

Fed primed for 75bps of cuts in 2024, starting in summer

The US Federal Reserve Open Market Committee's second meeting of 2024 saw its key interest rate left on hold last night. The target range for the Fed funds rate remains at 5.25-5.50%, a 22-year high. This was the fifth consecutive meeting that policy was left unchanged. The Fed had enacted 525bps worth of rate increases during its tightening cycle which began in March 2022, with the most recent hike occurring last July. The decision by the FOMC to leave rates unchanged was once again unanimous.

While the hold in rates was expected, Fed watchers were focused on the latest quarterly macro forecasts published last night.

In terms of GDP growth, the Fed revised up its median Q4 2024 projection to 2.1% from 1.4% in its December 2023 forecast. Growth is seen running at 2% y/y in both Q4 2025 and Q4 2026, revised up from 1.8% and 1.9%, respectively. The Fed's unemployment forecasts were largely unchanged, with the jobless rate seen as rising to 4% by end 2024 and remaining around that level throughout the remainder of the forecast horizon. Meanwhile, the Fed's projection for the core-PCE inflation rate shows it falling to 2.6% in Q4 2024, up slightly from the 2.4% rate pencilled in previously. The rate is seen at 2.2% by Q4 2025, unchanged from the December forecast. It is then seen hitting the 2% target in Q4 2026. Thus, after experiencing a sharp fall last year, the Fed expects core inflation to decline much more slowly back to 2% over the next three years.

The Fed's interest rate projections, known as the 'dot-plot' were broadly unchanged for 2024, with the median continuing to signal 75bps of cuts this year, likely beginning in June, to a 4.5-4.75% range. However, longer term projections are for more modest rate cuts than projected in December. Rates are seen as being cut by a further 75bps in both 2025 (one less cut than forecast in December) and 2026, with long term rates expected to settle around 2.6% compared to a 2.5% median forecast in December.

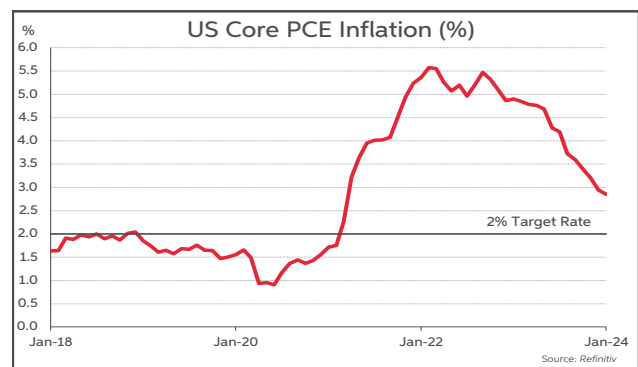
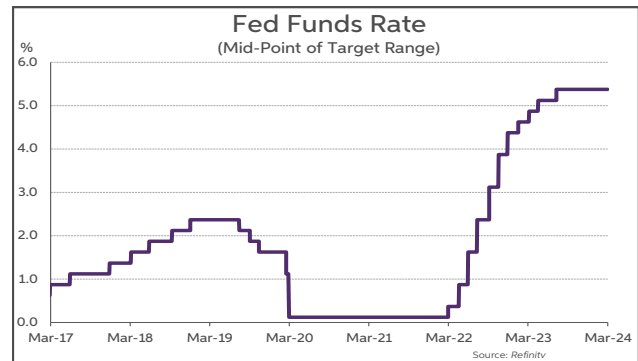
The FOMC statement contained few key changes and positions the Fed to move onto a policy easing stance over the summer months. The main change to the statement was reflected in commentary on the strength of the US labour market. It stated that employment growth has "remained" strong, whereas in January it noted that gains had "moderated since early last year, but remain strong".

At the post-meeting press conference, in response to questions on the potential timing of the first rate cut, Fed Chair Powell signalled that it is drawing near. He reiterated

that it will likely be appropriate to start easing policy "at some point this year" and stated that the recent strong inflation data represented a "bump in the road". The press conference overall was perceived by markets as bullish on the outlook for the US economy, spurring a bounce in equities. Indeed, Chair Powell stated "strong jobs growth is not a reason for us to be concerned about inflation." On its balance sheet reduction (QT) plans, while unchanged for now at a run rate of c.\$95bn/month, Powell also stated that "it will be appropriate to slow the pace of run-off fairly soon".

The latest dot-plot projections confirm the Fed has prevailed for now in its arm wrestle with markets, with expectations moving from c.150bps of cuts in 2024 at the beginning of January, to c.85bps post the announcement. Futures contracts signal that the market is almost fully pricing in a first rate cut by June, followed by a further cut in September, and another cut in December.

Further out though, by end 2026, the market is not expecting rates to be cut to the same extent as outlined in the Fed's own projections. The market is anticipating rates bottoming in a 3.50-3.75% range. In contrast, the Fed's projections have rates being lowered to a 3.00-3.25% range.



