FX

Global

FX Insight

FX Strategy Update - USD Vulnerable Beyond the Hawkish Fed

Key Shifts Are in the Dot Plot

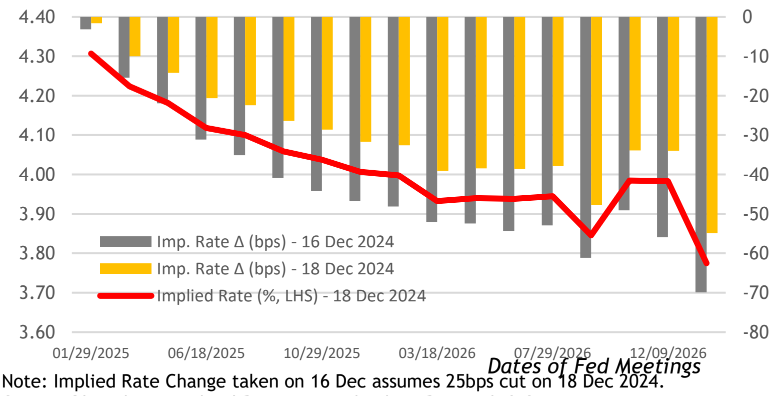
- **Fed lowers the benchmark rate by 25bps to 4.25-4.50% target rate with only one dissenter (Fed Cleveland Hammack) calling for no cut.** The statement was little changed except for a small phrase added - "the extent and timing" of additional adjustments to the Federal funds rates will be determined by incoming data, the evolving outlook and the balance of risks, giving emphasis that the pace of easing is less certain. The overnight reverse repurchase rate was lowered by 30bps.

- Key shift was in the summary of economic projections which was hawkish. 1) Growth forecasts were revised higher for 2024-2025. 2) Inflation forecasts were revised higher for 2024-2026. **3) Median forecast of Fed Fund target rate was raised, projecting only 50bps cut in 2025 (vs. 100bps seen in Sep).** This is roughly in line with what markets were expecting before the decision. Once again, markets seem to be leading the Fed.

- Fed Powell noted that there is more uncertainty surrounding the inflation outlook, notwithstanding the progress that it has made this year. Compared to Sep, inflation prints have surprised to the upside and 12-month inflation has moved sideways. Due to the uncertainty, the Fed thinks it is more prudent to move slower and carefully especially with balance of risks more even. The Fed officials have also been analyzing on how tariffs can impact inflation. However, Powell was also quick to point out that the committee does not have the information on the exact policies and would be able to make a more careful assessment when tariffs are announced.

- **FX Strategy:** The USD surged but a probable double-top has formed for the DXY index with eyes on key resistance at around 108.00. We see downside risks in the near-term given that markets tend to overshoot after being validated by the Fed, only to be moderated by data. That said, Trump's policies are assumed to be supportive of the USD. So this has bearish move depends on whether the DXY can remain above 108 by end of this week, forming the double top. Window of play expected to be between now and Trump's inauguration on 20 Jan 2025.

Chart: Dot Plot Shifted With Fewer Rate Cuts Seen



Note: Implied Rate Change taken on 16 Dec assumes 25bps cut on 18 Dec 2024.

Source: Bloomberg, Federal Reserve, Maybank FX Research & Strategy

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Fed Cuts 25bps, Shifts Dots Plot

Fed lowers the benchmark rate by 25bps to 4.25-4.50% target range with only one dissenter (new-comer Fed Cleveland Hammack) calling for no cut. The statement was little changed except for a small phrase added - *"the extent and timing"* of additional adjustments to the Federal funds rates will be determined by incoming data, the evolving outlook and the balance of risks, giving emphasis that the pace of easing into 2025 is less certain. **Based on this Fed statement alone, the emphasis on slowdown suggests that a pause in the monetary policy easing is more or less guided for the Jan meeting.**

Key: Hawkish Dot Plot shifts - Rate Cut Projections in 2025 *Reduced*

Key shift was in the summary of economic projections which was hawkish.

1) Growth forecasts were revised higher for 2024-2025. GDP is now seen at 2.5% for 2024 instead of 2.0% this year while growth is expected to moderate to 2.1% in 2025, a tad higher than 2.0% seen in Sep.

2) Estimates of unemployment rate (which were so suspiciously flat) at the last meeting are now revised lower for 2024 and 2025 at 4.2% and 4.3% respectively vs. 4.4% seen for both years.

3) Inflation forecasts were revised higher through 2026 and the two measures are expected to cool at a slower rate. Core PCE inflation is now expected to be 2.8%y/y for 2024 vs. previous estimate at 2.6%. For 2025 and 2026, inflation is expected to cool to 2.5% and 2.2% vs. 2.2% and 2.0% seen previously. In other words, core PCE and PCE inflation are expected to hit 2.0% only in 2027 vs 2026 estimated in Sep.

