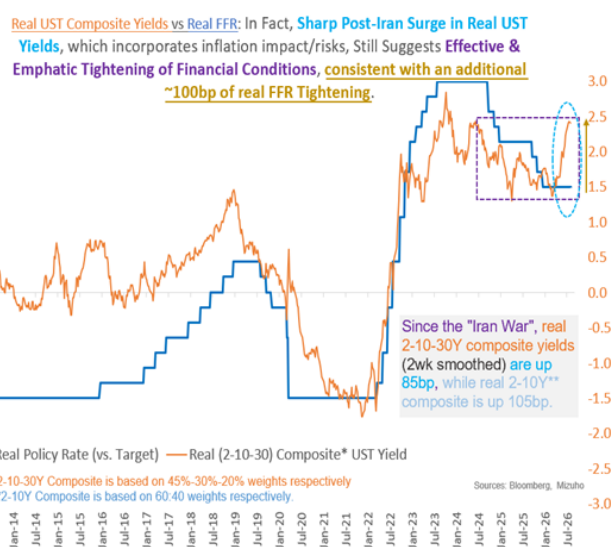
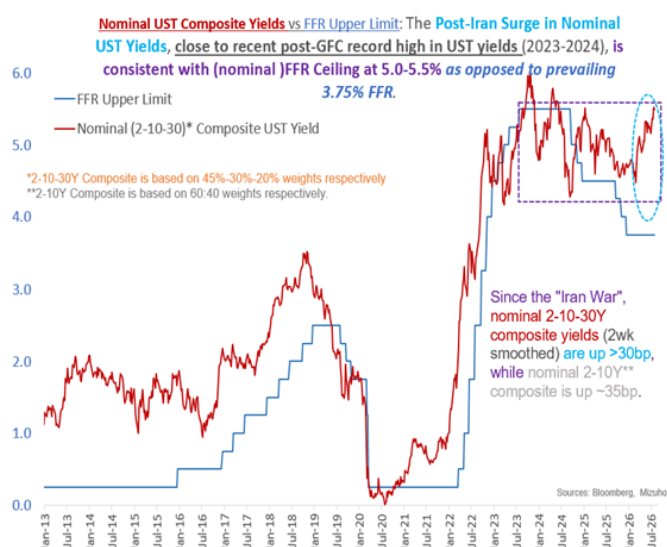


FOMC Quick Take: Read My (B)Lips

"The game is afoot." – Sherlock Holmes

In a Nutshell: The FOMC's assumed hawkish hold revealed a **dovish blips 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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