

It's okay to fight the Fed a little bit

By Taylor Schleich, with assistance from Jackson Atkinson

Don't fight the Fed. This advice would've served investors well over recent years. Many times, markets rapidly recalibrated their collective rate expectations downward in anticipation of aggressive FOMC easing. Time and again, rate cut optimism faded and expectations regressed back to the FOMC's signalled monetary policy stance. Just go back to the beginning of the year for a textbook example of this phenomenon.

Today, market expectations for year-end policy are tracking more closely to the Fed. Still, they are not in perfect harmony. Nor is the Fed and the private sector forecasting community. Despite a relatively fresh dot plot signalling just one 25 bp cut in 2024, markets, economists, rate strategists, etc. remain skeptical and see more easing being delivered this year.

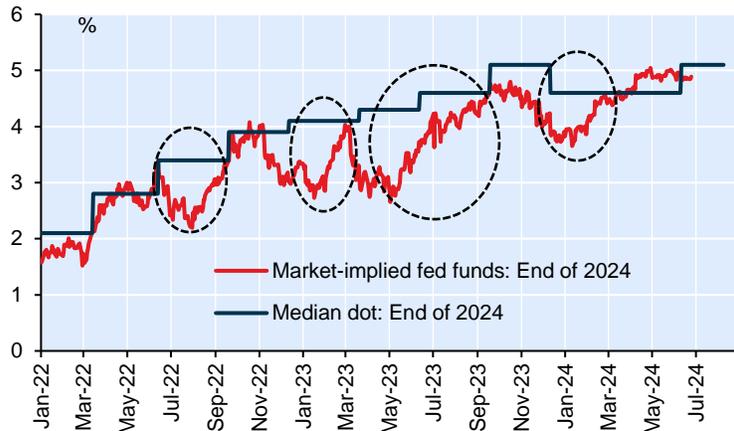
This begs the question: Are we due for a repeat of earlier this year, whereby investors and forecasters realize they've gotten out in front of their skis and are forced to reset their policy expectations back towards the Fed's? Perhaps not. Historically, as we illustrate below, even those responsible for setting policy don't have 20/20 vision of the short-term interest rate path. Since 2015 (when post-GFC tightening began), the fed funds target has ended the year in line with the FOMC's June projection less than half of the time. And in those years where the Fed was 'wrong',

market expectations proved to be a better (but not perfect) indicator of where policy would set. In today's context, there may not be scope for a 2022-style 'miss' (when the FOMC underestimated its end of year rate by 100 bps) but a modest 25 bp gap vs. consensus is entirely reasonable. That's especially true when considering why the Fed is more hawkish.

Economists and the FOMC both see inflation progress stalling in H2:2024 but there is a disconnect when it comes to thinking on the economy. Policymakers expect GDP growth to stay above potential and the jobless rate below its longer run assessment. Forecasters are understandably more pessimistic. For the Fed's economic outlook to play out, there'd need to be a break in the well-established (albeit modest) upward trend in the unemployment rate. We doubt the labour market picture will remain so rosy and see a Q4 jobless rate of 4.3%. If anything, risks to that forecast are skewed higher given the non-linear behaviour of the unemployment rate around 'turning points' in the economy. It's therefore here where the key to more aggressive easing lies. As Chair Powell, has stressed innumerable times, the FOMC is prepared to respond to an unexpected weakening in the labour market. Given that any weakening would be unexpected to them, two 2024 cuts seems like a good bet to us.

Chart 1: The market has consistently regressed to Fed dot plot

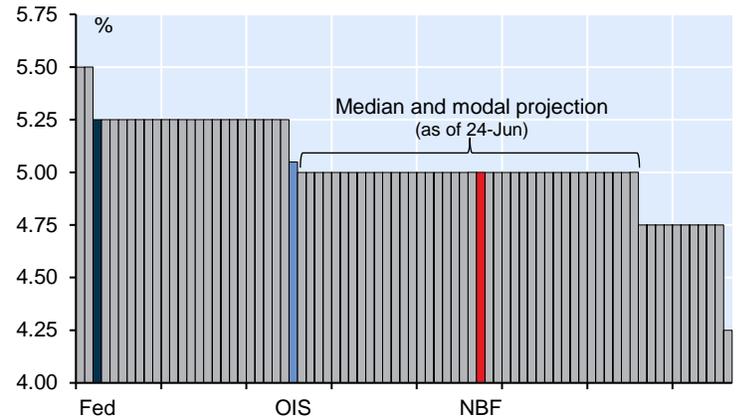
Market-implied end-of-2024 policy rate vs. rate projected in dot plot



Source: NBF, FRB, Bloomberg | Note: WIRP used since Jun-23, SFRZ4 used for earlier obs.

Chart 2: Most forecasters see two cuts in 2024

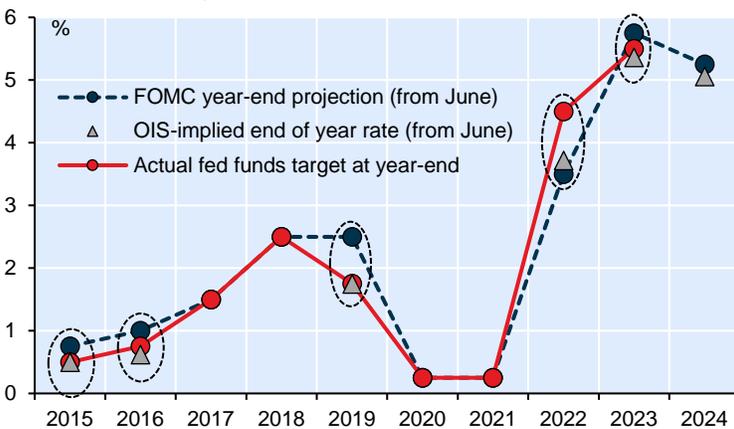
Q4:2024 fed funds (upper) projections: Bloomberg Jun. U.S. Economic Survey



Source: NBF, Bloomberg | Note: OIS and Fed rate projection adjusted to upper bound concept. Grey bars reflect all other forecasters from Bloomberg survey.

Chart 3: The FOMC is wrong more than it's right

Median fed funds projection from Jun. dot plot for Dec. of same year vs. actual



Source: NBF, FRB, Bloomberg | Note: Rates adjusted to upper bound concept. E.g. In Jun-19, median 2019 dot was 2.5%. By Dec-19, actual target was 1.75%..

Chart 4: The key to cuts lies in the labour market

U.S. unemployment rate with trend since Jan-23 and FOMC EoY projection



Source: NBF, BLS, FRB | Note: Fed projection reflects Q4 avg., which we assume = Dec-24



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