FOMC:
Time to sit back, relax, and wait for the landing (?)

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Executive Summary

- The Fed maintained its policy rate at 5.25-5.50%, marking an end to the tightening campaign that was started in March 2022.
- The BTFP facility and the expected 75bps rate cuts may protect the US banking sector from liquidity risks, allowing the Fed to continue its QT campaign.
- The start of the Fed's rate loosening campaign may not translate much to the sentiment on other markets, given that the dovish shift is already priced in and the substantial gap between markets' expectations and the Fed's policy outlook.

- The global interest rate expectation has been swinging quite dramatically towards the dovish camp in the past month. Questions have been made regarding whether the Fed would try to disperse this growing dovish expectation in its final FOMC meeting of the year. **The FOMC's decision to hold the Fed funds rate at its terminal rate of 5.25-5.50% does little to cool down the dovish expectation**, leading to a rally in the financial market that sends the US stock market (DJI) to its all-time high following the rate announcement.

- While signals sent from the previous meeting could be characterised as ambiguous, there are no arguments about what Fed chairman Jerome Powell meant in his post-meeting statements. The policy rate, as the FOMC chair argues, has been putting downward pressure on economic activity, albeit without strong evidence from the labour market. Inflation has also eased from its highs, while the threat of energy reflation seems to be losing credibility given the anaemic oil prices despite OPEC+'s continued efforts to cut production.

- However, the widening standard deviation in FOMC members' FFR projections shows that the policy hawk remains in the picture. The sticky core inflation is often cited as one factor that strengthens the policy hawk. It is important to note, however, that the 4.0% YoY core inflation reading in November 2023 may masked the extent of the disinflationary trend in the US.

- The sticky core inflation is influenced by the services component, which is exposed to sub-components such as the rent of shelters (6.5% YoY in Nov-2023, 8.3% YoY peak in Mar-2023) and owners' equivalent rent of residences (OER, 6.7% YoY in Nov-2023, 8.1% YoY peak in Apr-2023). A typical household, of course, would not have the opportunity to renegotiate their rents every month, leading to the statistical quirk that explains the stickiness of rental inflation and thus the steady albeit slow decline in the US core inflation.

- The robust labour market (the US unemployment rate fell to 3.7% in Nov-2023) is another factor that continues to excite US policy hawks. While the 4.0% YoY wage growth in November 2023 and the rising trend of labour unions in the US point to a limited labour supply condition, recent reports regarding the rising trend of double-income households (or even, double jobs workers) show that the bargaining power does not exclusively favour the job-seeking labour. Hence, there appears to be a ceiling for wage growth, limiting the threat of a wage-price spiral that further diminishes the hawk's cause.

- Meanwhile, the argument for the Fed to provide more support for the financial sector (if not the real economy) is gaining steam. First, higher issuance of short-term US treasury securities (T-bills) due to the treasury general account (TGA) 'refill' operation in 2023 has drained the Fed's RRP outstanding to around 44.25% from its 2023 peak, resurrecting the concern that further T-bills issuance in 2024 may eventually eat into US banks' reserves.

- The anticipated higher supply of T-bills and other US treasury securities in 2024 poses another risk for the US financial sector. Given the depleted RRP and foreign investors' weak demand for T-bills, the US government's apparent strategy to address its funding gap by issuing more T-bills may elevate the ST yields relative to the longer-tailed yield. Such a scenario, of course, also points to the risk of mounting paper losses on US banks' investment in securities, potentially leaving a gaping hole in banks' balance sheets that sparked the US regional banking crisis in March 2023.

"The statistical quirk behind the residential inflation may masked the extent of the disinflationary trend in the US from full view"

- Fortunately, the Fed found a powerful tool in the Bank Term Funding Programme (BTFP) to ring-fenced the USD liquidity risks that may arise in the US banking sector. While outstanding on the Fed's other facilities have been declining, the use of the BTFP facility appears to have increased by USD 12.63 Bn from the last month, illustrating BTFP's cemented status as the main outlet for emergency Fed funding amidst the wobbly USD liquidity condition within the US banking sector.

- Alas, there is an extra layer of uncertainty regarding the Fed's balance sheet condition in the next year. Chairman Powell's intention to resume the quantitative tightening campaign may add to the risk for banks and the US treasury market, as the Fed signals its unwillingness to step in to replace the lost demand due to the depleted RRP and the weakening demand from traditional foreign investors.

