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The Fed Shifts Toward a More Accommodative Policy

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The Fed's Rate Cut Cycle

The Federal Reserve's Open Market Committee (FOMC) completed its two-day September meeting on September 18th and began its rate cut cycle by announcing a 50-basis point cut to the Fed Funds rate.

WILL THE FED CUT RATES THIS MONTH?

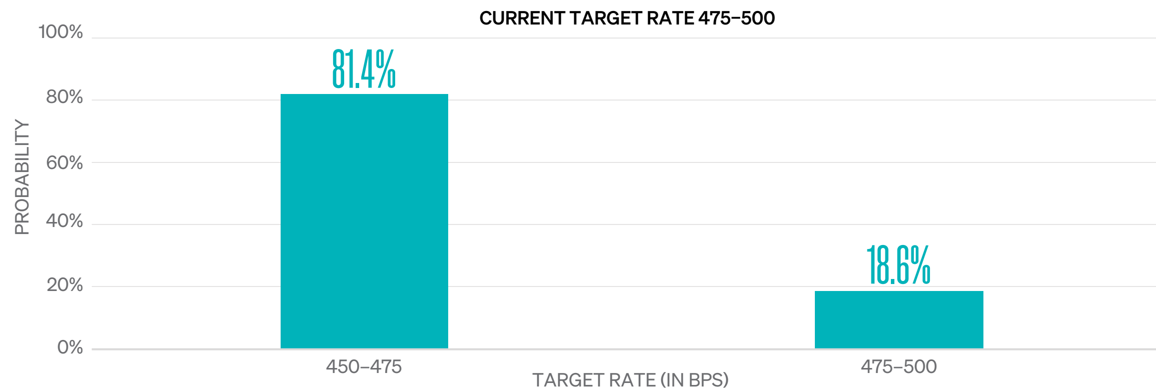
It is highly likely that the FOMC will cut the Fed Funds rate at its next two committee meetings. This rate, which is currently targeted between 4.75% and 5.00%, will almost certainly continue to decline. Federal Reserve Chair Jerome Powell admitted as much during his recent speech at the Kansas City Fed's annual economic conference in Jackson Hole, Wyoming. Powell stated, "The time has come for policy to adjust," in an effort to be extremely transparent about the Fed's direction on interest rates.

HOW MUCH WILL THE FED CUT RATES?

Given that there is near certainty that the Fed will indeed cut rates, the larger question is: How much will it cut by the end of this year? There is still debate over whether the Fed cuts by 25-basis points or decides on a larger 50-basis point move at its two remaining meetings in November and December. After the stronger-than-expected September jobs report, the market is pricing in an 84% likelihood of a 25-basis point cut, with a minor probability of the Fed keeping rates unchanged. As of October 7, the market is pricing in a total of 50 basis points in rate cuts before the end of the year.

EXHIBIT 1

TARGET RATE PROBABILITIES FOR NOVEMBER 8 FED MEETING
AS OF 10/7/2024



SOURCE: CME GROUP

SHOULD THE FED CUT RATES?

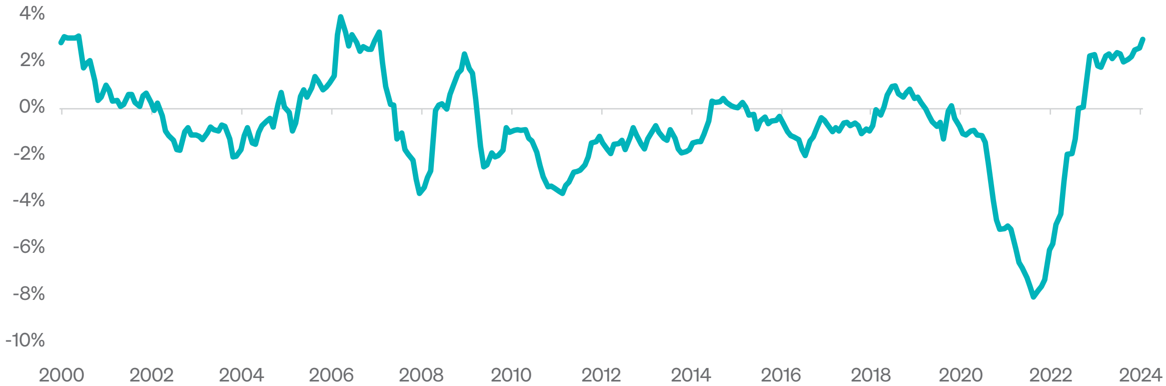
The simple answer is yes. The Fed has a dual mandate: To pursue the goals of maximum employment and price stability. It is the latter (inflation) that has been the primary concern over the past few years and the reason the FOMC began raising interest rates in March of 2022. Over the next 15 months, the Fed raised rates from 0% to 5.25%–5.50% to curb the highest inflation experienced by the U.S. since the 1970s.

