FLASH 19 SEPTEMBER 2024

Fed: The rate-cutting cycle has started with a bang

Key messages

- The Federal Reserve (Fed) started its rate-cutting cycle with a surprise 50bp cut but indicated that it does not intend to continue at this pace.
- Market expectations of a steep and rapid rate cut cycle have been tempered by the Fed's comments, but still remain too high in our view. We have brought forward our rate cut sequence to reflect the Fed's intention to carry out a quicker recalibration towards neutral policy. We now expect 25bp cuts at the November and December meetings, followed by quarterly 25bp cuts in 2025, thus leading to a policy rate of 3.5% by December 2025, close to our estimate of the neutral rate at 3.25%. We continue to expect the US 10-year yield to rise in the short term before falling to 4% in 12 months' time.
- The rate-cutting cycle should support global financial markets, especially equities, commodities and corporate bonds in the final months of 2024.
- Historically, bonds tend to outperform equities during rate-cutting cycles, especially in recessionary periods. However, in soft landing scenarios such as the current one, we expect equities to outperform bonds.

50bp

The long-awaited rate-cutting cycle has finally begun, and it started with a bang. The market was very undecided ahead of the September FOMC meeting, pricing in a 50% chance of a 25bp cut and a 50% chance of a 50bp cut. The vast majority of economists, including ourselves, were expecting a 25bp cut, as a larger cut could suggest an admission by the Fed that it was behind the curve or anticipating a recession.

However, despite acknowledging that the economy is in good shape, the Fed opted to go big with a 50bp cut, bringing the federal funds rate to a range of 4.75% to 5%. While the Fed believes that growth is strong and the labour market remains solid, it sees that inflation risk has diminished while labour market risk has increased. We believe that the 50bp cut is not so much a reflection of concerns around a potential recession, but rather a recognition that the disinflation process is well underway.

What's priced in matters

The market had priced in a very steep and rapid rate-cutting cycle ahead of the FOMC meeting, with over 50% odds of multiple subsequent 50bp cuts, and 250bp cuts priced in over the next 12 months. The Fed pushed back on these expectations, leading to some disappointment relative to expectations. Indeed long-term bond yields rose, with equities ending the day slightly negative.

Our expectations

We doubt that the Fed will continue to cut at a 50bp pace, which would be the likely approach under high recession risk - not our base case. We feel that the Fed wanted to reach the neutral rate faster than expected. We therefore bring forward our expected sequence of rate cuts, adding a 25bp cut at the November meeting and removing a 25bp cut planned for 2026. In essence, we expect 25bp cuts at the November and December meetings this year, followed by a quarterly pace of 25bp cuts, which would bring the policy rate to 3.5% by December 2025, close to our estimate of the neutral rate at 3.25%.

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Implications for US bond yields

We expect US long-term yields to rise in the short term for three reasons: 1) we do not expect the Fed to cut rates as aggressively as the market expects, 2) the US election could lead to higher rate volatility, and 3) Treasury supply is likely to remain high, with risks of increased bond supply in H2 2025 if the deficit deteriorates further. With the disinflationary trend continuing and the rate-cutting cycle underway, we expect the US 10-year yield to converge towards 4% over the coming year.

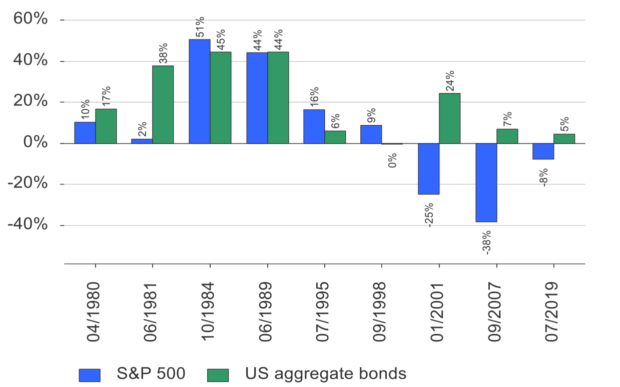
Which asset classes benefit from rate cuts?

Aside from the Bank of Japan, major central banks have entered a rate-cutting cycle. This has dragged both short- and long-term bond yields substantially lower since April. Given the recent upturn in the size of G4 central bank balance sheets and loosening bank lending standards, we should expect global liquidity and credit conditions to improve over the coming months. This should support global financial markets, in particular equities, commodities and corporate bonds as we move into the final months of 2024. Within corporate bonds, we favour investment grade over high yield, i.e. high quality.

Which asset class should outperform?

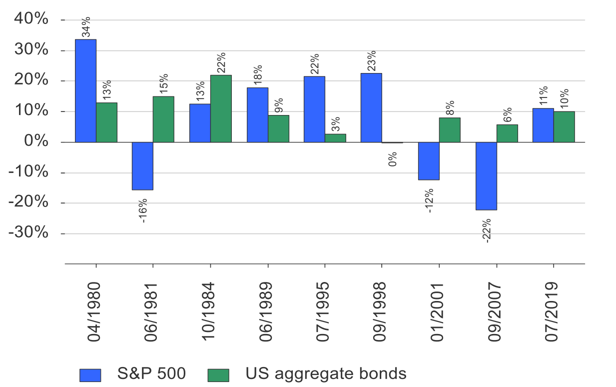
On average over the past nine cycles since 1980, US bonds (government and corporate) have tended to outperform US equities during rate-cutting cycles. This is true whether we look at performance one year after the first rate cut or over the entire cycle. However, that asset class which ultimately outperforms depends on the reason for the Fed's rate cuts. In most cases (six out of nine), the Fed cut rates aggressively because of a recession, and in these cases bonds outperformed equities since risk-off sentiment dominated. However, in the three soft landing cases, where the Fed cut rates due to an economic slowdown with inflation under control, equities outperformed bonds. Currently, we see a higher probability of a soft landing than a recession (25% probability of a recession over the next three to six months in our view), which supports our opinion that equities should outperform bonds.

TOTAL RETURNS THROUGHOUT A RATE CUT CYCLE



Source: LSEG Datastream, 17/09/2024

TOTAL RETURNS 12 MONTHS AFTER FIRST FED RATE CUT



Source: LSEG Datastream, 17/09/2024

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