4) Median forecast of Fed Fund target rate was raised, projecting only 50bps cut in 2025 (vs. 100bps seen in Sep). This is roughly in line with what markets were expecting. Once again, markets seem to be leading the Fed. Markets are now seeing only 32bps cut for the whole of 2025. Longer run Fed Fund rate is raised (again) to 3.0% from 2.9%.

Table 1: Summary of Economic Projections

	Median				
Variable (Percent)	2024	2025	2026	2027	Longer-Run
Change in Real GDP	2.5	2.1	2.0	1.9	1.8
Sep Projection	*2.0*	*2.0*	*2.0*	*2.0*	*1.8*
Unemployment Rate	4.2	4.3	4.3	4.3	4.2
Sep Projection	*4.4*	*4.4*	*4.3*	*4.2*	*4.2*
PCE inflation	2.4	2.5	2.1	2.0	2.0
Sep Projection	*2.3*	*2.1*	*2.0*	*2.0*	*2.0*
Core PCE Inflation	2.8	2.5	2.2	2.00	
Sep Projection	*2.6*	*2.2*	*2.0*	*2.0*	
Memo-Projected Appropriate Policy Path					
Fed Fund Rate	4.4	3.9	3.4	3.1	3
Sep projection	*4.4*	*3.4*	*2.9*	*2.9*	*2.9*

Note: For each period, the median is the middle projection when the projections are arranged from lowest to highest. When the number of projections is even, the median is the average of the two middle projections.

Source: Federal Reserve, Maybank FX Research & Strategy

Powell's Press Conference – Economy is Where We Want it To be But, there is Uncertainty Ahead (Especially for inflation)

Powell said that the 25bps cut overnight reflects the strength of the economy, the progress of disinflation as well as the increased uncertainty surrounding the inflation outlook into 2025. He also noted that the 12-month inflation has been moving sideways. The economy has been growing at a stronger pace than expected. The balance of risks at this point is even and the Fed officials have agreed to be more cautious moving forward. **Further easing would require further progress on the disinflation front**. On that note, the latest economic projections suggest that the inflation would moderate at a slower pace and only hit 2.0% target in 2027. As such, median projections of policy rate were also adjusted accordingly. **The hurdle for the next rate cut seems a tad higher compared to the cut today.**

Powell also pointed out that the labour market conditions are now looser than it was pre-pandemic. There is no need for labour market to cool further in order to bring inflation lower.

With regards to the current Federal Fund target range of 4.25-4.50%, it is now 100bps lower than the peak of the cycle. Powell noted that policy settings are now "significantly closer" to neutral but still sufficiently restrictive to dampen inflation.

In response to questions on whether the policies of the incoming administration are taken into account, Powell mentioned that there is a range of approaches on the committee with some incorporating policy uncertainty into their economic projections and others not. How tariffs can impact inflation is being analyzed carefully by the Fed staff but the exact policies are still unknown and as such, careful assessments can only be made when tariffs are announced. In addition, the economy is wholly different from where it was in 2018. There is a less likelihood that the Fed would "look through" any temporary hits to inflation from levies at this point where inflation remains above target compared to the low inflation environment in 2018.

Hawkish Reactions From the Market

Fed fund futures now look for the Fed to cut by only 33bps in 2025**. Once again, Fed's decision validated markets' projections and spurred further hawkish re-pricing from around 50bps seen in 2025 at first to around 32bps.** UST 10y and 2y yield jumped 13bps and 14bps respectively, one of the most hawkish reactions in this rate hiking cycle. US bourses were in a sea of red – DJI (-2.6%), S&P (-3.0%), NASDAQ (-3.6%). The DXY index rose 1.2% to clock a new high for the year at 108.26.

The reason for the hawkish reaction in the markets is due to

1) the hawkish shift of the economic projections by the Fed. Rate cut projections are now halved from 100bps to only 50bps seen in 2025 and another 50bps seen in 2026. Growth is revised higher, inflation as well.

2) Powell's acknowledgement that there is more uncertainty on inflation and he did not even want to rule out a rate hike, as "you don't rule things in or out in this world".

3) The hurdle for Fed to cut again seems a tad higher than before given the balance of risks as well as how policy settings are closer to neutral.

However, it is worth considering that markets have shown tendency to over-react. Data-dependency of the Fed has allowed the markets to lead the Fed in terms of rate projections simply because markets can react faster than Fed's in terms of forecast changes. Markets seem to be validated time and again by Fed's decision and guidance, leading to more instances of overshooting, only to be moderated by data releases thereafter. With only slightly more than 1 rate cut expected for 2025, there is a possibility that markets are at risk of leaning too hawkish at this point.