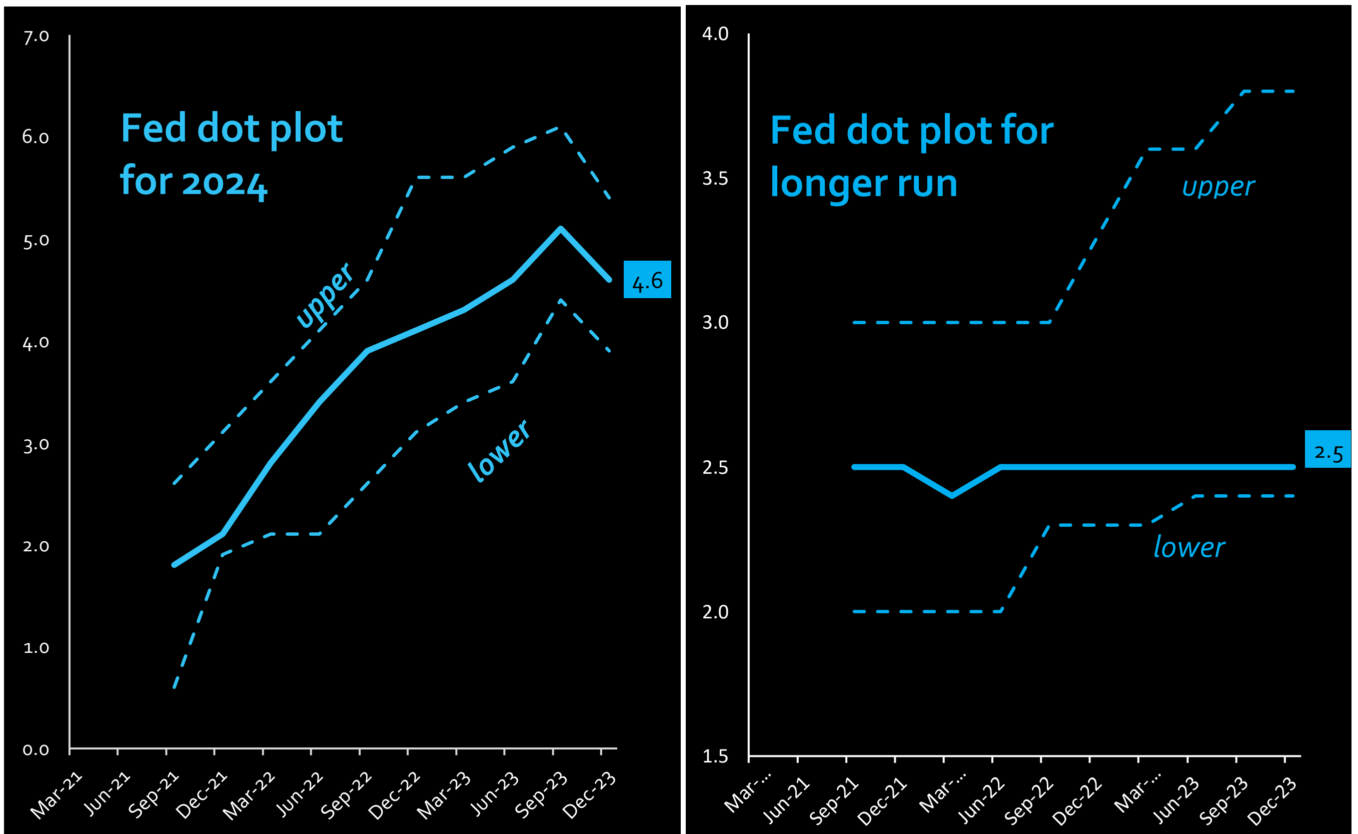
- However, it is hard to argue that the current format of the Fed's QT campaign would significantly exacerbate the liquidity risk in the UST market. The Fed has been shedding its securities holdings at a leisurely pace, as the UST and MBS outstanding on its balance sheet only declined by 14.35% compared to when QT was announced in April 2022. The Fed, then, may continue its QT campaign, opting instead to add to the rate cut signal in 2024 by another 25bps to limit the risk to banks' liquidity condition while also opening the possibility of retiring the QE as the BTFP's role becomes more central.

- The extra 25bps in the Fed's rate cut signals (from a total of 50 bps in the Sep-23 summary of economic projections to 75 bps) may confirm the dovish shift in the Fed's policy outlook. Such a shift, however, has long been priced in by the market. Multiple indices show that the

financing conditions in the US have been loosening since the start of Q4 2023, while the market also continues to expect a more aggressive 125-150 bps rate cut in 2024 (compared to 100 bps before the FOMC meeting). **The Fed's year-end gift of more robust dovish signals leads the market to ask for more cuts, illustrating a still-wide gap between the Fed's outlook and expectations in the market.**

