Fed Limbo: How Low Can Fed Funds Really Go?

The market narrative surrounding the timing and extent of Fed rate cuts continues to be dynamic as expectations shift with incoming data. The latest CPI data, which came in broadly hotter than anticipated, led to a swift market repricing, seeing expectations of Fed cuts for 2024 contract to fewer than 2. Considering markets were pricing in over 6 cuts for 2024 at the start of the year, expectations have rebased significantly over the past few months. Much of this has been driven by recent data which have indicated hotter inflation and a stronger labor market than anticipated. With this magnitude of repricing, it is clear the market's perspective has shifted dramatically, but has anything fundamentally changed? The answer, with respect to our initial macro view coming into this year, would be no.

Our top-down macro view at the beginning of the year challenged the market's view on the number of rate cuts the Fed would deliver in 2024 based on expectations of a slowing economy that would find its way into recession. We viewed the economy as more resilient and stronger than the consensus. Economic data has continued to support this narrative, with NFP indicating strong job growth and a healthy labor market, retail sales illustrating resilient consumer spending, and hotter CPI readings reflecting stickier inflation. Markets have reacted quickly to the view that fewer cuts, if any at all, will be necessary amidst the current economic backdrop. While this mirrors the Fed's economic projections more closely, the market and Fed never seem to be in alignment for long. If the rate selloff continues, yielding higher rates along the curve, and expectations dwindle on fewer cuts, financial conditions could deteriorate and lead to unintended consequences that trickle through the rest of the economic system. Markets will continue to be volatile, and expectations will fluctuate between "the Fed is behind again", with a more restrictive policy stance required, and "recession is coming", implying swifter cuts are needed.

The noise around the constant repricing of expectations in markets can often muddle the fundamental picture. **We maintain our conviction that due to strong growth, a healthy labor market, and stickier inflation than expected, the Fed will not have to cut anytime soon, if at all this year. The policy rate can be maintained for a prolonged period to ensure inflation recedes to the target without significantly damaging the economy.** In light of our view, we acknowledge that there are many risks on the horizon that could quickly trigger a reversal in rates and/or a significant flight to quality trade. The Fed could get drawn into cutting rates without hitting their inflation objectives.

Given the fundamental backdrop, we expect rates to be range-bound but can overcorrect in both directions near-term as data guides quick changes in expectations. On the upper end of the range, 2s topped out essentially flat to the Fed Funds (FF) rate at 5.25% back in October 2023, which likely serves as the cap, with the upper bound on 5s likely around the 5% area given the growth and inflation backdrops. While the curve inversion has been prolonged and difficult to manage, it will likely persist as long as inflation remains above the target level. We anticipate 10s and 30s will be limited by a flight to quality bid emerging at potential signs of economic disruption. After the most recent breakout, we believe rates will readjust from overcorrection and settle back into a range trade, until key data shifts the narrative again.

As the bar for rate cuts continues to be raised and lowered by current economic data in this game of Fed limbo, it is important to maintain conviction based on the foundations of the underlying economy and expectations on future inflation to manage through the volatility. **Our fundamental macroeconomic view remains unchanged, but we will continue to monitor market interpretations of incoming data and position appropriately when mispricing occurs.**

Let's keep talking!

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