Fed Powell has mentioned that the Fed can be "flexible", slowing when the environment requires it to and quickening its pace of easing when the conditions demand it.

While further cooling in the labour market is not necessary to bring down inflation, any sign of further deterioration in the labour market could still force the hand of the Fed as the Fed is now “attentive to both sides of its mandate – employment and inflation”.

Table 2: Market Implied Rate Trajectories for the Next 1Y

	Current Policy Rate (%)	Market Implied Policy in 1	Implied Policy Change (%)
US	4.38	4.05	-33
Canada	3.25	2.78	-47
Eurozone	3.00	1.59	-141
UK	4.74	4.23	-51
Switzerland	0.50	-0.06	-56
Australia	4.35	3.62	-73
New Zealand	4.25	2.99	-126
Japan	0.25	0.72	47
China	1.50	0.92	-58
India	6.50	5.7	-80
South Korea	3.00	1.97	-103

Note: Prices are taken as of 18 Dec 2024
Source: Bloomberg

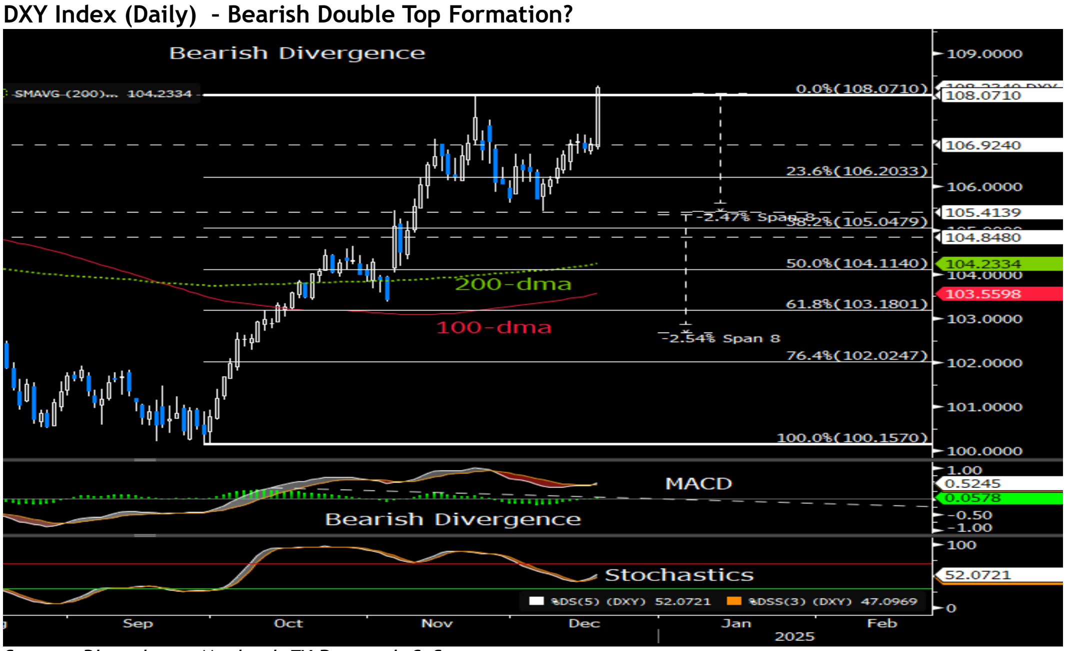
Central Banks are Set to be Less Synchronous In their Easing Cycle

The Fed is now expected to cut only one-two more times in 2025 due to high inflation uncertainty. That contrast to the ECB and RBNZ where markets continue to expect 5-6 more cuts. USD is set to remain supported on exceptional carry advantage as easing pace across central banks become less synchronous.

FX Strategy - Near-term Risks

With the DXY index surging back to 2024 high and only slightly more than 1 cut expected for 2025, we are more cautious of chasing the USD higher from this level. Market’s tendency to overshoot after recent FOMCs suggest that positioning could be moderated by any signs that the economy could soften from here. The balance of risks have shifted to the downside in the near-term. We are rather bearish on the USD in the near-term but we like to stress that Trump’s policies seem supportive of the USD. Between now and his inauguration however, there is a window for the DXY index to correct, especially if the DXY index is not able to remain above key resistance at 108.10 by the end of the week. A failure to remain above this level could form a bearish double top formation and bring this index back to 105.40 before 103.

DXY Index (Daily) – Bearish Double Top Formation?



Source: Bloomberg, Maybank FX Research & Strategy

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