SMBC SMBC Group

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What Do We Expect from the Fed?

The Fed is done tightening in this business cycle. The next move is clearly an ease. The question is when and then how much will the Fed ultimately cut?

Recent history is consistent with a March 2024 interest rate cut as it would be eight months from the last rate hike, which is the average time following the last five tightening cycles. Financial markets had well above a 50% probability of this action, but the percentage has recently fallen below 50%. Ultimately, the data will determine the path of the fed funds rate, and there is a lot of data between now and the March 20 meeting—two more employment, two more CPI, and two more retail sales reports.

If Friday's employment results surprise financial markets, they will surprise the Fed, too. That matters because Chair Powell has no incentive at this point to rule out a March cut and will look foolish if January's results surprise to the downside, which is the risk. While he may hint that a rate cut is likelier later in the year than for March, he is likely to state that economic data will be the determining factor. Remember the Fed does not publish updated forecasts in January — that comes in March.

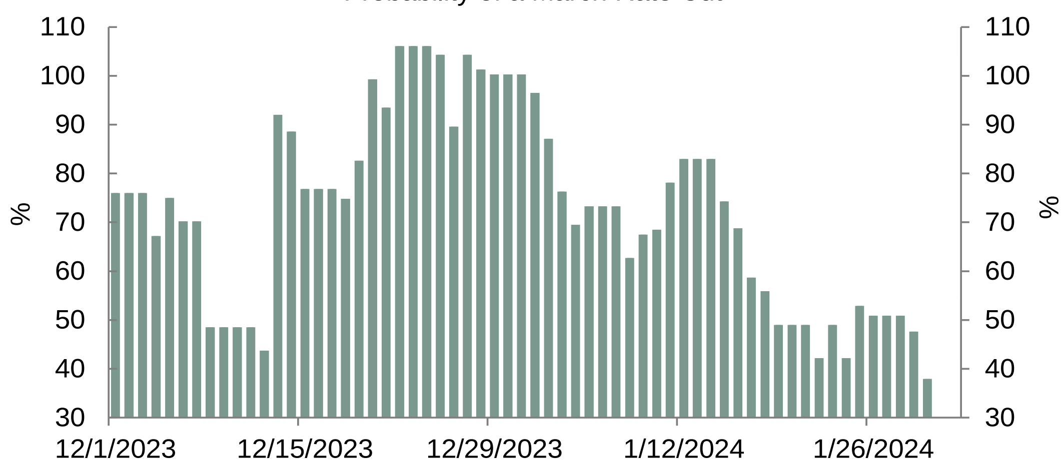
We expect the Fed to cut rates by 25 basis points (bps) in March because inflation has fallen to the Fed's target and is expected to stay there. For example, the monthly percent change in the core PCE deflator has been under 0.2% in six out the last seven months, and there is a panoply of indicators suggesting this moderation will persist — residential rents, goods prices, and labor costs continue to soften. However, as we can see below, the probability of a March rate has plunged and is lower than at any time since last December.

All else being equal, there is another reason for the Fed to move sooner rather than later. Since 1984, the Fed has never initiated rate cuts in a Presidential Election year. The optics of rate cuts beginning this summer sandwiched in between both party conventions could be thorny. This generally favors a rate cut sooner than later. If the Fed can justify a rate cut as soon as March, our hunch is that policymakers will exercise that option.

How much will the Fed ultimately lower the funds rate? Since 1960 there have been 15 interest rate cutting cycles, which we define as at least three interest rate reductions. **The historical average amount of cumulative rate cuts has been 400 bps spanning 15-months**. But the average masks substantial variability within the sample so caution is warranted.

Given our estimate of R-Star and the current shape of the Treasury yield curve, **we project the Fed will ultimately need to cut by 300 bps** and that it will likely happen over the course of 2024 and 2025. Broadly speaking, the bond market has a similar trajectory but looks for only 200 bps over this time.

Probability of a March Rate Cut



Source: Bloomberg, SMBC Nikko

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