The Fed's preferred inflation gauge, Core PCE (Personal Consumption Expenditures Price Index), which peaked at 5.57% in February of 2022, dropped in July to 2.62% year-over-year. Another commonly followed inflation index, the CPI (Consumer Price Index) also fell from a high of 9.10% in June of 2022 to its current level of 2.50%. The Fed's long-term goal is to keep the level of inflation at or around 2.00% and the recent decline toward that level has given it confidence that it can indeed begin to cut rates.

Looking at the real Fed Funds rate (a measure of the Fed Funds rate minus inflation) confirms its beliefs. As the graph below shows, the Fed's current rate stance is as restrictive to economic growth as it has been in nearly two decades. Beginning a rate cut cycle and easing monetary conditions is likely warranted as current policy is not only restrictive, but inflation has also fallen significantly.

EXHIBIT 2

REAL FED FUNDS RATE (FED FUNDS TARGET RATE UPPER BOUND – CPI YOY INFLATION)
AS OF 8/31/24



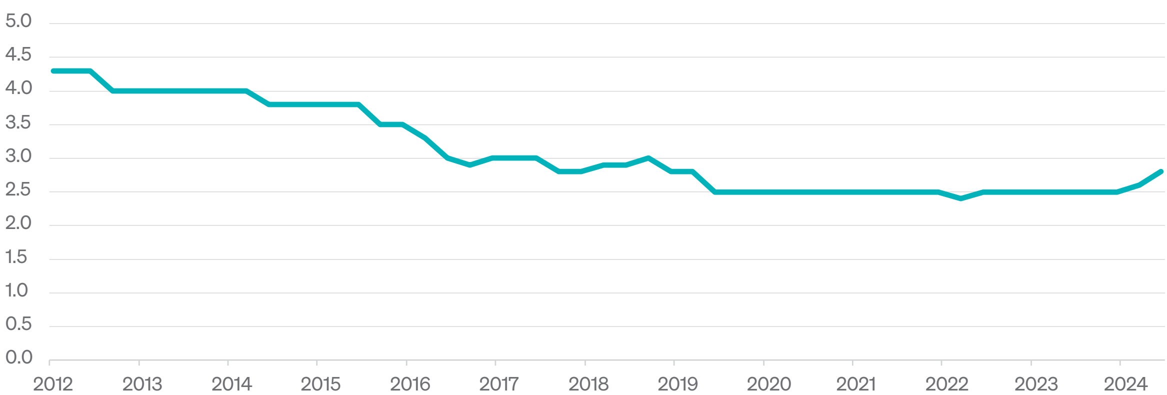
SOURCE: BLOOMBERG

HOW LOW WILL THE FED GO?

This question is the most difficult to answer, as it requires a view of future economic growth and inflation levels, both of which are difficult to forecast years in advance. Current market expectations are for the Fed to eventually reduce rates to roughly 3.00% over the next couple of years. The Fed's own expectations as of today are to eventually reduce rates to roughly 2.80% by the end of 2026.

EXHIBIT 3

LONGER RUN FOMC SUMMARY OF ECONOMIC PROJECTIONS FOR THE FED FUNDS RATE, MEDIAN
AS OF 6/12/24



SOURCE: FRED

This so called "neutral rate" would be the point at which the Fed believes monetary policy is neither accommodative nor restrictive and would likely be the point it stops cutting rates. A neutral rate of 3.00% would indicate that the Fed had cut rates 225 basis points (or nine 25-basis point cuts). Barring a recession, the Fed is expected to cut at a gradual pace, making it unlikely to reach the 3.00% Fed Funds rate until some point in 2026.

THE NEXT STEPS

The Fed began cutting interest rates at its September meeting. Given the slight rise in unemployment and the decline in inflation, current monetary policy is extremely restrictive. The full number of rate cuts and associated decrease in interest rates will be determined over the next couple of years, but current estimates are for about nine rate cuts and an eventual Fed Funds rate of about 3.00% by the end of 2026.

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