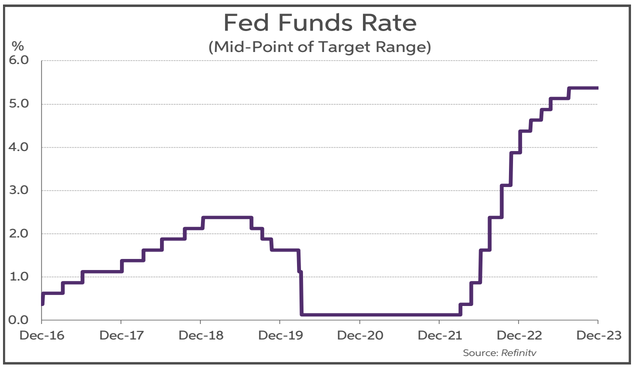
Fed Watch

AIB Treasury Economic Research Unit

14th December 2023

Fed turns dovish, markets expect numerous rate cuts in 2024

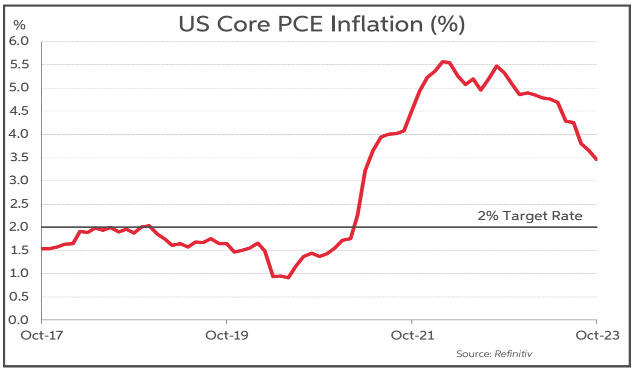


As widely expected, the US Federal Reserve Open Market Committee left its key interest rates on hold at the conclusion of its two-day meeting last night. As a result, **the target range for the funds rate remains at 5.25-5.50%, a 22-year high.** This was the third consecutive meeting that policy was left unchanged, after the Fed had enacted 525bps worth of rate increases between March 2022 and July 2023.

The decision to leave rates unchanged was unanimous. **It was no surprise to markets, which believe that rates are at a peak and will be cut next year.** In the run-up to the meeting, futures contracts were pricing in that rates would be lowered by 110bps by end 2024. Hence, market attention yesterday was very much focused on the insights on the future path for rates provided by the FOMC statement, Chair Powell's comments at the post-meeting press conference, the new Fed interest rate dot-plot and its updated macro-economic forecasts. **The outcome of all this new information was that markets doubled-down on their rate cut bets. They are now pricing in 160bps of easing during 2024,** starting in March, with rates being lowered by 25bps at every FOMC meeting from then to possibly December. Bond yields fell sharply with 10 year US yields declining by 20bps to below 4%, while stock markets rallied and the dollar lost ground.

The FOMC statement acknowledged that inflation has eased and growth has slowed, suggesting the Fed's tightening job is done. Chair Powell cautioned, though, that it would be premature to declare victory in the battle to restore price stability, and thus indicated the FOMC is moving carefully in terms of its policy assessment. That said, his press conference was far more dovish than anticipated. He indicated that **the question of rate cuts is "coming into view" and there was a general expectation at the FOMC that it "will be a topic of discussion of conversation going forward".**

Meanwhile, **the Fed's updated dot-plot of rate projections published after the meeting was also more dovish**. In the last dot-plot in September, a large majority of FOMC members had anticipated there would be a further hike in rates. Now all FOMC members believe that the next move in rates will be downwards. The December dot-plot shows **the median projection of FOMC members is that rates will be cut by 75bps by end 2024 to 4.5-4.75% range,** which is 50bps lower than in September. **Rates are then seen as being cut by a further 100bps in 2025 and 75bps in 2006.**



The latest set of Fed quarterly macro forecasts were also published yesterday. In terms of economic activity, the Fed upgraded its Q4 2023 GDP growth forecast from 2.1% to 2.6% year-on-year, but lowered its Q4 2024 projection slightly, from 1.5% to 1.4%. Growth is seen running at 1.8% year-on-year in Q4 2025 and 1.9% by Q4 2026. The Fed's unemployment forecasts were largely unchanged.

Meanwhile, **the Fed's projection for the core-PCE inflation rate in Q4 2023 was revised down to 3.2% from 3.7%** in the September forecast, though this seems a bit too ambitious to us. The latest projections show the **core-PCE rate falling to 2.4% in Q4 2024, down from 2.6% previously.** The rate is seen at 2.2% by Q4 2025, compared to 2.3% before. **It is then seen hitting the 2% target in Q4 2026.** Thus, after a sharp slowdown in core inflation this year, the Fed expects it to decline much more slowly back to 2% over the next three years.