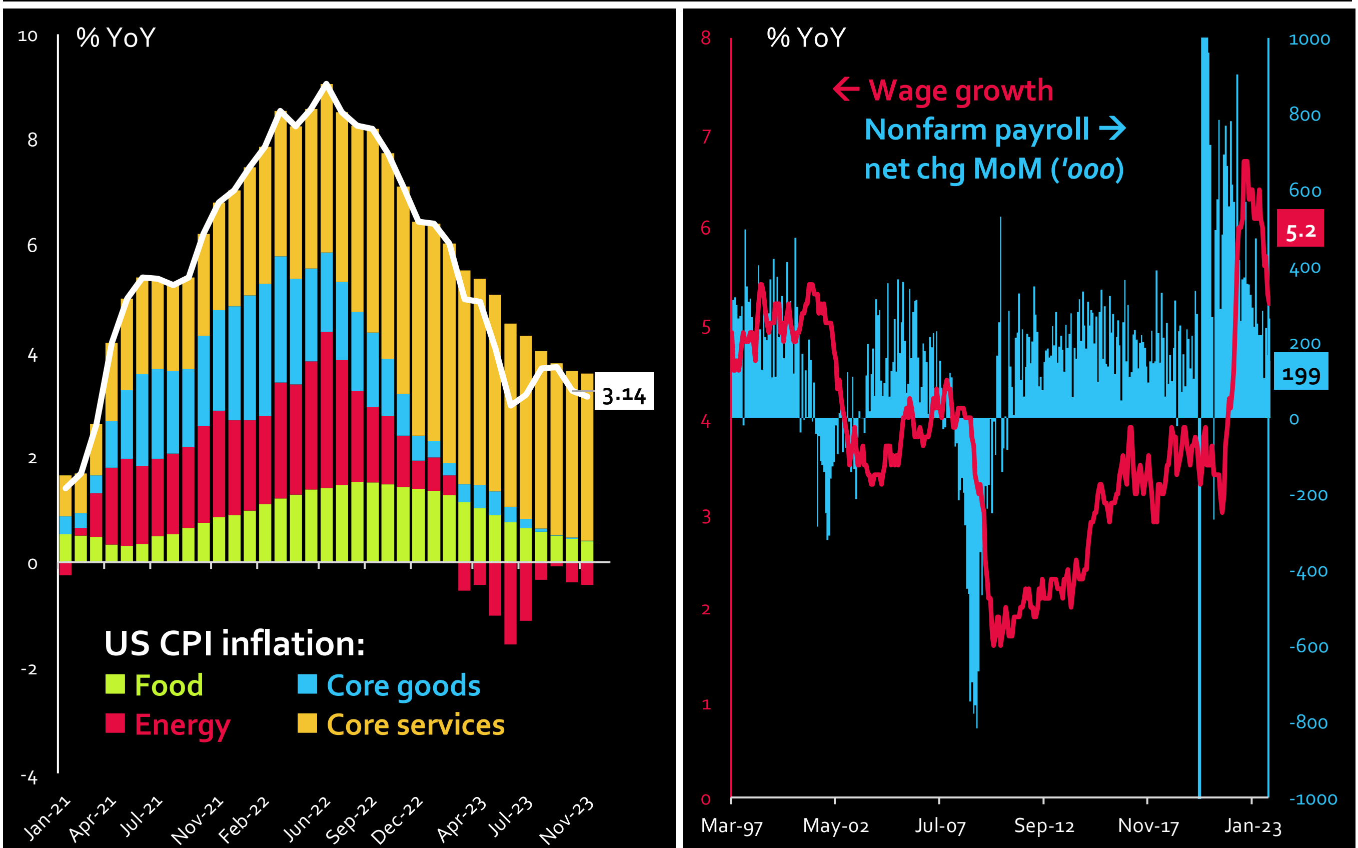
- The current situation highlights the problem facing the financial market outside of the US. Given that the Fed's dovish pivot has already been priced in, the actual opening salvo of the Fed's rate loosening campaign may not have a significant impact on the sentiment in other financial markets, including in Indonesia.
- Meanwhile, **the substantial gap between the market- and the Fed-projected interest rates in 2024 may also continue to fuel volatility in the Indonesian (and other) financial markets.** Indeed, foreign investors have not consistently returned to the Indonesian financial market, and the declining bid for BI's SRBI instrument further reveals investors' demand for even higher yields on Rupiah-denominated assets. Given the dovish shift in the Fed's policy outlook, it is safe to say that BI's next policy move is to lower the BI7dRR. However, until the promised day when the Fed finally cuts its policy rate truly comes, the ensuing state of volatility in the domestic financial market may continue to put BI on high alert.

Panel 1. **The Fed adopts a lower policy rate in its short-term outlook, but the widening spread in long-term rate expectation shows that the hawkish expectation remains in the picture**



