Perspectives

JAN
2024

Great Expectations

After ending 2023 with a steep market rally, 2024 began on a more muted note, with Fed-pivot exuberance giving way to the details of execution. Of the many opportunities and risks facing markets this year, one of the most scrutinized will likely be how the Fed's interest rate cuts compare to market expectations.

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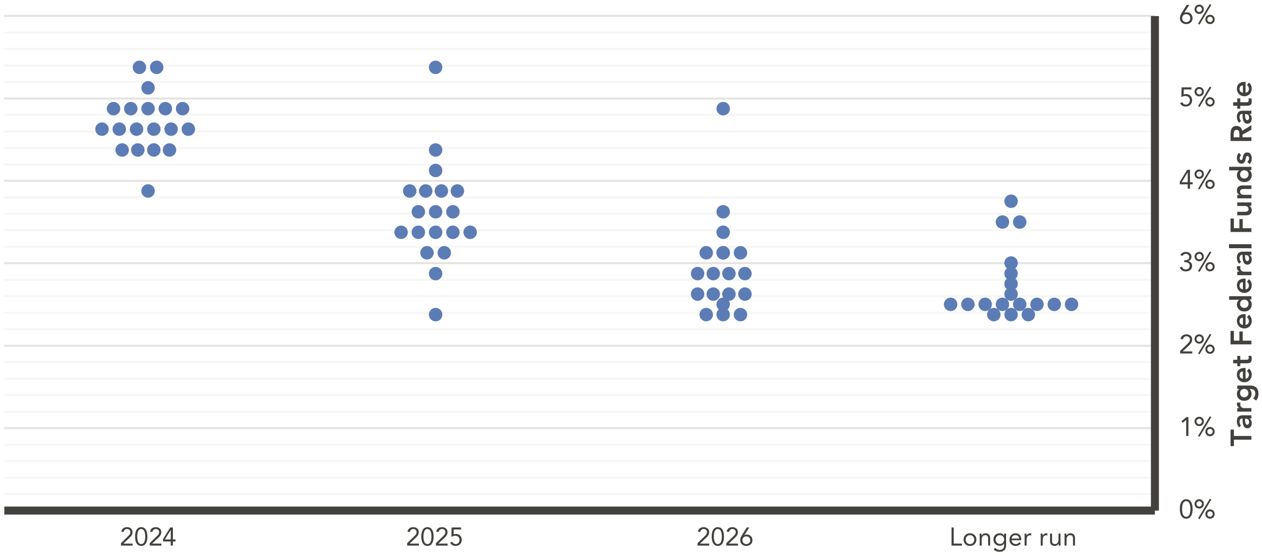
The Fed began its current tightening cycle in March 2022, raising the federal funds rate by a cumulative 5.25% over the next roughly 18 months, to a target range of 5.25–5.50%. The Fed "pause" followed, leaving rates unchanged beginning with the September 2023 meeting, with market expectations almost immediately jumping forward to the highly-anticipated Fed pivot. As supportive macro data points fueled optimism through the last few months of the year, the December 2023 FOMC meeting all but confirmed that rate cuts were on the way. At the December press conference, while still characteristically hedging all comments, Fed Chair Powell did state, for the first time, that the Committee believed the policy rate was "likely at or near its peak." The implication fed right into markets' momentum, with the S&P 500 ending 2023 less than 1% off all-time highs.

