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Situation analysis September 18, 2024

Fed initiates interest rate cuts with larger-than-normal 0.5% reduction

Key takeaways

- The U.S. Federal Reserve (Fed) cut interest rates by 0.50% to a range of 4.75-5.00% today amid decelerating inflation and slightly softer labor market data.
- The Fed's projections suggest a faster rate cutting campaign than previously indicated, acknowledging the risk of weakening employment as inflation nears its target.
- The Fed's statement noted, "The risks to achieving its employment and inflation goals are roughly in balance."

The Federal Reserve cut its target federal funds interest rate by 0.50%, to a target range of 4.75%-5.00% today following its regularly scheduled two-day meeting. Pre-meeting economist and investor expectations were divided between cuts of 0.25% and 0.50%. Today's move was the first change to the policy rate since mid-2023 and the first cut since March 2020 as we entered the COVID-19 pandemic. The Fed uses interest rate policy to carry out its maximum employment, price stability and moderate long-term interest rate mandates.

In recent days, investors engaged in a vocal debate whether the Fed would cut 0.25% or 0.50% this week. The argument centered on whether a gradual rate cutting campaign using normal 0.25% rate cuts would loosen policy fast enough to avoid unnecessary harm to the labor market, within the context of decelerating inflation that remains above the Fed's 2.0% target. By cutting rates by 0.50% today and projecting 0.50% in additional cuts this year, the Fed appears to acknowledge the risks of keeping rates higher for longer outweigh the risk of a reacceleration in inflation due to loosening policy. Today's move jump-starts the return to a more neutral policy rate, which would neither restrict nor inflate economic activity.

The Fed's Summary of Economic Projections (SEP), published every other meeting, shows members' median policy rate projections falling to 4.375% by year-end 2024 (from 5.125% in the June projections) and 3.375% by year-end 2025 (from 4.125%), returning to near long-run estimates by 2026. Fed projections reinforce our guidance to ensure ample diversification within bond portfolios and to lock in steady income at compelling levels for years, rather than facing reinvestment risk due to falling policy rates when remaining in cash.

The SEP also projects a modest increase in the expected unemployment rate and reduction in expected inflation in coming years versus its June projections, while leaving economic growth expectations largely unchanged, implying a gradual stabilization in growth, inflation and employment.

Importantly, current monetary policy remains restrictive, and the Fed's official statement noted, "Inflation made further progress toward the Committee's 2% objective but remains somewhat elevated … (we have) gained greater confidence that inflation is moving sustainably toward 2% and judge the risks to achieving employment and inflation goals are roughly in balance." During Chairman Jerome Powell's press conference, he said incoming data showing decelerating inflation along with downward revisions in job growth were factors contributing to the larger-than-normal rate cut as the Fed recalibrates the speed to return rates to a more normal level.

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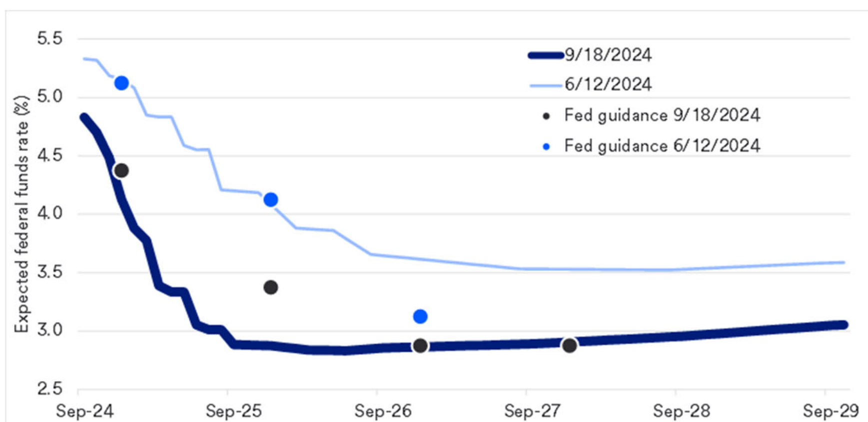
Aggressive policy tightening between early 2022 and mid-2023 helped drive the Core Personal Consumption Expenditures Price Index (Core PCE), the Fed's preferred inflation gauge, from a peak above 5.5% in 2022 to 2.6% in July. Most components of inflation remain well-contained, though recent reports suggest still-elevated shelter inflation.