In the aftermath of the meeting, as already noted, futures contracts rallied strongly. They are now pricing in six to seven 25bps rate cuts over the course of next year, taking rates down to 3.75% by end 2024. This is 75-100bps lower than in the Fed's dot-plot. Close to a further 50bps of rate cuts are anticipated by the markets for 2025. Thus, **a large gap has opened up between the Fed and markets on the scale of policy easing in 2024, though they are aligned on the view that significant rates cuts are likely over the next two to three years.** The disagreement is on the speed of the rate reductions. The Fed is naturally more cautious, and as ever the data will decide. **If core inflation declines more quickly next year than the Fed expects, then it is likely to respond with more rapid rate cuts in 2024 than suggested in its dot-plot.** Time will tell, but **market expectations of a rate cut by March may prove overly optimistic**.

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Economy expected to slow after performing strongly in 2023

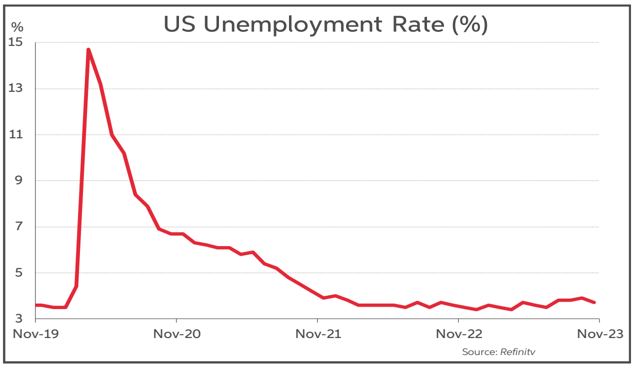
The US economy has continued to perform very strongly this year. GDP expanded by between 2.1-2.7% annualised per quarter between mid-2022 and mid-2023, before growing by a very robust 5.2% annualised rate in the third quarter of this year. Meantime, real final domestic sales rose by 3.5% in Q3, up from 2.1% in Q2. Overall, the data show that the US economy, which was already growing at a strong pace, gained further momentum in Q3, with year-on-year GDP growth picking up to 3%.

Regarding the underlying breakdown of GDP in the third quarter, consumption rose strongly by 3.6% annualised, contributing a significant 2.4 percentage points (p.p.) to the total rise. Fixed investment added a further 0.7 p.p. to growth. Government spending jumped by 5.5% in Q3, led by a big increase in defence expenditure, with non-defence spending also growing strongly, boosting GDP by 0.9 p.p.. Net trade was flat, while inventories contributed a large 1.4 p.p. to the GDP total.

The data available to date in the fourth quarter have been somewhat mixed. The composite PMI was unchanged at 50.7 in November, which is virtually identical to its average level in the third quarter. Both the manufacturing and services PMIs have been little changed in recent months, with the former in contraction territory and the latter in expansion mode. Meantime, industrial production was down by 0.6% in October, including a fall of 0.7% in manufacturing output. Growth in real consumer spending slowed in October, increasing by a modest 0.2%, with the rise in personal income also decelerating. Auto sales slowed in both October and November. Furthermore, both the Conference Board and University of Michigan measures of consumer confidence deteriorated in October before recovering in November.

In terms of the labour market, conditions remain tight, but are starting to ease. Payrolls expanded at a robust pace in the first three quarters of the year, rising by an average of 260k per month. The pace of increase has slowed though, to 150k in October and 199k in November. Meantime, the number of job openings is also declining, falling to 8.7m in October from 9.35m in September, and it is now well below the total of 11.2m at the end of 2022. Indeed, October was the lowest reading since March 2021. Elsewhere, the unemployment rate had edged higher to 3.9% in recent months, before dropping back to 3.7% in November. Furthermore, weekly jobless claims numbers, have remained very low. Against this backdrop of still tight labour market conditions, average earnings growth remains strong, at 4.0% year-on-year in November, although, this is down from 4.8% last December, and a peak of 5.9% in March 2022. However, the closely followed wages component of the employment cost index rose by 1.2% q/q in Q3, up from 1% in Q2.

Headline CPI inflation has proven to be range bound in a 3.1-3.7% corridor since mid-year, having fallen sharply in the first half of 2023. This can largely be attributed to a sharp rise in fuel prices, which jumped by 10.6% in August, and 2.1% in September. The headline PCE deflator, though, declined to 3% y/y in October. **Meantime, core inflation has continued to trend lower,** with core-CPI falling to 4.0% in October and remaining at that level in November, down from 4.7% back in July. Similarly, core-PCE inflation, had been in a narrow 4.3-4.9% between December 2022 to July 2023, before declining in recent months. It fell to 3.5% in October.



To surmise, the US economy performed very strongly in the first three quarters of this year. Furthermore, the US appears to be relatively unscathed by the stresses which emerged in parts of its banking system in the spring. The expansionary stance of fiscal policy has been a considerable support to the economy. **GDP growth is set to average close to 2.5% this year.** The economy is expected to slow next year, with the Fed seeing growth easing to 1.4% y/y in Q4 2024, and then picking up to 1.8% y/y in Q4 2025. **Both the IMF and OECD, in their latest updates, see GDP slowing to 1.5% in 2024.** Overall, the economy appears to be on course for a soft landing, although the Fed continues to warn that it is too early to proclaim victory in the fight against inflation, without there being a downturn in activity. However, **with long term rates falling sharply since late October, rate cuts expected to come on to the agenda next year and real incomes starting to rise on lower inflation, the elusive soft landing may be at hand.**

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