Situation analysis December 18, 2024

Federal Reserve cuts interest rates 0.25% but signals a patient approach going forward

Key takeaways

- The U.S. Federal Reserve (Fed) cut interest rates by 0.25% to a range of 4.25%-4.50% to gradually normalize policy as inflationary pressures stabilize.
- The Fed's rate cut today continued its trajectory of lower policy rates, but its new projections indicate a more patient approach to easing policy going forward.
- The Fed's median projections call for 0.50% of rate cuts in 2025, which generally aligns with interest rate market pricing.

The Federal Reserve cut its target federal funds interest rate by 0.25% to a target range of 4.25%-4.50% following its regularly scheduled two-day meeting. Economists and investors anticipated the incremental shift lower in policy rates for the third meeting in a row. The Fed's updated projections centering on 0.50% of additional rate cuts in 2025 surprised investors somewhat, after the previous estimate from September projected 1.0%. Stronger economic growth data and stabilizing inflation recently served as the primary catalyst for the Fed's more modest plans around further policy rate cuts. The Fed remains data driven, and further inflation deceleration toward its 2% target would likely unlock additional rate cuts. The Fed uses interest rate policy to carry out its maximum employment, price stability and moderate long-term interest rate mandates.

Despite recent rate cuts, Fed Chairman Jerome Powell said, "We believe policy is still meaningfully restrictive," indicating Fed officials believe current policy rates would continue slowing inflation closer to their target. Aggressive policy tightening in the form of rate hikes between early 2022 to mid-2023 helped drive the Core Personal Consumption Expenditures Price Index, the Fed's preferred inflation gauge, from a peak above 5.5% year-over-year in 2022 to 2.8% in October. The headline Consumer Price Index, another widely followed inflation measure, has decelerated from a high of 9.1% in 2022 to 2.7% in November. The most recent year-over-year inflation figures indicate a slight uptick versus readings earlier in the year, contributing to the more modest expectations for rate cuts next year.

The most notable new information from this meeting, beyond the rate cut itself, was the Fed's guidance via its Summary of Economic Projections, which officials update every other meeting. The median Fed committee member projection indicates slightly better economic growth and lower unemployment in 2025 versus September projections, but also modestly higher inflation than previously anticipated. The combination of a better economic outlook coupled with sticky inflation contributed to the Fed's median projection for 2025 rate cuts migrating from 1.00% in the September projections to 0.50% of cuts from today's projections. New voting member Beth Hammack dissented, favoring no change to the policy rate versus the 0.25% cut announced today.

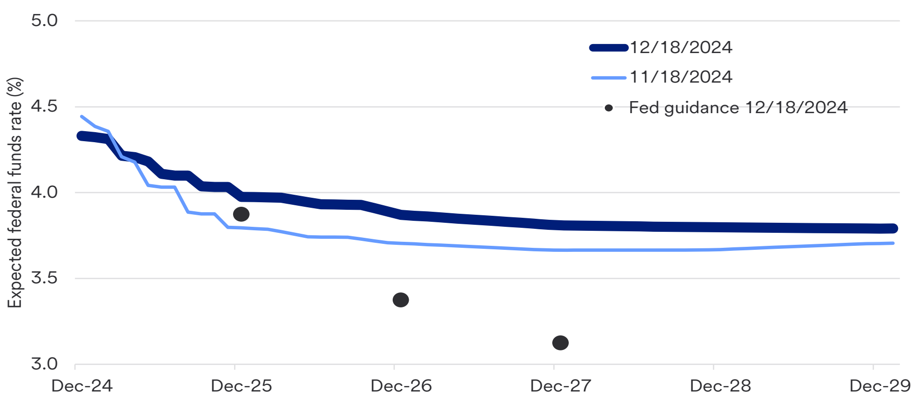
Federal Reserve Summary of Economic Projections: 2025-2026

	2025	2026
Change in real GDP	2.10	2.00
September projection	*2.00*	*2.00*
Unemployment rate	4.30	4.30
September projection	*4.40*	*4.30*
PCE inflation	2.50	2.10
September projection	*2.10*	*2.00*
Core PCE inflation	2.80	2.20
September projection	*2.40*	*2.00*
Federal funds rate	3.90	3.40
September projection	*3.40*	*2.90*

Source: Federal Reserve, 12/18/2024

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 currently in the Fed's inventory. This pace reflects a drop from the previous $60 billion per month in Treasuries as of June. Many anticipate this runoff should decelerate further or cease altogether in the first half of 2025. Slower or no 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 should remain constructive into early 2025. The Treasury Department's cash balances remain elevated and near target balances, meaning there is ample cash awaiting deployment via government spending, which can boost liquidity in the near term.

Market pricing of the expected path of the federal funds rate

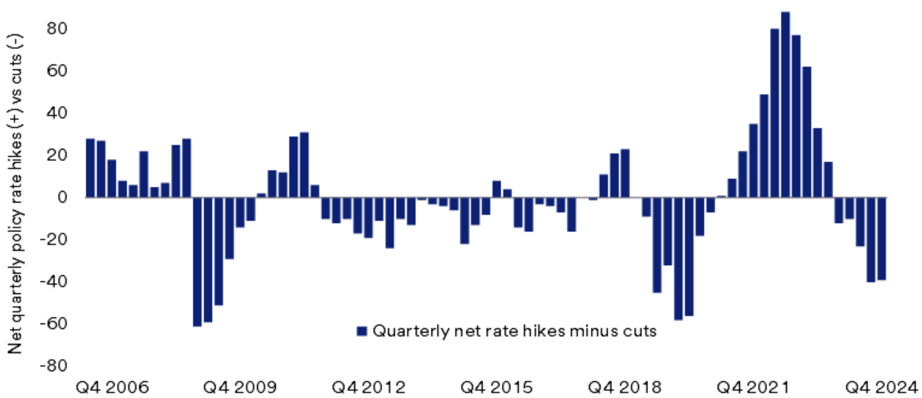


Sources: U.S. Bank Asset Management Group Research, Federal Reserve, Bloomberg, 11/18/2024-12/18/2024

Stock prices fell Wednesday, with slower rate cut projections from the Fed prompting bond yields to move higher while dampening investor hopes for faster rate cuts. Large stocks, represented by the S&P 500, fell 2.95% while small stocks, which are particularly sensitive to financing costs, fell 4.39%. Ten-year Treasury bond yields rose 0.11% to 4.51% today, while two-year Treasury yields rose 0.11% to 4.36%.

Monetary policy, defined as central bank target interest rates, remains restrictive in most geographies around the globe. However, policy has begun easing, as central bank rate cuts exceeded hikes starting in the fourth quarter of 2023 as inflation began trending lower. Investors anticipate 2025 rate cuts from other major central banks in addition to the Fed, including the Bank of England, European Central Bank, Bank of Canada, and the Reserve Bank of Australia.

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



Sources: U.S. Bank Asset Management Group Research, Factset, 4/1/2006-12/18/2024

We retain a constructive outlook for diversified portfolios due to still-solid corporate profits, an improving economic growth trajectory and easing monetary conditions. Stable to robust consumer and business activity translated into stronger-than-expected economic data, with more dependency on the labor market and wages, which we continue to monitor closely. Consensus economist forecasts call for a smooth and slower trajectory of real (inflation-adjusted) growth settling near 2% in coming quarters. In aggregate, consumer activity remains near normal historical levels, driven disproportionately by wealthier cohorts. Moderating medium-term 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.

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