Rates Spark: One more 25bp cut, and then we wait

A 25bp cut is practically certain. It's 90% discounted. Not delivering is not really a viable option, given the way the Fed behaves. But, expect a *hawkish* cut, with a pause to be heavily intimated for the January meeting. It will be interesting to see next Fed liquidity management steps; likely they will need to buy more bills than the MBS roll-off requires

The Federal Reserve is widely expected to cut rates by 25bp but then likely pause in January

There is still a containment job to be done in the face of liquidity tightness

At the last FOMC meeting, the Fed announced a freezing of its balance sheet. The roll-off of the MBS portfolio continues, but is broadly offset by the buying of T-Bills. That should then stabilise bank reserves at or near current levels. A dominant rationale for the balance sheet freeze was the prior rise in the effective funds rate (relative to the other fixed policy rates). The spread from the funds rate to the rate on excess reserves (IOER) was 7bp. That had narrowed to 3bp. Not a great look, reflecting liquidity pressures.

Fast-forward to today, and the effective funds rate (3.89%) has drifted up even tighter to the IOER

(3.90%); the spread is now just 1bp. It's reflective of continued tightness in conditions and elevated market repo rates. The funds rate can technically go above the IOER, but would likely not go too far above, as there is then an arbitrage back into the IOER bucket from the funds rate bucket. Still, all of this is somewhat suboptimal as the effective funds rate is then getting closer to the ceiling on the funds rate range (currently set at 4%).

To address all of this, it's quite possible that the Fed decides to buy more bills than required from the MBS roll-off, thus acting to increase bank reserves. We don't think the Fed needs to do anything dramatic here, maybe only to announce that they have that flexibility. Alternatively, they can get more specific and announce a specific volume of bills buying.

Bottom line, while the Fed wants to freeze the balance sheet, in actual fact, they will ultimately have to re-expand the bank reserves at the same pace as the nominal economy is growing at. So, if nominal GDP is growing at 3-5%, bank reserves too should expand at that rate. This equates to the Fed buying bills to the tune of US$10-15bn per month, over and above the roll-off in MBS bonds (an additional US$10-15bn), which implies a total of some US$20-30bn per month of bills buying.

Euro rates won't be fazed by this Fed cut, but cannot sit on sidelines entirely

More Fed cuts won't have an immediate impact on euro rates, but the indirect implications through the FX channel should not be ignored. When we look at the short end, we see that the correlation between the US and euro curves is minimal. The European Central Bank has landed whilst the Fed is clearly still in cutting mode. That means that the euro curve out to two years will continue to do its own thing. And as we've seen this week, it can still have quite a strong will. Markets are even suddenly aware that we may very well see a hike as the next step.

If, however, the Fed ends up being forced to cut a lot more than currently priced in, then the ECB will face increasing disinflationary risks. Faster and more Fed cuts would weaken the dollar, which would compound with any US economic weakness. In a scenario where the eurozone economy stays afloat, that would translate to a significant strengthening of the euro. Given we still see a material risk of inflation undershooting the target, we think markets should remain well aware of this link. And remember, the ECB is unlikely to cut just once.

Author

Padhraic Garvey, CFA
Regional Head of Research, Americas
padhraic.garvey@ing.com

Michiel Tukker
Senior UK & Eurozone Rates Strategist
michiel.tukker@ing.com

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