The Fed is currently allowing to runoff, or mature without replacement, up to $25 billion per month in Treasuries and $35 billion per month of mortgage bonds they currently own. This reflects a drop from the previous pace of $60 billion per month in Treasuries as of June 1, 2024. Slower balance sheet runoff improves market liquidity, which refers to the amount of money readily available to buy goods, services and financial assets in an economy. Shorter-term liquidity measures dipped slightly this month as quarterly business tax payments were paid, temporarily removing cash from the economy, but should stabilize and improve modestly now that the Treasury Department's General Account reached their near-term target.

Market pricing of the expected path of the federal funds rate

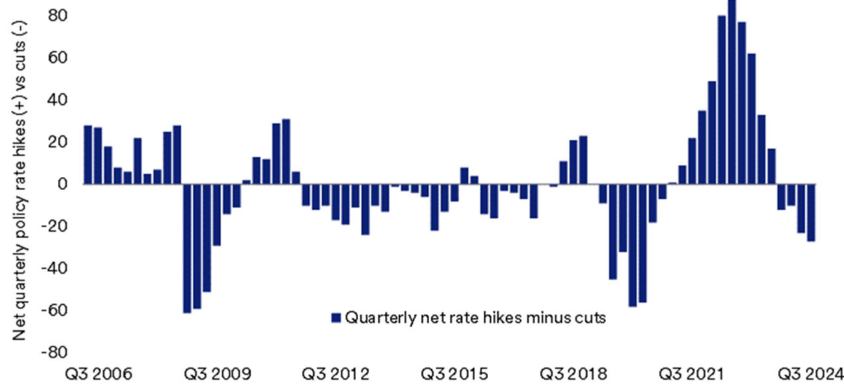


Source: U.S. Bank Asset Management Group Research, Federal Reserve, Bloomberg; 6/12/2024-9/18/2024.

Stock prices rose broadly today after the Fed's announcement, with investors initially cheering a faster return toward normal and signs of additional rate cuts to come, but finished the trading session mixed as Powell reiterated today's cut did not imply a sequence of 0.50% cuts at subsequent meetings. Treasury bond yields were little changed; the bond market had already begun incorporating expectations for fast rate cuts in coming months. Smaller companies that are more sensitive to financing costs rose the most, though gains were broad based across most equity markets. Large stocks represented by the S&P 500 fell 0.29%, while small stocks, represented by the Russell 2000, rose 0.04%. Ten-year Treasury bond yields rose 0.06% to 3.70% today, while two-year Treasury yields rose 0.01% to 3.62%.

Monetary policy, defined as central bank target interest rates, remains restrictive around the globe. However, policy has begun gradually easing, with central bank rate cuts exceeding hikes starting in the fourth quarter of 2023 as inflation began trending lower. Investors anticipate modest rate cuts from other major central banks in addition to the Fed.

Global net central bank rate hikes (net hikes minus cuts), quarterly



Source: U.S. Bank Asset Management Group Research, Factset; 3/31/2006-9/18/2024.

We retain a glass-half full viewpoint regarding corporate profits while acknowledging the Fed's dilemma of normalizing policy with inflation remaining above target and some early signs of labor market softening emerging. Robust consumer and business activity has translated to stronger-than-expected economic data for most of the year. In aggregate, consumer spending remains solid, driven primarily by wealthier cohorts. We remain attentive to some moderation in the labor market, which the Fed highlighted today. Moderating inflation trends remain clear despite stimulative fiscal policy in the form of deficit spending and increasing government debt. We will keep you informed of our views as incremental data becomes available and as we update our assessment of market conditions.

As always, we value your trust and are here to help in any way we can. Please do not hesitate to let us know if we can help address your unique financial situation or be of assistance.

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