

13 December 2024

# Research US

## Fed preview: Gauging for neutral

- We expect the Fed to cut the policy rate target by 25bp in the December meeting. The Fed could also cut the ON RRP facility rate by an additional 5bp, but we do not expect this to have a significant impact on the policy stance (see p. 2).
- Markets have fully priced in next week's cut. Main focus will be on updated rate projections, and especially on the FOMC's latest view on the terminal rate level. 2024 and 2025 GDP and inflation forecasts will likely get revised slightly higher.
- We think the Fed is likely to continue cutting rates faster than markets expect also in 2025. If the 'dots' continue to signal several cuts for 2025, UST yields could shift lower and EUR/USD edge higher upon announcement.

Since the FOMC participants filed their latest economic projections in mid-September, market pricing for real terminal policy rate has shifted roughly 60bp higher. Real 1y forward OIS curve stabilizes around 1.7-1.8% level, which is 0.8-0.9% above the September median real long-term dot (chart 1). While 25bp cut next week is mostly a done deal, the true focus is on how FOMC's terminal rate view has shifted alongside markets.

While part of the increase in market pricing can be attributed to term premium (NY Fed's ACM model estimate for 10y term premium is roughly 30bp higher than 3M ago), markets are discounting in expectations of more resilient economy and supportive fiscal policy.

But while we wait for the details on the latter, we struggle to see why the Fed should suddenly be more concerned with the economy overheating again. This week's CPI data showed continuing cooling in both housing and non-housing services inflation, suggesting that the underlying disinflation trend remains on track. The ratio of job openings to unemployed has stabilized around 1.1, which suggests labour market balance is slightly cooler than before the pandemic. Both market and survey-based measures of inflation expectations remain well aligned with the 2% target.

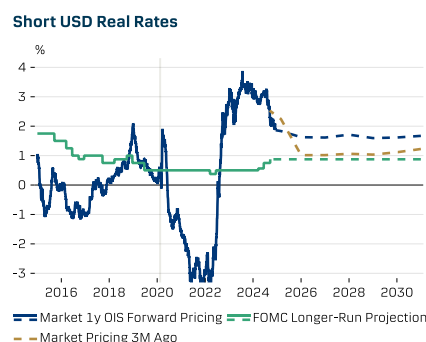
Still low level of mortgage applications and weak commercial loan demand signals from the Fed's latest SLOOS data also suggest current policy stance remains restrictive. As such, we think the Fed can continue to reduce rates towards neutral not just next week, but also into 2025. And when it comes to estimating the neutral level, we do not think the magnitude of the shift in market pricing is quite yet justified. More modest upward-shift in longer-term dots could be a dovish surprise for the markets.

We expect minor positive revisions to GDP and inflation forecasts for 2024 & 2025 but think 2026 forecasts will remain stable. We think Powell will aim for a neutral tone in his remarks, but he is still likely to verbally open the door for slowing the pace of cuts, in line with what we have heard from other Fed commentators lately. Markets are currently pricing in only 6bp for the January meeting, and we do not expect a dramatic re-pricing after next week, as the decision ultimately hinges on data released later on. 10-12bp (or close to 50/50) would be a fair level at this stage in our view. Markets' most likely scenario includes 25bp rate cuts in every other meeting during H1 2025 (chart 2), but we still believe the Fed will end up cutting rates in every meeting until June.

### Our Fed call summarized (unchanged)

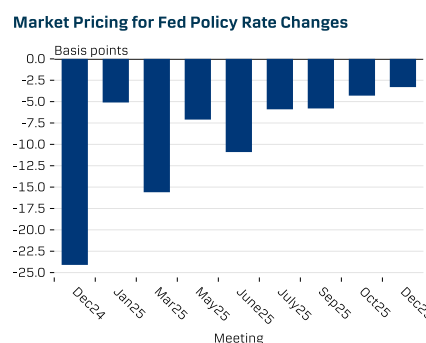
- 25bp cuts in every meeting until June, terminal rate at 3.00-3.25% reached by September 2025.
- QT continues into H2 2025

Chart 1: Markets' real terminal rate pricing has shifted higher since Sep



Sources: Macrobond Financial, LSEG, The Fed

Chart 2: Markets expect rate cuts in the meetings where the Fed publishes updated economic projections



Sources: Macrobond Financial, LSEG

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## ON RRP cut would not predict an imminent end to QT

The Fed could also deliver a 5bp additional technical reduction to the ON RRP rate as discussed in the November minutes, which would align it with the lower bound of the Fed Funds target range. We do not think it would have a significant impact on the overall policy stance, but rather, such a move should be seen as a sign of the Fed wanting to err on the side of caution amid the risk of repeating the repo market turmoil in September 2019.

All else equal, the reduction would make it less attractive for money market funds to park cash into the facility, which could then provide a positive boost to markets' liquidity conditions. ON RRP usage peaked above USD2300bn around two years ago, but the level has already declined to around USD150bn, meaning the impact would be modest either way.

Market-based overnight repo rate (SOFR) has traded mostly in tandem with the Fed Funds rate over past years, but as liquidity conditions have gradually tightened due to QT, SOFR has seen occasional spikes around month and quarter turn dates. The very latest fixings have been on the higher side again, which could increase the likelihood of the cut.

If the Fed does decide to cut the ON RRP rate, Powell would certainly face questions about the future of QT, which is still draining liquidity at a rough pace of USD40bn/month. However, the near-term liquidity outlook does not appear too concerning in our view. The US debt ceiling suspension ends at the beginning of 2025, which means that the government will start to utilize its cash balance to fund the ongoing deficits until the ceiling is lifted or suspended again. This could theoretically boost liquidity by as much as USD775bn over the course of H1 2025. If the remaining funds from the ON RRP facility would also get drained back to the market, the level of bank reserves could even start rising again despite the QT. As such, we do not expect the Fed to halt the QT before H2 2025 at earliest. Read more from the STIR section of *RtM USD – December cut in the horizon*, 10 December).

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