Will Fed rate cuts translate into a strong U.S. economy?

From the Field
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Key Insights

- Many investors wonder whether rate cuts by the U.S. Federal Reserve will boost growth in 2025. So far, the impact of the Fed's first cut has been muted.
- Mortgage rates will need to fall further to boost U.S. housing activity. So investors may need to temper their expectations for the impact of Fed rate cuts.

Tim Murray, CFA
Capital Markets Strategist
Multi-Asset Division

The U.S. economy appears to have avoided a recession despite one of the sharpest rate hiking cycles ever by the Federal Reserve. Now investors are wondering how strong economic growth will be in 2025.

Thus far, the rebound has been slow and modest, with notable weakness in the manufacturing sector. The Institute for Supply Management's index of manufacturing conditions remained in contractionary territory at 47.2 as of the end of September.

As a result, company earnings have been broadly disappointing so far in 2024, with the notable exception of companies benefiting from spending on infrastructure for artificial intelligence applications.

The housing market will be important

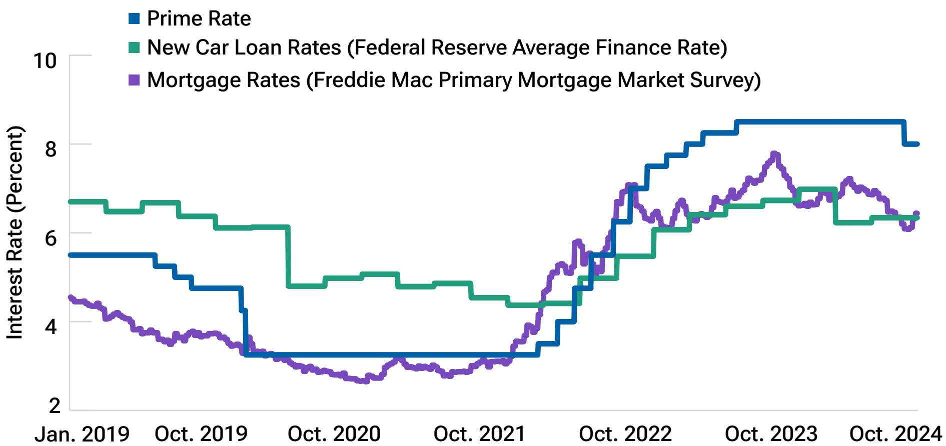
One reason for optimism that the pace of growth will quicken in 2025 is the expectation that interest rate cuts by the Fed will drive economic activity higher as falling interest costs boost spending by U.S. consumers.

However, there has only been minimal improvement in interest costs for U.S. consumers thus far. While interest rates on credit cards and new car loans have fallen, they are only about 50 basis points (a half of a percentage point) below their peak levels (Figure 1).

More Fed cuts appear likely, so further relief should be on the way. But it will take some time, and the ultimate magnitude of those cuts is still very much in question.

Consumer loan rates remain elevated

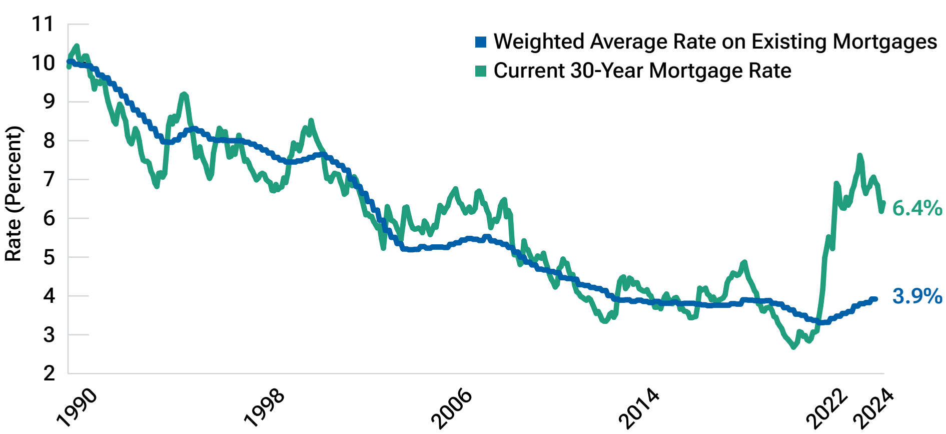
(Fig. 1) U.S. consumer loan rate proxies



January 1, 2019, to October 22, 2024.
Source: Bloomberg Finance L.P.