US economy maintains good momentum in 2024

The most recent GDP update showed the US economy expanded by 3.2% annualised in Q4. Overall, the US economy confounded expectations last year, growing by 2.5%, up from 1.9% in 2022. Despite elevated levels of inflation and an aggressive tightening of monetary policy, consumer spending remained a key driver of growth throughout 2023. Furthermore, increased government expenditure and business fixed investment boosted GDP, particularly in the first half of the year. In the second half of 2023, economic growth broadened, with all of the main sub-categories, including residential investment, net exports and inventories contributing positively to GDP.

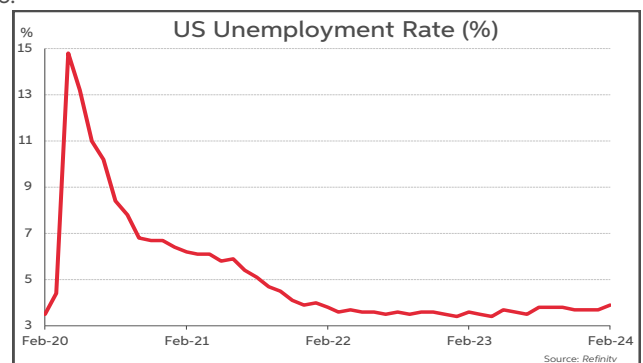
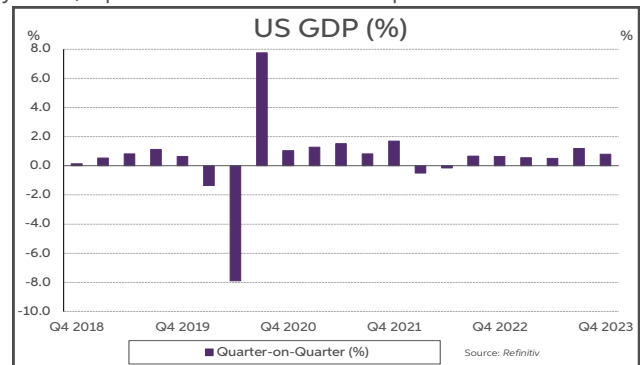
Survey data available for the opening few months of 2024 suggest the economy maintained good momentum at the start of the year. Both the manufacturing and services PMIs improved in January, with the former printing above 50 for the first time since April 2023. They continued to trend higher in February also. Similarly, the non-manufacturing ISM was consistent with an expansion in activity in the sector. In contrast, the manufacturing ISM deteriorated in February and stayed in contraction mode. Meantime, the Michigan measure of consumer sentiment rose sharply in January to 79.0, its highest level since July 2021, before inching trivially lower throughout the rest of Q1, amid higher gas prices. Likewise, homebuilder sentiment increased for a fifth consecutive month in March.

Meanwhile, hard data in Q1 have been somewhat mixed. Retail sales contracted by 1.1% in January, before rebounding modestly by 0.6% in February. Furthermore, the control group measure, a key core sales metric fell by 0.3% in January before stagnating in February. However, inclement weather at the start of 2024 may have depressed sales. Elsewhere, industrial production rose by just 0.1% in February, having declined by 0.5% in January. In terms of the residential property market, existing sales look to have bottomed out, albeit at low levels, while building permits and housing starts increased sharply in February.

Regarding the labour market, conditions remain tight, although they are starting to ease. Payroll growth averaged 252k in the first two months of the year, compared to 210k during 2023. However, the unemployment rate rose to 3.9% in February, its highest level since January 2022. Amid still tight labour market conditions, average earnings growth remains strong, at 4.3% year-on-year in February. Indeed, wage growth has been in and around 4.3-4.5% since last August, although the monthly increase of 0.1% in February was the lowest in two years.

In terms of inflation, headline CPI inflation has been in a 3.1-3.7% corridor since mid-2023. It stood at 3.2% in February, as housing costs remained stubbornly high. The headline PCE deflator, though, declined to 2.4% in January, from 2.6% in November and December. **Meantime, core inflationary pressures are slowly dissipating.** Core-CPI has fallen in 15 of the last 18 months, but it remained elevated at 3.8% in February. Similarly, core-PCE inflation, had been in a narrow 4.3-4.9% range between December 2022 to July 2023, before declining in the second half of last year. It fell to 2.8% in January, its lowest level since March 2021. The Fed is forecasting core-PCE will ease to 2.6% in Q4 2024, 2.2% in Q4 2025 and to 2.0% by Q4 2026.

To surmise, the US economy performed very strongly in 2023. The expansionary stance of fiscal policy has been a considerable support to the economy. Furthermore, the economy appears to have maintained solid momentum at the start of 2024. Looking ahead, the economy is expected to continue to perform well this year, with the IMF predicting a modest slowdown in growth to 2.1%. The IMF sees GDP rising by 1.7% in 2025. The Fed sees GDP growth running at 2.1% annualised in Q4, and at 2% by the end of next year. 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. We would note, that the large amount of excess savings in the US, which provided a supportive backdrop for consumption, a key driver of growth in 2023, have largely been run-down. Thus, the risks to the outlook, appear to be tilted to the upside for inflation and to the downside for growth. **However, with rate cuts expected this year, and real incomes starting to rise on lower inflation, the elusive soft landing may be at hand.**



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