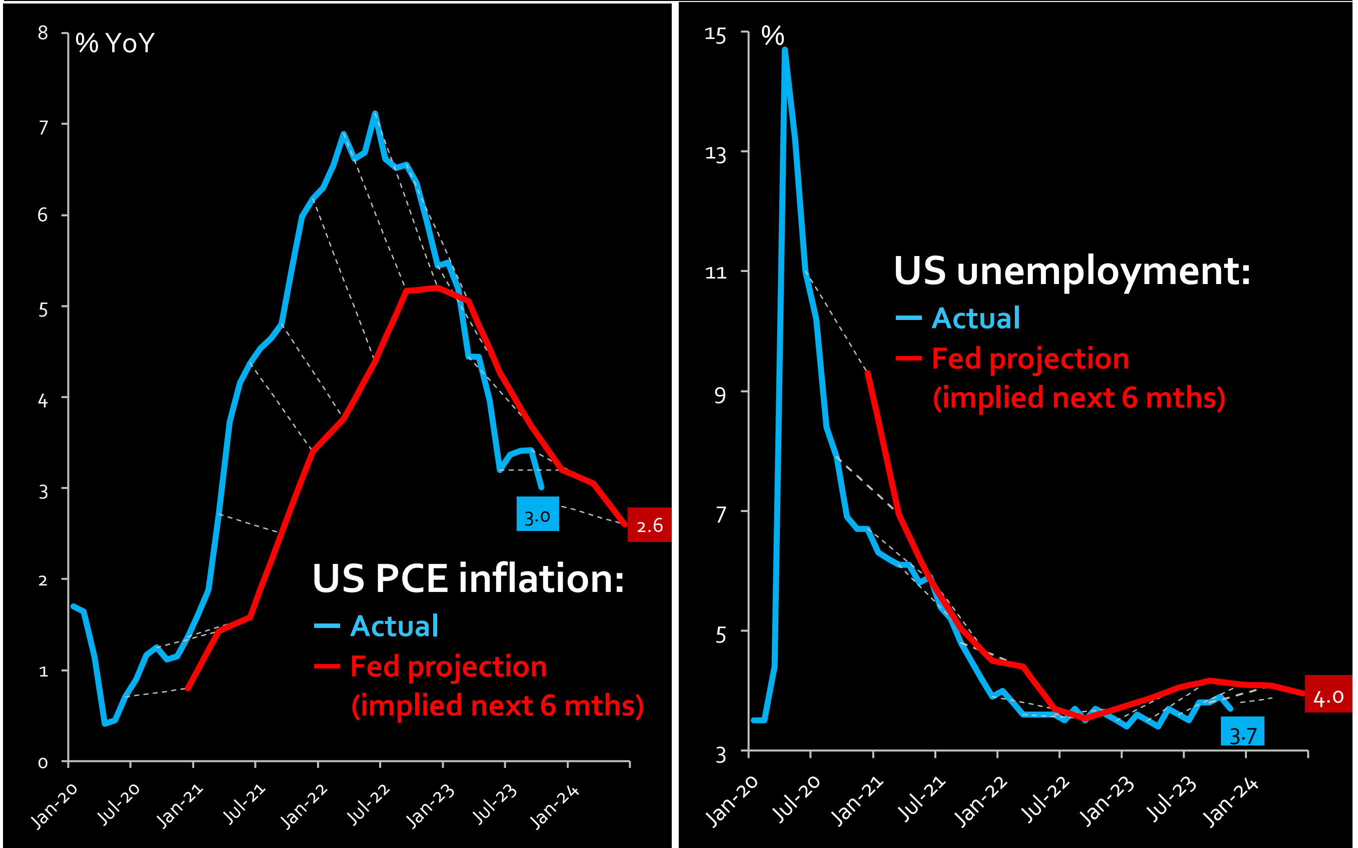
Source: Federal Reserve

Panel 2. **The sticky core inflation number may mask the full extent of the disinflationary trend in the US**



