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MARKET SIGHT LINES

The Federal Reserve Shares A Change in its Views for 2024 Monetary Policy

By Michael O'Keeffe, *Chief Investment Officer*

As we approach the Christmas and New Year's holidays, my team and I are putting the finishing touches on our outlook for 2024, which we plan to publish on or around January 3, 2024, with a client webinar the following day. As we've developed our views looking forward, we've been struck by how much the world has been changing, a concept that will anchor our outlook for the new year. The results of the Federal Reserve (Fed) meeting reinforced the idea of change, as the Fed shared what really is a subtle shift in its thinking.

In this week's Sight|Lines, our last of 2023, we review the results of the Fed's December meeting and briefly discuss how the Fed's change in thinking will influence 2024.

THE TAKEAWAY: FED POLICY IS UNCHANGED, BUT ITS VIEW OF 2024 HAS CHANGED.

The Fed left its monetary policy unchanged in the December meeting, but is now focusing on the possibility of rate cuts in 2024. In summary:

- As we approached the December Fed meeting, inflation continued to show signs of cooling.
- The Fed funds rate remains unchanged, and its program to reduce the balance sheet in place.
- Subtle changes in the Fed statement signal its view that the economy is slowing, inflation is cooling, and future debate will be balanced and may include a discussion of possible rate cuts.
- In fact, Fed members project further inflation cooling, positive economic growth, and rate cuts in 2024.
- And Fed commentary, from Fed Chair Jerome Powell's post-meeting press conference to other Fed officials' speeches, signal more balance about future policy debate.

Market participants have responded quite positively to this subtle change in Fed thinking, perhaps too much so.

IN-DEPTH: FED POLICY IS UNCHANGED WITH THE FED FUNDS RATE AND CONTINUED QUANTITATIVE TIGHTENDING, BUT ITS MEMBERS NOW EXPECT TO CUT RATES IN 2024.

The Fed left its monetary policy unchanged in the December meeting but is now focusing on the possibility of rate cuts in 2024. Going deeper:

- Inflation has cooled into the December Fed meeting. For the three months ended November:
  - The consumer price index (CPI) averaged 0.179%, in line with 0.17%, the monthly equivalent of the Fed's 2% target.
  - The producer prices index (PPI) averaged -0.016%, so prices are little changed over the period.
- In its December meeting, the Fed left monetary policy unchanged:

    - The Fed funds rate sits at 5.25%-5.50%, reflecting a tight monetary policy.
    - The Fed quantitative tightening (QT) program remains in place, with the Fed reducing its balance sheet by not reinvesting in securities as they mature. Since June 2022, the Fed has reduced its balance sheet by $1.2 trillion to $7.7 trillion.
- The Fed's statement contained subtle changes from November 1 to this meeting, as marked (see full statement, with marked changes, on page 3):
    - "… growth of economic activity ~~expanded at a~~ has slowed from its strong pace in the third quarter.
    - "Inflation has eased over the past year but remains elevated."
    - Some see the introduction of the work "any" below as a sign of a more balanced approach:
        - "In determining the extent of any additional policy firming, the Committee will …"
- The Fed issued a Summary of Economic Projections in December, showing expected improvements:
    - The median projection for Personal Consumption Expenditure inflation is 2.4%, closer to the Fed's 2% target.
    - The Fed sees GDP growth at 1.4% next year – positive, but its long-term projection of 1.8%.
    - The median projection of the funds rate is 4.6%, inferring 0.75% in rate cuts next year.
- Comments from the Fed have affirmed this more balanced approach, with a focus on future rate cuts:
    - Fed Chair Jerome Powell said "the question of 'when will it become appropriate to begin dialing back the amount of policy restraint in place'… is … a discussion for us at our meeting today."
- We believe market participants may be too positive, with market results possibly ahead of themselves:
    - The 10-year treasury yield has fallen from 4.2% before the Fed meeting to 3.8%.
    - The S&P 500 has returned 2.1% since the meeting.

CONCLUSION

We're headed for the Christmas and New Year's holidays in the coming two weeks, and my team and I are finishing up our outlook for 2024. We'll talk about change, including the subtle shift in Fed thinking we learned in the wake of the December Fed meeting. Fed officials expect inflation to cool further, the economy to experience modest growth, and three 0.25% rate cuts later in the new year. This future policy shift will dampen the economic headwinds from higher interest rates, but market participants may be too optimistic about the timing and magnitude of this Fed policy shift. We'll share more in our 2024 outlook, but we enter the year cautiously optimistic, albeit perhaps more cautiously than most.

Michael P. O'Keeffe, CFA
Chief Investment Officer
michael.okeeffe@stifel.com
www.stifelinsights.com

Fed Statement on December 13, 2023 (marked with changes from its November 1, 2023 statement)

Recent indicators suggest that <u>growth of</u> economic activity ~~expanded at a~~<u>has slowed from its</u> strong pace in the third quarter. Job gains have moderated since earlier in the year but remain strong, and the unemployment rate has remained low. Inflation <u>has eased over the past year but</u> remains elevated.

The U.S. banking system is sound and resilient. Tighter financial and credit conditions for households and businesses are likely to weigh on economic activity, hiring, and inflation. The extent of these effects remains uncertain. The Committee remains highly attentive to inflation risks.

The Committee seeks to achieve maximum employment and inflation at the rate of 2 percent over the longer run. In support of these goals, the Committee decided to maintain the target range for the federal funds rate at 5.25% -5.50%. The Committee will continue to assess additional information and its implications for monetary policy. In determining the extent of <u>any</u> additional policy firming that may be appropriate to return inflation to 2% over time, the Committee will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, and economic and financial developments. In addition, the Committee will continue reducing its holdings of Treasury securities and agency debt and agency mortgage-backed securities, as described in its previously announced plans. The Committee is strongly committed to returning inflation to its 2% objective.

In assessing the appropriate stance of monetary policy, the Committee will continue to monitor the implications of incoming information for the economic outlook. The Committee would be prepared to adjust the stance of monetary policy as appropriate if risks emerge that could impede the attainment of the Committee's goals. The Committee's assessments will take into account a wide range of information, including readings on labor market conditions, inflation pressures and inflation expectations, and financial and international developments.

Voting for the monetary policy action were Jerome H. Powell, Chair; John C. Williams, Vice Chair; Michael S. Barr; Michelle W. Bowman; Lisa D. Cook; Austan D. Goolsbee; Patrick Harker; Philip N. Jefferson; Neel Kashkari; Adriana D. Kugler; Lorie K. Logan; and Christopher J. Waller.

For media inquiries, please email or call 202-452-2955.

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