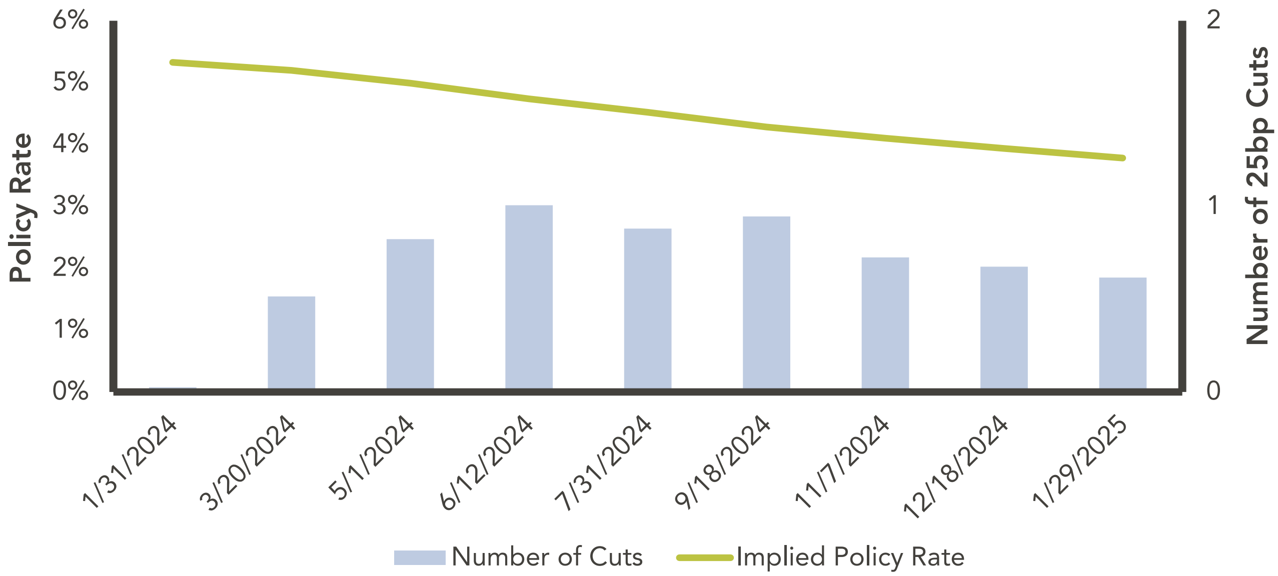
The more tepid start to 2024 brought out concerns of overbought market conditions, fears that returns had been pulled forward into 2023. While this remains to be seen, with the economy and markets still resembling a choose-your-own-adventure game, the current gap between the Fed dot plot and market expectations does present a potential source of downside risk. The Fed's dot plot (*Exhibit 1, next page*), released quarterly along with its Summary of Economic Projections, captures individual FOMC members' forecasts of the future fed funds rate. The December 2023 release showed a year-end 2024 median projection for both PCE inflation and core PCE inflation of 2.4% and a fed funds rate of 4.6% (range of 4.50–4.75%), implying three 25bp cuts throughout the year. The market, however, based on futures-implied probabilities, is pricing in between five and six 25bp cuts in 2024, including a 50% chance of the first cut coming at the March FOMC meeting (*Exhibit 2, next page*).

Exhibit 1: The Fed's most recent dot plot



Source: Federal Open Market Committee as of December 13, 2023

Exhibit 2: The market is pricing in five to six rate cuts this year to an implied policy rate of 3.9% by year end



Source: Bloomberg as of January 17, 2024

Powell has stated the Fed intends to keep policy restrictive until it is confident inflation is on a path to the 2% target, while also acknowledging restriction would have to be reduced well before actually hitting 2% so as not to overshoot. Inflation has now corrected meaningfully from highs, and on a 6-month annualized basis, the latest core PCE reading — the Fed's preferred inflation gauge — fell below target to 1.9%. Though as Fed officials have admitted in the past, reversing course is more art than science, maybe especially this cycle. In a more common scenario, after a period of monetary tightening, the Fed is forced to react and cut interest rates in response to slowing growth. Growth has instead held up this cycle — better than many expected. There is no urgency to stimulate a troubled economy dictating the Fed's timing. While a good problem to have, normalizing rates back to a more neutral level —closer to the 2.5% fed funds rate in the dot plot's longer-run forecast — while remaining data-dependent in an ever-evolving global macro landscape is no straightforward task.

One possible hiccup is inflation could reaccelerate, fueled by loosening financial conditions, including the rate cuts themselves. In a number of plausible scenarios, annual inflation gets stuck moderately above 2%, forcing the Fed to shift gears again to more specifically address remaining price pressures. Housing alone, with shelter comprising 35% of the CPI basket, could be a roadblock. The shelter component of CPI is lagged and the benefits of the disinflation seen in more real-time housing indices throughout 2023 have yet to be fully felt, which should support lower inflation in the near term. That said, those real-time housing metrics now seem to be bottoming, if not already rebounding, with demand increasing amid newly-lower mortgage rates. This suggests that a reacceleration in shelter CPI — unsurprisingly, in a structurally undersupplied market — may already be in view.

The opposite scenario also presents a risk to markets. Monetary policy has a lagged impact on the economy, and a number of other factors this cycle may have further distorted the relationship. Inflation came down as rates rose, but also as supply improved — goods supply chains corrected and the labor supply increased as participation recovered and immigration rose. Above-trend growth persisted, but massive amounts of fiscal stimulus and a cash-flush post-pandemic consumer may have also blurred the connection between any labor market stress and consumer spending. As supply gains slow and excesses are worn down, there is a risk that the full effect of higher rates more heavily weighs on growth. If we do see an unexpected slowing, it could lead to more and/or earlier rate cuts than the market is currently pricing in, though for the wrong reasons, which could lead to additional downside pressures.

2024 could take many paths, but understanding what the market is currently pricing in is an important starting place for assessing incoming data points. Interest rates remain a key part of the narrative this year, with the potential for incremental changes in wording and even tone from the Fed to move markets. The FOMC's first meeting of the year concludes on January 31, and we look forward to hearing the latest update from Chair Powell.

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