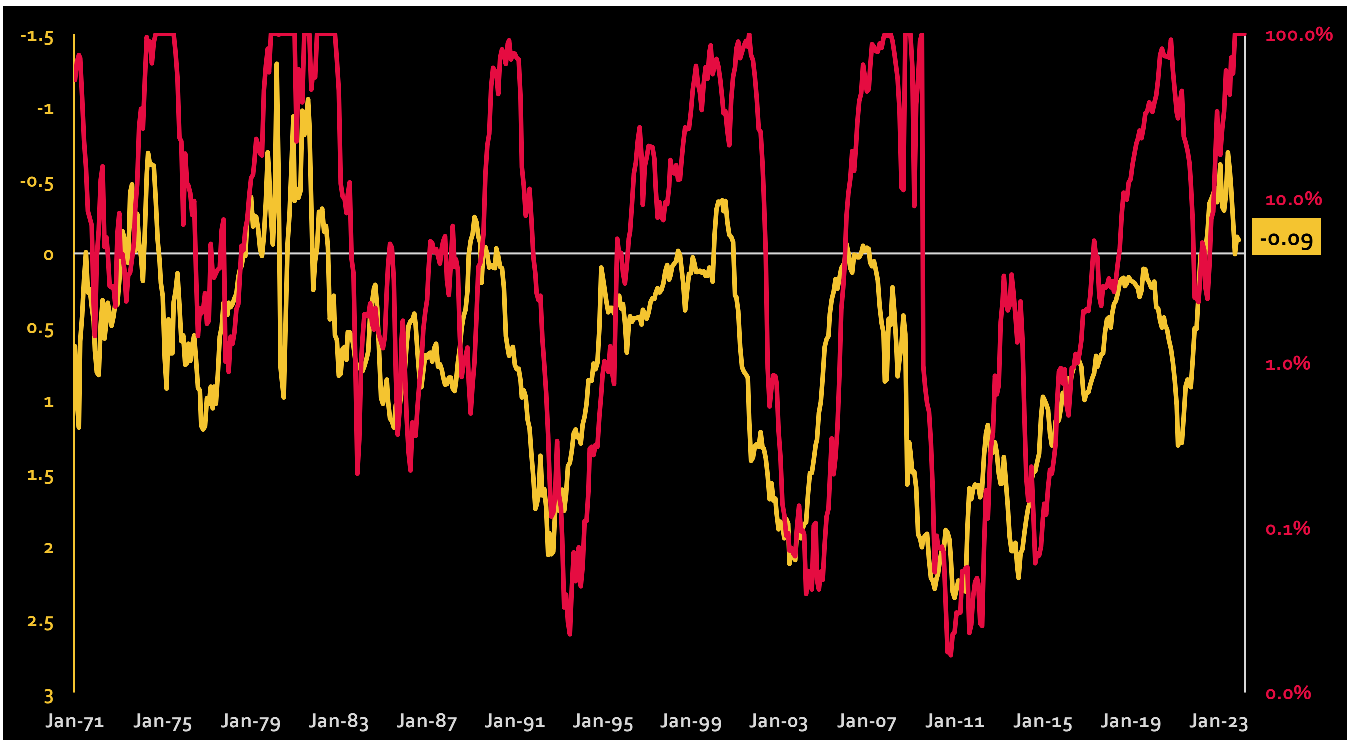
Source: US BLS, Bloomberg

Panel 3. **The Fed's recent forecast illustrates the central bank's growing confidence in its ability to deliver the "soft landing" scenario**



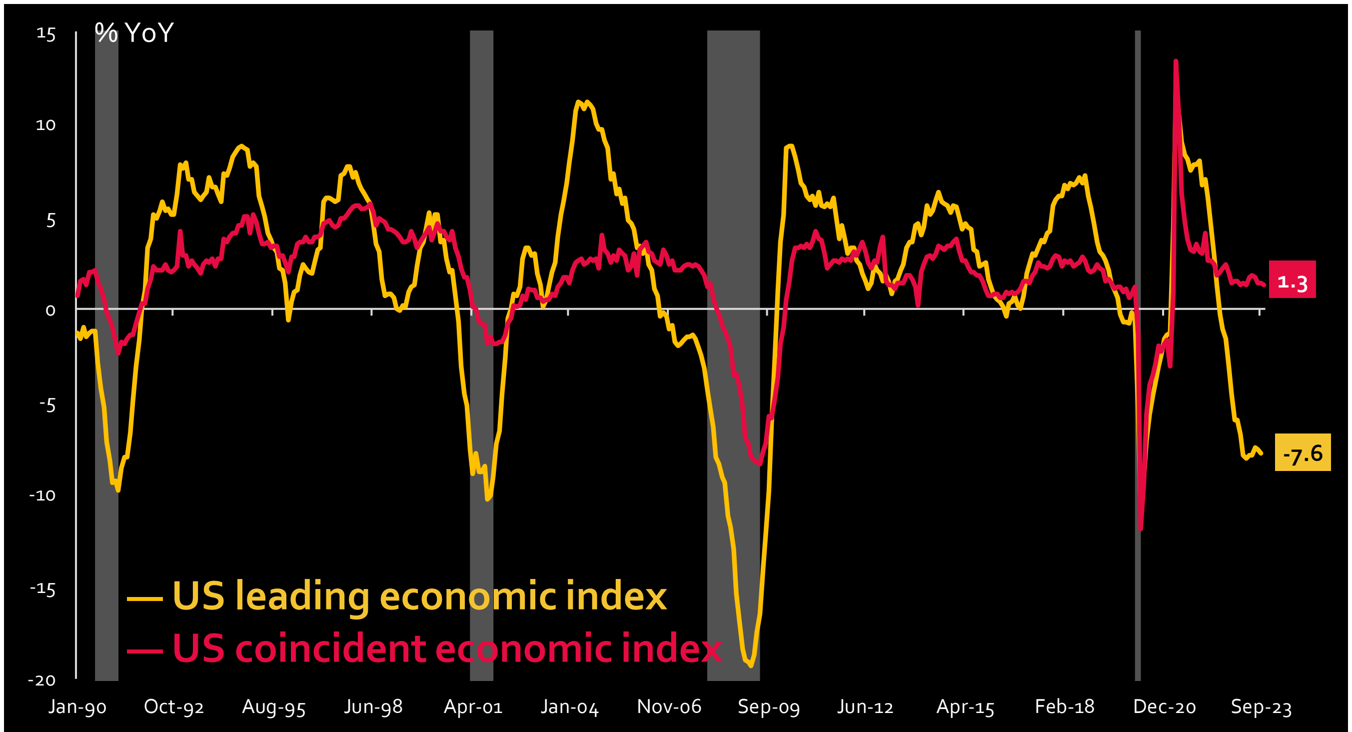
Source: Bloomberg, Federal Reserve

Panel 4. **The inverted yield curve may be a product of higher T-bills issuance rather than weaker confidence in the US economic growth**



