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Economic QuickView

FOMC Meeting: The Fed held the rate unchanged again amid tighter financial conditions

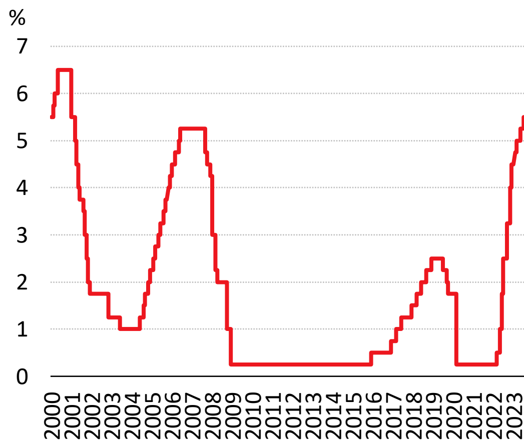
- The FOMC held the fed funds rate unchanged at 5.25-5.50% for a second consecutive meeting.
- Tighter financial conditions driven by higher longer-term bond yields have possibly lessened the need for further rate hikes.
- The Fed's rate hike cycle is likely to reach its peak, but a restrictive monetary stance will persist.

The FOMC voted unanimously to maintain the fed funds rate at 5.25-5.50% at the November meeting. The decision was in line with expectations, as market participants generally considered that Fed officials have turned to a slightly hawkish tone in their recent remarks. The post-meeting statement offered a backward-looking assessment of the economy, mentioning strong economic activity in Q3 2023 and moderate but still strong job gains. Regarding the economic outlook, the statement added that tighter financial conditions are likely to weigh on economic activity. This subtle change was widely reported by the media, as it could hint that current monetary policy is sufficiently restrictive, meaning fewer needs to tighten further.

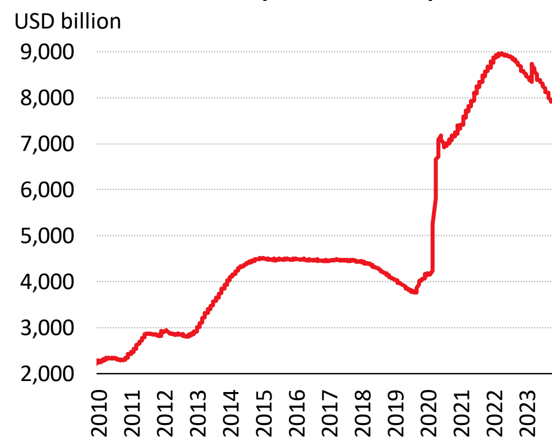
Tighter financial conditions driven by higher longer-term bond yields have become a focus of monetary policy. Since the last FOMC meeting in September, longer-term bond yields have trended up significantly, with the closely-watched 10-year US treasury yields once hitting above 5% last month. In addition to the Fed's forward guidance for keeping rates higher for longer and quantitative tightening (QT), there are other factors triggering higher bond yields, such as an increase in treasury supply, rising uncertainties over inflation and the fiscal outlook, a rising term premium to compensate for investors taking on interest rate risks for longer durations, weakened demand from foreign investors for holding US treasuries, etc. Higher treasury yields are leading to higher borrowing costs for US households and businesses, which could weigh on consumption and investment ahead. Most notably, the 30-year mortgage rate has increased to nearly 8%, a level not seen for two decades. Furthermore, higher longer-term bond yields have led to a stronger dollar and declining stock prices, which together can slow the economy. During the press conference, Chairman Powell revealed that the Fed is monitoring the impacts of increasing longer-term bond yields, which have

contributed to a tightening of broader financial conditions. In other words, the recent bond market response, if lasting more persistently, has lessened the need for further rate hikes by the Fed.

Chairman Powell downplayed the dot plot but left the door open to another rate hike. The interest rate projections from the dot plot released in September indicated that Fed officials pencilled down one more hike rate to 5.50-5.75% by the end of 2023. However, Chairman Powell commented that the projections only reflected the officials' personal forecast six weeks ago, which could change over time. He further stated that the efficacy of the dot plot probably decayed between the September meeting and the December meeting. These remarks indicated the Fed's intention to manage market expectations by not reading too much into the dot plot. When asked about a further pause in December, Chairman Powell emphasized that they have not made a decision for the December meeting, which would depend on the development of inflation, growth and broader financial conditions. Besides, Chairman Powell mentioned that there was no discussion on rate cuts. Overall, these messages suggested that the Fed continues to favour a restrictive monetary stance by leaving the door open to another rate hike.



Source: Bloomberg



Source: Bloomberg

There is no plan to change the pace of balance sheet runoff. While the Fed's plan to reduce its bond holdings is a major factor in raising longer-term bond yields, Chairman Powell made it clear that the Fed is not considering changing the pace of balance sheet runoff. And he viewed a drop in reserves to a level of USD 3.3 trillion as manageable. The view is consistent with his previous accounts that rate cuts would come earlier than adjusting the pace of QT, as the two monetary pools are progressing on different normalisation paths. Moreover, the Fed would prefer to keep long-term bond yields at elevated levels to cool inflation.

The Fed's rate hike cycle is likely to reach its peak, but a restrictive monetary stance will persist. Taken together, we consider that the Fed is likely to keep the fed fund rates at the current 5.25-5.50 unchanged for the December meeting. While there are encouraging signs for moderating inflation, the US labour market is still very tight, which would keep wage growth at a faster pace, thereby keeping core inflation above the Fed's 2% policy target. Thus, the Fed is likely to set a high bar in determining its next move to reduce interest rates to normal levels. After the November meeting, financial markets broadly turned risk-on. Although, it should be noted that the Fed is only taking a slightly less hawkish turn. A restrictive monetary stance is still likely to persist ahead. As such, commercial banks in Hong Kong are expected to stand pat for an extended period while the Fed holds rates unchanged.

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