Daiwa Securities

Daiwa's View

Things to watch for in 2023 (1): A return by the Fed to dual mandate objectives

➢ When the Fed starts to strike a balance between employment and inflation

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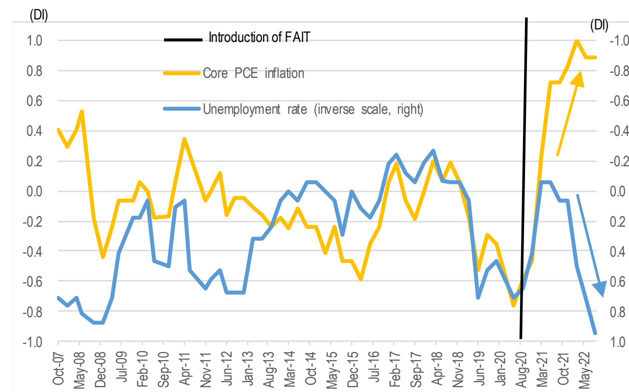
When the Fed starts to strike a balance between employment and inflation

Since the reverse CPI shock on 10 November, the US long-term yield has been holding steady at the 3.6-3.8% level. One factor behind this is the Fed regaining a forward-looking perspective at the November FOMC meeting. The impact from the change in the Fed's behavior is great.

However, while the Fed may have regained a forward-looking perspective to some extent, it is still staying on maximum alert regarding inflation. This is obvious based on the fact that the diffusion index of risk weightings for core PCE inflation among FOMC participants has remained in the highest range at above 0.8 since December 2021. Moreover, with caution about a worsening unemployment rate also on the rise recently, the diffusion index of risk weightings for the unemployment rate in the September Survey of Economic Projections worsened to 0.95, higher than the level at the time of the Global Financial Crisis (chart below). These two diffusion indexes of risk weightings suggest that, while it may not happen right now, the Fed will eventually return to its "dual mandate objectives" of achieving a balance between employment and inflation.

Diffusion Indexes of Participants' Risk Weightings (inflation, unemployment rate)



While Fed has continued to stay on maximum alert for inflation, it has also quickly become increasingly cautious about worsening employment, albeit after a slight time lag. (The day when Fed starts giving consideration to employment may not be far off.)

Source: Fed; compiled by Daiwa Securities.

Checking the Survey of Primary Dealers released on 25 November from this perspective, we see that the projection for the terminal rate level rose to 4.875%, and the projection for the probability of recession rose to more than 80%, leading to the projection for the timing for "an adjustment rate cut" moving forward to Oct-Dec 2023, from Jan-Mar 2024 in the previous survey. The more projections for the terminal rate rise, the sooner primary dealers are likely to sense a strong economic downturn, which would move forward the expected timing for the Fed to return to its "dual mandate objectives." The rise in the projected terminal rate is leading to a situation in which there might be a faster shift in the Fed's stance in the future, which is a shift from the previous situation, which pointed to rate hikes leading to the FF rate remaining high, and that in turn leading to a rising long-term yield. A return by the Fed to its "dual mandate objectives" is something to look out for in 2023.

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