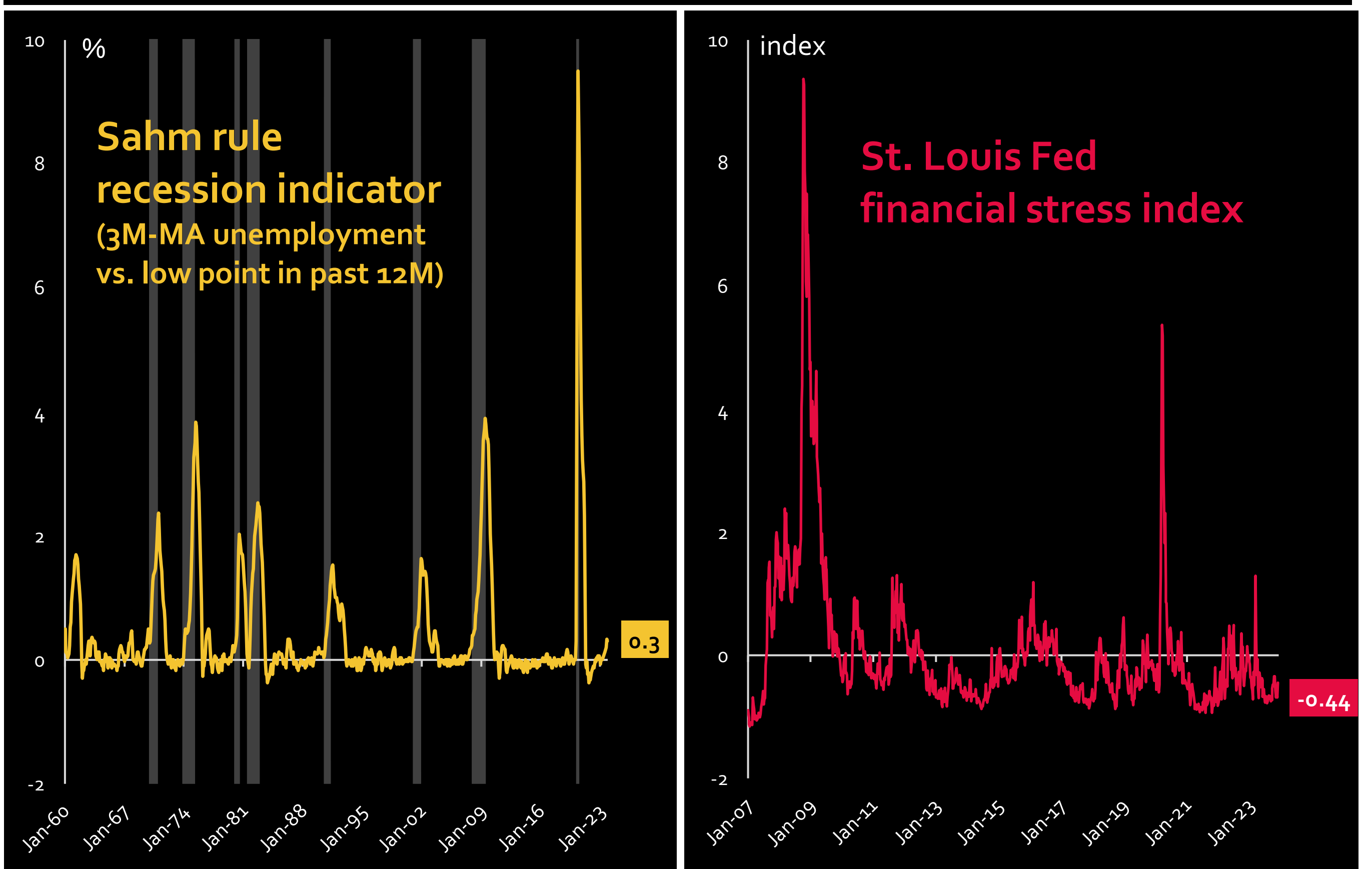
Source: Bloomberg, calculations by BCA Economist

Panel 5. The bottoming US leading index further push a recession scenario from view