New mortgage rates are still well above those on outstanding mortgages

(Fig. 2) Current mortgage rate vs. weighted average existing rate



January 1990 to October 2024. Current mortgage rate is as of 10/22/24. Weighted average rate on existing mortgages is as of 6/30/24.
Sources: U.S. Bureau of Economic Analysis, Federal Home Loan Mortgage Corporation/Haver Analytics.

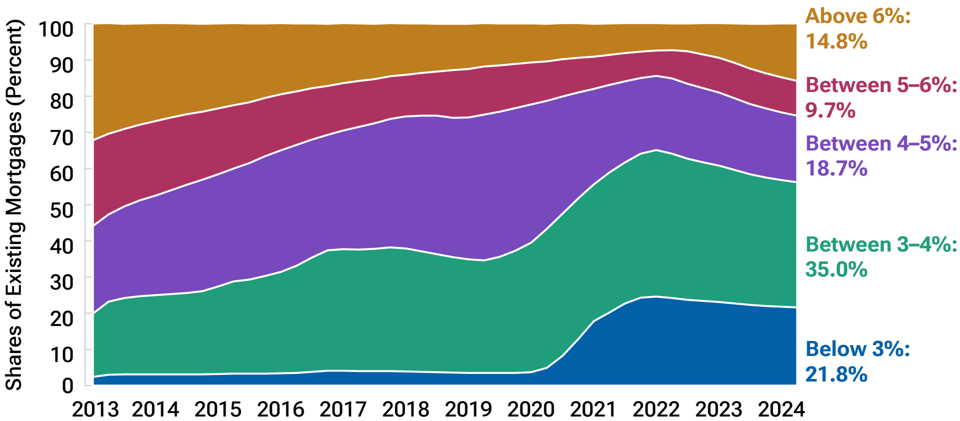
Meanwhile, rates on fixed rate mortgages are about 135 basis points below their peaks. Mortgage rates are perhaps the most important rates to monitor because the housing market has such a heavy impact on U.S. economic activity.

But the current 30-year fixed mortgage rate, 6.4% as of October 22, is still well above rates on most existing mortgages, currently 3.9% on a weighted average basis (Figure 2). This means that many homeowners are unwilling to sell because they would have to pay a much higher mortgage rate to buy another home.

This raises the question of how much lower mortgage rates will need to go in order to have a significant impact on the housing market.

Most outstanding U.S. mortgages are below 4%

(Fig. 3) Distribution of U.S. mortgages by rate (based on the number of loans)



First quarter 2013 to second quarter 2024.
Sources: Federal Housing Finance Agency/Haver Analytics.

How much lower do rates need to go?

Data from the Federal Housing Finance Agency can help answer this question. Unfortunately, that answer is not very encouraging.

The data suggest it would take a substantial further decline in mortgage rates to make selling financially palatable to most homeowners. As of June 30, only 24.5% of outstanding mortgage loans had rates above 5%, and almost 60% had rates below 4% (Figure 3).

Conclusion

The bottom line is that the impact of Fed cuts is likely to be much more muted than normal given the limited effect they could have on housing activity.

This doesn't mean Fed cuts will have no impact at all, as rate cuts can affect a wide array of financing activity. But the housing market is typically the most direct way for lower interest rates to translate into a stronger economy. As a result, we believe investors should temper their expectations regarding the economic impact of Fed rate cuts in 2025.

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