Mizuho Brief: FOMC

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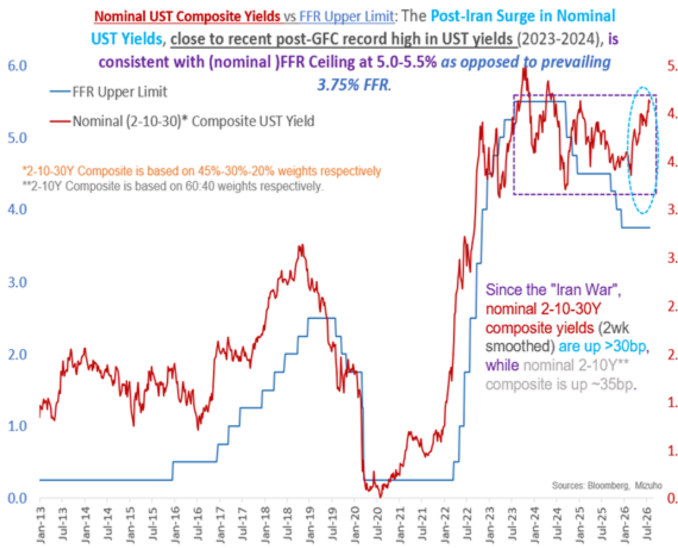
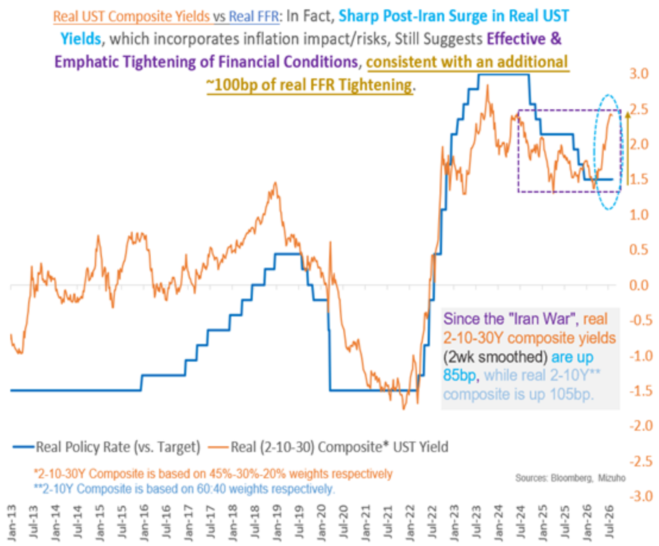
FOMC Quick Take: Read My (B)Lips

"The game is afoot." – **Sherlock Holmes**

In a Nutshell: The FOMC's **assumed hawkish hold revealed** a **dovish blip**s *in the details and between the lines* of the press conference. Notably, **Warsh's** reference to "*watchful -thinking*", coupled with **perceptions** – *misconstrued or otherwise* – **that the Fed is happy to (free-)ride on appreciably higher yields** across the Treasury curve. Most **acutely so in real yields**, which have *by some measures surged 85-105bp,* **threatening to result in "real pain"**. So, to be sure, Warsh is not wrong that the financial conditions are effectively tighter, and that leaning into this amid uncertainty carries its own risks. Nonetheless, the **danger is that markets hastily conclude** that **the *Fed risks falling be behind the proverbial curve*** *(ironically) in taking cover in higher yields across the UST curve.* The post-conference drop in front-end yields in stark contrast to lift in long-end yields **warns of further upside volatility in the long-end** yields.





1. Hawkish Noise
   - The **FOMC's hawkish hold** was **neither a surprise *nor particularly revealing*** – with an unchanged statement.
   - Although, the **headlines came across hawkish**, led by the three dissenters (9:3 vote to hold) favouring a hike.
   - Moreover, Fed Chair **Warsh adopted an ostensibly hawkish inflation stance**, alluding to "*no soft, implicit target … only a (2%) target*".
   - ***But despite the hallmarks of hawkish flex* scrutiny suggests** there is **more noise than** guaranteed **signal**.
   - Point being, it was the **dovish blips in the press conference** and *between the lines,* that probably **carry more weight**.

2. Credibility & Necessity
   - Even the **assertion of** "*unwavering commitment*" (to price stability and the 2% inflation target) **establishes credibility** *rather than affirming a hawkish course.*
   - More revealingly, **Warsh's hawkish spin on the hold**, that "(the Fed) *where necessary and appropriate .. will not hesitate to act*", **is arguably**, **dovish cover**.
   - Specifically, what's **implied** is **that the current conditions are not yet** in the vicinity of "**necessary**" with reference to hikes.
3. Deferring to the Market (?)
   - Crucially, Warsh pointed out that **exceptional rise in UST yields across the curve** (inter-meeting and beyond) constitute an **effective tightening in financial conditions**.
   - In addition, he further suggested that the *Fed is "trying not to interfere" with* **bond markets responding to real data *rather than gaming central banks***.
   - Which he thinks is **a good thing** as markets "*play the ball, not the referee*".
   - Possibly, this **could square with** the Fed's, or at least **Warsh's inclination to extend the policy hold** *as markets adjust, unadulterated.*
4. Real Tightening …
   - Notably, Warsh was very specific about both **nominal and real yields rising sharply across the UST curve**.
   - If we broaden the horizon to **post-Iran** and take a view of (weighted) yield shifts, **nominal yields are up 30-35bp** while **real yields are up 85-105bp** (see Charts).
   - Depending on the viewpoint, this may **arguably be deemed to be *effective compensatory tightening by up to 100bp*** in real terms (adjusting for inflation volatility).
5. "Watchful Waiting"
   - To be sure, a distinctly hawkish argument, would be that higher yields suggest that **bond markets are expecting the Fed to hike** rates **to some corresponding order**.
   - **But Warsh appears to be challenging this**, saying this is open to interpretation, adding that *bond markets are (over-)reacting "real time",* whereas the **Fed is examining deeper issues/dynamics**.
   - Notably, adding that **this period may be better characterized as** the **Fed's** "*watchful thinking, not watchful waiting*".
6. (Free-)Riding on Market Hikes?
   - The bottom-line being, **Warsh is of the view** that (market) **rates are already higher** – *even if not by direct Fed influence* – and by extension, *at least buying time*.
   - Tellingly, Warsh made the point that *monetary policy asserts itself not only just by direct Fed talk/action*.
   - But crucially, by the **how it affects the real economy**, **including market prices (rates) responding to the Fed**.
7. Hikes Deferred by Forward Guidance Drop?
   - What's more, Warsh has suggested that **dropping forward guidance has led to appreciable tightening** – as bond markets respond real time.
   - **Consequently**, requiring a further adjustment period – which further underpins the **case for not hastening to tighten**.

8. Beware Bond Bears & Back-end Pain

- But *regardless of the Fed's "thoughtful waiting",* **bond bears may not be inclined to wait**.
- *Especially if risks of price shocks mount* amid unrelenting geo-political uncertainties.
- Inadvertently (and unfortunately), resulting in **worries that the Fed free riding the higher yield curves will eventually end up *ironically* "behind the curve"**.
- And **upside volatility in long-end yields may harden the longer the Fed defers hikes**.
- For now, the **lift in long-end yields juxtaposed against front-end dip** arguably reveal *doubts about imminent hikes but bake-in/compound inflation risks.*
  - *i.* *FX (USD): The Greenback has slipped, arguably amid concealed dovish caveats at the press conference.*
  - ii. *FX (AXJ): But corresponding gains in AXJ may be limited amid prevailing uncertainties. And further rise in long-end UST yields could hurt the higher-yielding AXJ more acutely.*

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