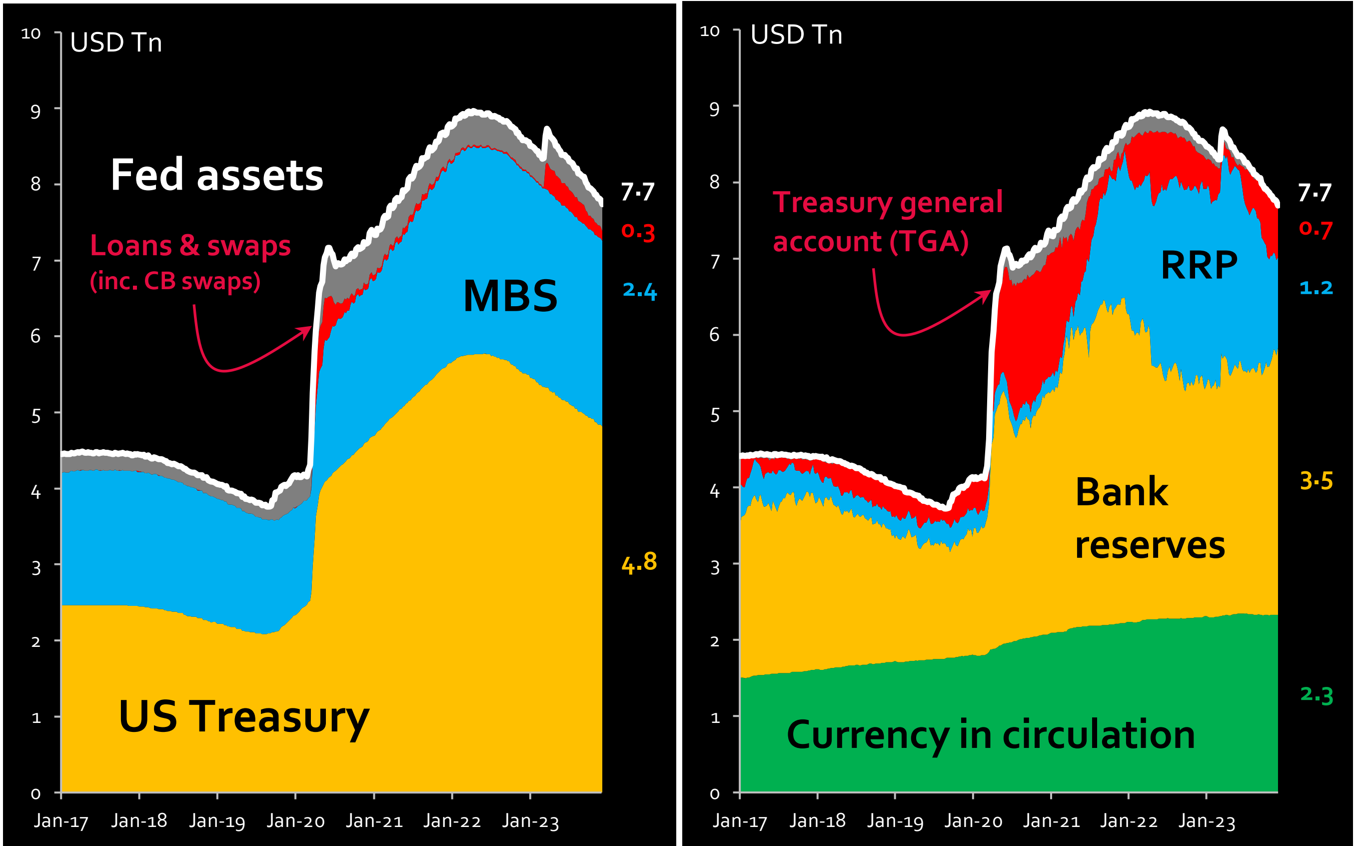
Source: Conference Board

Panel 6. Both on the real and financial sides, signs of impending US recession remain limited



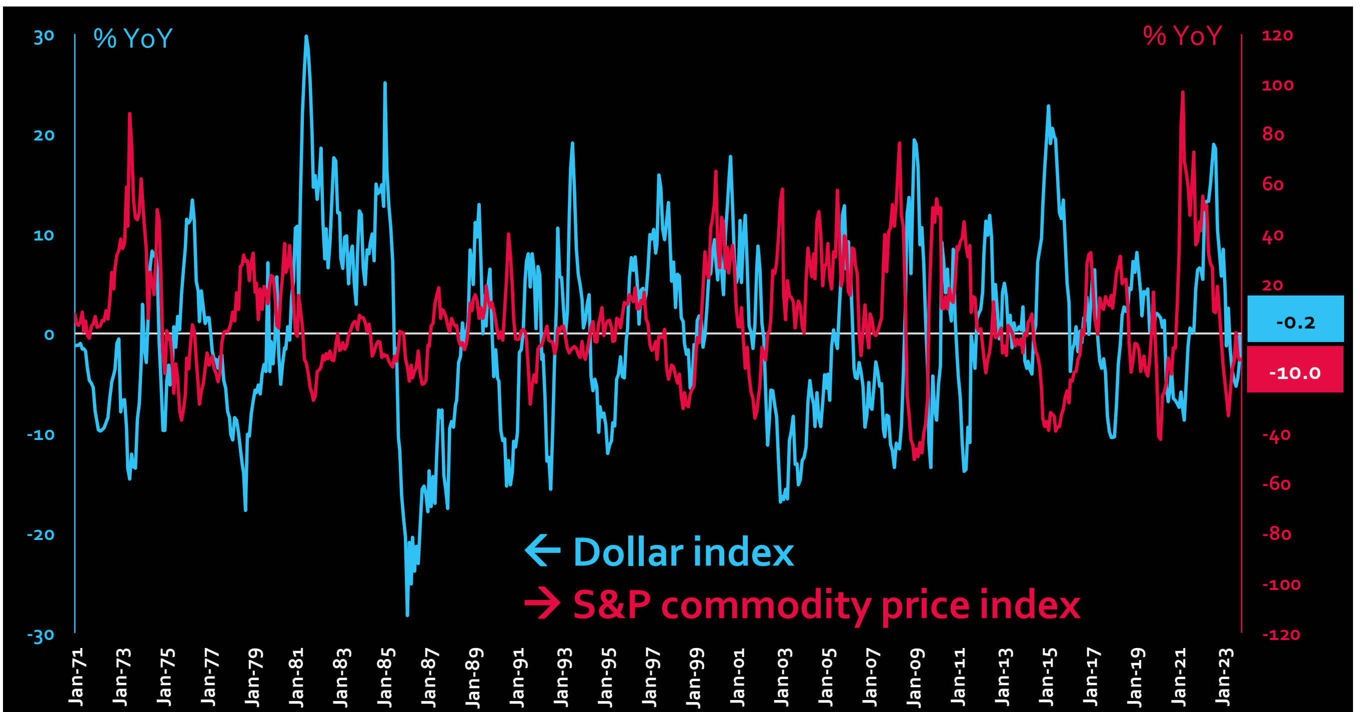
Source: St. Louis Fed

***Panel 7.* The depleted RRP amidst the still-going fiscal build-ups may pose a risk to banks' reserves**



Source: St. Louis Fed

***Chart 1.* The USD's value and oil prices moved down simultaneously, signalling weaker inflationary pressure and the restoration of the Fed's credibility**



