

Murky environment to challenge Fed policymakers

Investors have steadily ratcheted back their expectations for Federal Reserve rate cuts in 2024. In most previous economic cycles, the Fed has been the first to ease, but the ECB was the first mover this time. We still see a slight possibility of a Fed cut this summer followed by the central bank cutting 25 basis points at its December policy meeting, after the November elections are out of the way.

Fed policymakers seem eager to implement an “insurance cut” or two in 2024 to preempt a slowdown—assuming that inflation moderates. The Fed believes that monetary policy is tight, so it would only take modest softening in the labor market to convince the central bank to cut.

The Fed wants to avoid any sign that it is influenced or motivated by politics, so will not act at the September or November Federal Open Market Committee (FOMC) meetings. In fact, a July rate reduction might be earlier than the Fed would act if it were not an election year.

Elevated potential for Fed surprises

The potential for surprises from the Fed is much greater than in a typical late-business-cycle environment. There’s an increasing chance that a lack of progress on getting annual core inflation to 2% will prompt the Fed to keep rates steady

for an extended period. Stepping back for a broader view, we are more likely to see the Fed surprise with fewer cuts than with more. Preempting the question on whether it is possible that resurgent inflation could prompt the Fed to raise rates later this year, we place less than 20% odds on that outcome.

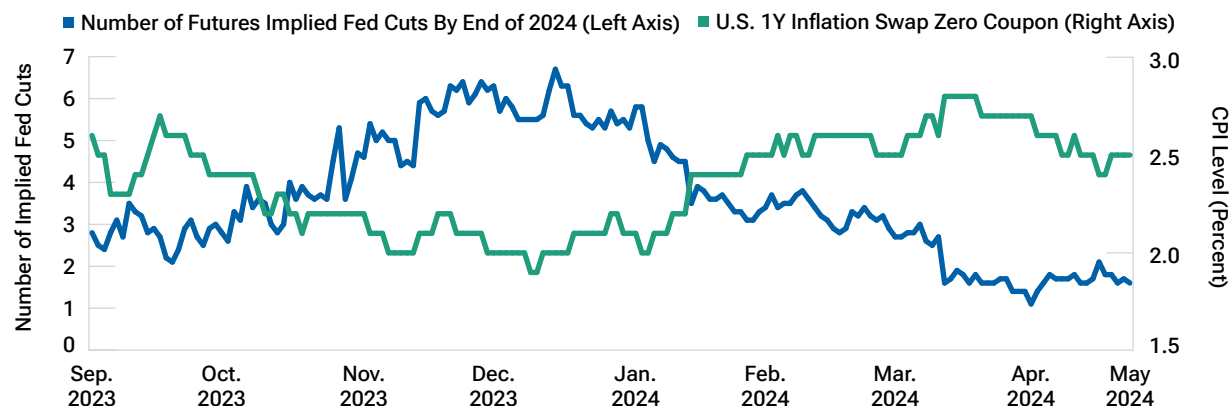
The outlook for Fed easing in 2025 is even murkier. Two to three cuts in 2025 are priced in now, which appears too dovish. One or two rate reductions next year seems more realistic. And there is a risk that “insurance cuts” by the Fed could allow inflation to fester and raise the chances of the Fed moving back to a hiking bias in 2025.

Key takeaway

The Fed is more likely to surprise with fewer cuts than with more.

Rate cut expectations have fallen steadily in 2024

(Fig. 2) Rising inflation concerns have dampened anticipation of significant easing



As of May 22, 2024.

Source: Bloomberg Finance L.P.

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