EDITORIAL

UNITED-STATES: SANTA CLAUS IS COMING TO TOWN

The latest communication from the Federal Reserve -the new projections of the FOMC members for the federal funds rate and the comments of Fed Chair Powell during his press conference- reinforces the view that the US economy should experience a soft landing, which should allay potential worries about the outlook for corporate cash flows and household income. Bond and equity prices rallied, reflecting a feeling amongst investors of 'Santa Claus is coming to town'. The focus will now shift to the trickier part of the soft landing scenario: how fast and far will rates be cut? Another important question is when will bond markets start to anticipate the risk that the pick-up in growth that should follow from further disinflation and lower interest rates would quickly lead to new bottlenecks.

Every tightening cycle by the Federal Reserve gives rise to a debate about whether a soft landing is possible. Will the central bank succeed in bringing inflation back to target without causing a huge increase in the unemployment rate and triggering a recession? The current cycle has been no exception to this 'rule' but in recent months, favourable surprises in terms of inflation and ongoing labour market resilience, have led to a notable shift from questioning whether a soft landing is at all possible considering the extent and speed of rate hikes to a consensus view -and a feeling of relief- that such a positive outcome is now very likely. The latest communication from the Federal Reserve reinforces this view. The dot plot -the FOMC members' projection for the federal funds rate- points to three 25 basis points interest rate cuts in 2024 and Fed Chair Powell's comments during the press conference made it clear that the terminal rate has been reached and that the next move will be down. This triggered a big market rally in bonds as well as equities and a weakening of the dollar[1] with positive spillovers to markets in Asia and Europe the following day. This reminds us that investor risk appetite across the globe is highly dependent on what happens to the federal funds rate[2].

The news from the FOMC is obviously good for households and firms because they no longer need to be concerned about further rate increases and their detrimental impact on the economy. Rather, they can look forward to easier borrowing conditions, at least in nominal terms[3]. For financial market participants, the outcome of the FOMC created a feeling of 'Santa Claus is coming to town'. However, at the risk of spoiling the festive mood, one can argue that the easy part of the soft landing scenario is now behind us and that investors should prepare themselves for the hard, trickier part. Significant rate cuts are now priced in as shown by the federal funds futures curve in chart 1 but the timing and pace of policy easing will be very data dependent. Wage growth, despite trending lower, remains elevated compared to the Federal Reserve's inflation target of 2.0%, particularly considering that labour hoarding in a slowing economy should weigh on productivity gains[4]. Given the resilience of the labour market -a still very low unemployment rate, a participation rate that has increased to a level last seen early 2020 and a slow decline in the pace of job creation- the central bank will stick to a cautious approach. The dot plot reflects that, whereas markets are pricing in a bigger decline in the federal funds rate in 2024 (chart 2)[5]. Based on the incoming data, the FOMC members and investors will update their views, which could lead to increased volatility in Treasury yields. It also remains to be seen how quickly bond investors will start looking 'at the other side of the valley': the combination of a soft landing, declining inflation and lower interest rates will pave the way for an economic recovery, raising the question how soon labour market bottlenecks will reappear. Finally, one should also consider the possibility that the landing could be bumpier after all, either because disinflation takes more time or because the impact of past rate hikes on activity and demand would intensify.

FED FUNDS RATE VS FED FUNDS FUTURES AT DIFFERENT POINTS IN TIME

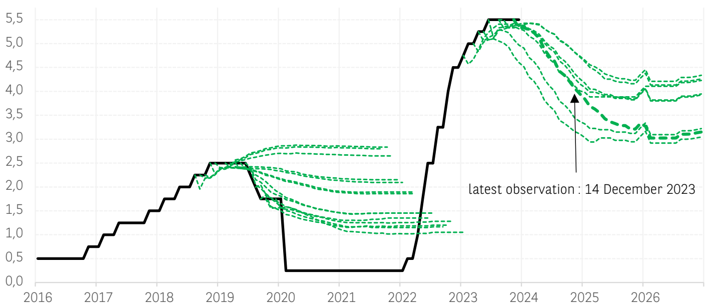

CHART 1
SOURCE: REFINITIV, FEDERAL RESERVE, BNP PARIBAS

FEDERAL FUNDS RATE: MARKET PRICING AND FOMC MEMBERS' PROJECTIONS

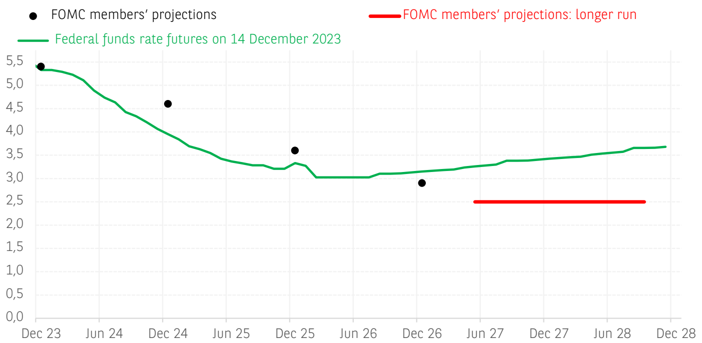

CHART 2
SOURCE: REFINITIV, FEDERAL RESERVE, BNP PARIBAS

To conclude, the message from the Federal Reserve is undeniably good news because it boosts the likelihood of a soft landing. This should allay potential worries about the outlook for corporate cash flows and household income. The focus is now shifting to the timing and pace of rate cuts and what this means for Treasury yields.

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1 This reflects a market expectation that in 2024 the ECB will cut rates less than the Fed.
2 Global risk appetite rises (declines) when the Federal Reserve lowers (raises) the federal funds rate. This relationship has been demonstrated empirically in Òscar Jordà, Moritz Schularick, Alan M. Taylor and Felix Ward, *Global financial cycles and risk premiums*, NBER working paper 24677, June 2018.
3 In real terms it is less clearcut and it depends on the decline in nominal interest rates versus the decline in inflation.
4 The Federal Reserve Bank of Atlanta's wage tracker shows annual wage growth of 5.2% in November.
5 Interestingly, the FOMC members' projection of the federal funds rate at the end of 2026 (2.9%) and for longer run (2.5%) are below current market pricing.