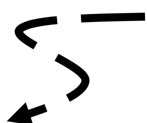
Source: Bloomberg

Selected Macroeconomic Indicator

Key Policy Rates	Rate (%)	Last Change	Real Rate (%)
US	5.50	Dec-23	2.40
UK	5.25	Dec-23	0.65
EU	4.50	Dec-23	2.10
Japan	-0.10	Jan-16	-3.40
China (lending)	2.50	Nov-23	4.85
Korea	3.50	Nov-23	0.20
India	6.50	Oct-23	0.95
Indonesia	6.00	Nov-23	3.14
Money Mkt Rates	**13-Dec**	**-1 mth**	**Chg (bps)**
SPN (1M)	6.21	6.22	-0.8
SUN (10Y)	6.74	6.84	-9.7
INDONIA (O/N, Rp)	5.83	5.82	0.5
JIBOR 1M (Rp)	6.65	6.66	-0.5
Bank Rates (Rp)	**Sep**	**Aug**	**Chg (bps)**
Lending (WC)	9.02	8.96	5.79
Deposit 1M	4.33	4.29	4.24
Savings	0.66	0.66	0.38
Currency/USD	**13-Dec**	**-1 mth**	**Chg (%)**
UK Pound	0.793	0.818	3.20
Euro	0.920	0.936	1.76
Japanese Yen	142.9	151.5	6.04
Chinese RMB	7.171	7.286	1.60
Indonesia Rupiah	15,660	15,695	0.22
Capital Mkt	**13-Dec**	**-1 mth**	**Chg (%)**
JCI	7,075.3	6,809.3	3.91
DJIA	37,090.2	34,283.1	8.19
FTSE	7,548.4	7,360.6	2.55
Nikkei 225	32,926.4	32,568.1	1.10
Hang Seng	16,228.8	17,203.3	-5.66
Foreign portfolio ownership (Rp Tn)	**Nov**	**Oct**	**Chg (Rp Tn)**
Stock	3,136.1	2,895.1	240.91
Govt. Bond	833.9	810.4	23.50
Corp. Bond	11.2	11.3	-0.14

Trade & Commodities	13-Dec	-1 mth	Chg (%)
Baltic Dry Index	2,438.0	1,643.0	48.4
S&P GSCI Index	522.7	558.0	-6.3
Oil (Brent, $/brl)	74.3	81.4	-8.8
Coal ($/MT)	144.8	133.0	8.8
Gas ($/MMBtu)	2.33	2.71	-14.0
Gold ($/oz.)	2,027.7	1,940.2	4.5
Copper ($/MT)	8,237.4	7,954.7	3.6
Nickel ($/MT)	16,243.0	17,025.5	-4.6
CPO ($/MT)	771.7	779.4	-1.0
Rubber ($/kg)	1.41	1.47	-4.1
External Sector	**Oct**	**Sep**	**Chg (%)**
Export ($ bn)	22.15	20.75	6.76
Import ($ bn)	18.67	17.34	7.68
Trade bal. ($ bn)	3.48	3.41	2.08
Central bank reserves ($ bn)*	133.1	134.9	-1.27
Prompt Indicators	**Nov**	**Oct**	**Sep**
Consumer confidence index (CCI)	123.6	124.3	121.7
Car sales (%YoY)	-7.5	-13.9	-20.1
Motorcycle sales (%YoY)	-2.8	-4.0	-0.9
Manufacturing PMI	**Nov**	**Oct**	**Chg (bps)**
USA	46.7	46.7	0
Eurozone	44.2	43.1	110
Japan	48.3	48.7	-40
China	50.7	49.5	120
Korea	50.0	49.8	20
Indonesia	51.7	51.5	20

Source: Bloomberg, BI, BPS
Notes:
^Data for January 2022
*Data from earlier period
For changes in currency: **Black indicates appreciation against USD, **Red** otherwise
***For PMI, **>50** indicates economic expansion, **<50** otherwise



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Indonesia – Economic Indicators Projection

	2019	2020	2021	2022	2023E	2024E
Gross Domestic Product (% YoY)	5.0	-2.1	3.7	5.3	5.1	5.0
GDP per Capita (US$)	4175	3912	4350	4784	4982	5149
Consumer Price Index Inflation (% YoY)	2.7	1.7	1.9	5.5	2.8	3.2
BI 7 day Repo Rate (%)	5.00	3.75	3.50	5.50	6.00	5.50
USD/IDR Exchange Rate (end of year)**	13,866	14,050	14,262	15,568	15,728	16.037
Trade Balance (US$ billion)	-3.2	21.7	35.3	54.5	34.9	32.6
Current Account Balance (% GDP)	-2.7	-0.4	0.3	1.0	-0.4	-0.5

*Estimated number

** Estimation of Rupiah's fundamental exchange rate

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