The surge in bond yields means the Fed is likely to remain on hold next week and probably in December too. The stronger incoming data mean officials won’t rule out an additional rate hike, but it’s clear most officials see that as conditional on a continued re-strengthening in job growth and inflation, which we think is unlikely. We think the next move will be a cut, though the risks are skewed towards that loosening coming later than the May 2024 cut in our baseline.

Strong GDP growth in Q3 and the solid retail sales and employment reports for September suggest the economy entered Q4 with more momentum than Fed officials anticipated, while the latest inflation data also surprised to the upside. However, the broader trend in inflation remains downward, and officials have made clear they won’t change course based on one month’s data.

That is especially true given the surge in bond yields since the September meeting. That should give officials more confidence that the economy and labor market conditions will continue to weaken over coming quarters, keeping inflation on a downward trend. Officials will be quietly pleased that financial conditions have tightened and will remain sounding hawkish in order not to trigger a reversal of those market moves. But with the markets doing the heavy lifting in terms of tightening financial conditions, the case for the Fed to remain on hold from here is strong.

The Fed is widely expected to leave interest rates unchanged at the policy meeting ending Wednesday November 1. The policy statement could receive some minor tweaks to reflect the stronger tone of incoming data but will otherwise be a carbon copy of September’s version. With this meeting not accompanied by updated economic projections, all the focus will be on the post-meeting press conference with Chair Jerome Powell, where he is likely to leave the door open to additional hikes but make clear that those are conditional on continued upward surprises to inflation and growth.

Chart 1: Financial conditions tightening

US: Financial conditions index

Index, 100= neutral

Tighter conditions

Source: Oxford Economics/Haver Analytics

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Incoming data has been stronger than officials expected

Officials already upgraded their language in the September policy statement on economic growth, now describing it as "solid" rather than "moderate", but they may need to up the ante considering the blowout 4.9% gain in Q3 GDP. Given the stronger September payroll figure and upward revisions to previous months' gains, they will need to upgrade the language around the strength of the job market too, with the current statement noting that job gains "have slowed...but remain strong".

Meanwhile, the stronger than expected September CPI report won't have changed the outlook too much because a lot of the surprise reflected a stronger rise in shelter prices, which the private sector rental data suggests will be reversed soon. What's more, the Fed's PCE inflation forecasts for this year already appear on the high side, suggesting they have already accounted for some near-term acceleration in inflation. Ultimately, there is little in the data (yet) to change the Fed's assessment that inflation remains too high but is still on a gradual downward trend.

…but higher bond yields the bigger factor for the outlook

The far bigger development since the September FOMC meeting is the continued surge in longer-term bond yields, which has led to a sharp tightening in financial conditions (Chart 1). That has already fed through to significantly higher borrowing costs for households and firms, with mortgage applications for home purchases turning down again, homebuilder sentiment becoming more pessimistic, and firms reporting that credit is becoming harder to get.

That will begin to weigh on the economy over the next few quarters, which will help to keep labor market conditions on a gradual cooling path, consistent with a steady decline in inflation back toward the 2% inflation target.

In recent speeches, Fed officials have not been shy about mapping out the policy implications. with San Francisco Fed President Mary Daly saying that higher bond yields "could be equivalent to another rate hike" and means that "maybe the Fed doesn't need to do as much”. Fed Chair Jerome Powell appears to agree, responding to a question of whether higher borrowing costs mean fewer rate hikes that “at the margin, it could”.

While a majority of Fed officials at the September FOMC meeting projected an additional rate hike this year in their economic projections, the consensus on the committee appears to be that any hike is conditional on stronger economic data. Powell repeated the same line we heard last month that “additional evidence of persistently above-trend growth, or tightness in the labor market is no longer easing, could put further progress on inflation at risk and could warrant further tightening of monetary policy” (emphasis ours). The conditionality in his language does not make that sound like a base case.

Markets are still pricing some risk of an additional rate hike over the coming meetings, but we expect the more relevant question officials are focused on is when to signal the first rate cut (Chart 2). Our forecast that the first cut will come in May is more aggressive than current market pricing, but that is conditional on our forecast for a sharp slowdown in the economy and rise in unemployment toward 5% between now and then. If the economy remains resilient, we would push out the date of policy loosening into the second half of next year (Chart 3).
Chart 2: Markets still pricing a risk of a hike over next few meetings

US: Rate change outlook

- Expected rate increase/decrease (LHS)
- Forward OIS Rate (RHS)
- OE Forecast (RHS)

Note: Data collected October 27, 2023
Source: Oxford Economics/Bloomberg

Chart 3: Our view of rate cuts is predicated on a much weaker economy

US: Economic Projections

- FOMC Sep-23
- OE Sep-23

Source: Oxford Economics/Federal Reserve