewed by, and may not reflect information known to, professionals in other Morgan Stanley business areas, including investment banking personnel.

Morgan Stanley may make investment decisions that are inconsistent with the recommendations or views in this report.

To our readers based in Taiwan or trading in Taiwan securities/instruments: Information on securities/instruments that trade in Taiwan is distributed by Morgan Stanley Taiwan Limited ("MSTL"). Such information is for your reference only. The reader should independently evaluate the investment risks and is solely responsible for their investment decisions. Morgan Stanley Research may not be distributed to the public media or quoted or used by the public media without the express written consent of Morgan Stanley. Any non-customer reader within the scope of Article 7-1 of the Taiwan Stock Exchange Recommendation Regulations accessing and/or receiving Morgan Stanley Research is not permitted to provide Morgan Stanley Research to any third party (including but not limited to related parties, affiliated companies and any other third parties) or engage in any activities regarding Morgan Stanley Research which may create or give the appearance of creating a conflict of interest. Information on securities/instruments that do not trade in Taiwan is for informational purposes only and is not to be construed as a recommendation or a solicitation to trade in such securities/instruments. MSTL may not execute transactions for clients in these securities/instruments.

Morgan Stanley is not incorporated under PRC law and the research in relation to this report is conducted outside the PRC. Morgan Stanley Research does not constitute an offer to sell or the solicitation of an offer to buy any securities in the PRC. PRC investors shall have the relevant qualifications to invest in such securities and shall be responsible for obtaining all relevant approvals, licenses, verifications and/or registrations from the relevant governmental authorities themselves. Neither this report nor any part of it is intended as, or shall constitute, provision of any consultancy or advisory service of securities investment as defined under PRC law. Such information is provided for your reference only.

Morgan Stanley Research is disseminated in Brazil by Morgan Stanley C.T.V.M. S.A. located at Av. Brigadeiro Faria Lima, 3600, 6th floor, São Paulo - SP, Brazil; and is regulated by the Comissão de Valores Mobiliários; in Mexico by Morgan Stanley México, Casa de Bolsa, S.A. de C.V which is regulated by Comision Nacional Bancaria y de Valores. Paseo de los Tamarindos 90, Torre 1, Col. Bosques de las Lomas Floor 29, 05120 Mexico City; in Japan by Morgan Stanley MUFG Securities Co., Ltd. and, for Commodities related research reports only, Morgan Stanley Capital Group Japan Co., Ltd; in Hong Kong by Morgan Stanley Asia Limited (which accepts responsibility for its contents) and by Morgan Stanley Bank Asia Limited; in Singapore by Morgan Stanley Asia (Singapore) Pte. (Registration number 199206298Z) and/or Morgan Stanley Asia (Singapore) Securities Pte Ltd (Registration number 200008434H), regulated by the Monetary Authority of Singapore (which accepts legal responsibility for its contents and should be contacted with respect to any matters arising from, or in connection with, Morgan Stanley Research) and by Morgan Stanley Bank Asia Limited, Singapore Branch (Registration number T14FC0118J); in Australia to "wholesale clients" within the meaning of the Australian Corporations Act by Morgan Stanley Australia Limited A.B.N. 67 003 734 576, holder of Australian financial services license No. 233742, which accepts responsibility for its contents; in Australia to "wholesale clients" and "retail clients" within the meaning of the Australian Corporations Act by Morgan Stanley Wealth Management Australia Pty Ltd (A.B.N. 19 009 145 555, holder of Australian financial services license No. 240813, which accepts responsibility for its contents; in Korea by Morgan Stanley & Co International plc, Seoul Branch; in India by Morgan Stanley India Company Private Limited having Corporate Identification No (CIN) U22990MH1998PTC115305, regulated by the Securities and Exchange Board of India ("SEBI") and holder of licenses as a Research Analyst (SEBI Registration No. INH000001105); Stock Broker (SEBI Stock Broker Registration No. INZ000244438), Merchant Banker (SEBI Registration No. INM000011203), and depository participant with National Securities Depository Limited (SEBI Registration No. IN-DP-NSDL-567-2021) having registered office at 18th Floor, Tower 2, One World Center, Plot- 841, Jupiter Textile Mill Compound, Senapati Bapat Marg, Lower Parel, Mumbai 400013, India Telephone no. +91-22-61181000; Compliance Officer Details: Mr. Tejarshi Hardas, Tel. No.: +91-22-61181000 or Email: tejarshi.hardas@morgan-