13 September 2024

Research US

Fed preview: Dovish 25bp

- **We expect the Federal Reserve to cut rates by 25bp in the next week's meeting. Markets price in around 40% probability of a larger 50bp move. We do not expect changes to the pace of QT despite the Fed now initiating rate cuts.**
- **We expect the updated dots to signal a total of 3x25bp cuts in 2024 (prev. 1) followed by 6x25bp cuts in 2025 (prev. 4). We expect no policy rate changes in 2026 (terminal rate at 3.00-3.25%, unchanged from June forecast). We foresee modest downward revisions to inflation forecast for 2024-2025 and slight upward revisions to unemployment rate forecast for 2024-2026.**
- **We expect Powell to communicate a series of rate cuts and to maintain the door open for larger cuts, even if they are not our base case. The combination of 25bp cut and dovish forward guidance should lead to relatively muted market reaction, but we see risks skewed towards stronger USD and higher short-end UST yields.**

Markets have remained divided over the Fed's September rate decision for unusually long. We were surprised to hear both Williams and Waller explicitly avoiding giving any concrete guidance last Friday, when the Fed had just received the final piece of labour market data before of the blackout (see *RtM USD: NFP left the markets hanging - we still see 25bp in Sep*, 10 September).

This week's slightly faster-than-expected core CPI reading appeared to tilt the balance towards a smaller cut, markets price in around 40% of a larger move. (see *Global Inflation Watch - Inflation expectations heading lower*, 11 September, for details). The economy is inarguably cooling, **but with no signs of rapid weakening, we still think the Fed will opt for only a 25bp reduction**. And to some extent, markets have also converged towards pricing in more, but not necessarily larger rate cuts over the past few weeks.

To us, the lack of guidance signals preference for avoiding stirring up changes in current financial conditions. In other words, the Fed appears to largely agree with markets' assessment on the rates outlook.

In our view, the decision that would most likely minimize post-meeting volatility would be a 25bp cut delivered with dovish forward guidance. We expect Powell to emphasize that the cut marks a beginning of a series of rate reductions, and that the door for larger cuts remains open (even if they are not our base case).

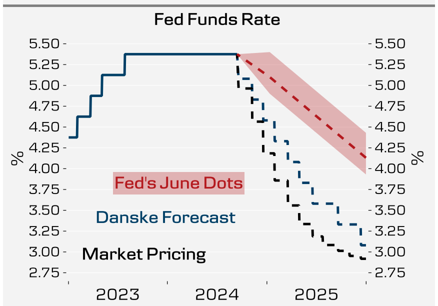
We expect the updated median dot to signal 25bp cuts in the two remaining meetings of the year (total of 75bp of cuts in 2024, prev. 25bp), followed by six more 25bp cuts in 2025 (total of 150bp, prev. 100bp). We expect no rate cuts in 2026, which would leave the Fed's terminal rate estimate at the end of 2026 (3.00-3.25%) unchanged from June.

Risks are skewed towards modest downward revisions in 2025 GDP forecasts. We expect downward revisions to inflation forecasts for 2024-2025 and modest upward revisions on unemployment rate forecasts for 2024-2026. **Note that we do not expect changes to the pace of QT despite the Fed now initiating its rate cutting cycle.**

Our Fed call summarized

- 25bp cuts in every meeting until June, terminal rate at 3.00-3.25% by the end of 2025.
- QT continues past the first rate cut, likely well into 2025

The Fed is likely to revise down its rate projections ('dots') for coming years



Sources: Macrobond Financial, Refinitiv, The Fed, Danske Bank. Shaded red area reflects the Fed's projections' Central Tendency Range

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Markets: Modest downside potential in EUR/USD

Although the likelihood of a 50bp rate cut has gradually declined over the past week, it remains a possibility, especially after several news articles on Friday indicated a close call between the two options, which increased the market pricing for a jumbo cut to around 34bp (OIS pricing). If our call for a 25bp cut materializes, the USD could strengthen following the announcement. However, the potential for significant USD appreciation is likely limited, as a 25bp cut appears to be the base case for markets heading into the meeting. Hence, any potential USD rally will likely be contained, especially if Powell signals openness to larger cuts if necessary.

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Ad hoc

Date of first publication

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