

Special Commentary — September 16, 2024

Part IV: A New Framework to Predict Probability of Monetary Policy Pivots

Soft-Landing, or No Soft-Landing, That Is the Question

Summary

- The fourth installment of this series develops a new framework to quantify episodes of monetary policy pivots.
- We also present a probit regression to predict the probability of a policy pivot during the next two quarters.
- In our view, accurately predicting periods of monetary policy pivots is vital, as a rate cut that comes too late or too soon would be harmful to the economy and damage the FOMC's reputation.
- Our framework estimated that there are 26 episodes of policy pivots in the post-1990 period.
- Using a threshold of 35%, the probit framework accurately predicted episodes of policy pivots in the post-1990 era.
- The latest probability (Q2-2024) of 43% indicates that a rate cut cycle may start soon (within the next two quarters).
- Given the historical accuracy of our framework, we believe the toolkit would provide useful insights for decision makers, as it can be updated in real time to gauge the likely duration of the upcoming easing cycle.
- We believe accurately predicting the near-term path of the fed funds rate is vital for effective policymaking as well as policy communication. The next installment of the series will present a new approach to predict the fed funds rate two quarters out (up to four FOMC meetings ahead).

Economist(s)

Azhar Iqbal

Econometrician | Wells Fargo Economics
Azhar.Iqbal@wellsfargo.com | 212-214-2029

Delaney Conner

Economic Analyst | Wells Fargo Economics
Delaney.Conner@wellsfargo.com | 704-374-2150

Why Is Accurately Predicting Monetary Policy Pivots Important?

[Part three](#) of the series presented four-quarters-out probabilities of the three growth scenarios of soft-landing, stagflation and recession. This installment develops a framework to employ those probabilities to predict monetary policy decisions. We follow two different paths to gauge the usefulness of our toolkit. The first method predicts monetary policy pivots, and the second approach forecasts the near-term level of the fed funds rate (a topic we'll cover in the next installment).

We believe accurately predicting the timing of a policy pivot compliments the generation of the future potential path of the fed funds rate. By predicting the timing of a policy pivot, decision makers could anticipate the potential duration of the current stance, at least in theory. The prediction for the fed funds rate would shed light on how many rate cuts (a relevant discussion for the current cycle) are appropriate in the near future.

In our view, accurately predicting periods of monetary policy pivots is vital, as a rate cut that comes too late or too soon (a widely discussed topic in the present cycle) would be harmful to the economy and damage the FOMC's reputation. Members of the FOMC have repeatedly acknowledged that their goal is to avoid a mistimed rate cut, whether it be too soon or too late. Some analysts suggested the March 2022 rate hike was too late, as the FOMC misjudged higher inflation as "transitory" and waited too long to act. By the same token, significant changes in the FOMC's SEP (June 2023 vs. June 2024) made some analysts worry that the next policy pivot (which is expected to be a rate cut) may be mistimed as well.

A New Framework To Quantify Episodes of Monetary Policy Pivots

We develop a new framework to quantify episodes of monetary policy pivots and present a probit regression to predict the probability of a policy pivot during the next two quarters. At present, the FOMC regularly meets eight times a year, with four meetings in the first half and four in the second half. Thereby, we set a two-quarters-out forecast horizon to predict the chances of a policy pivot during the next four meetings. Given the volatile nature of the economy during the post-pandemic era, a one-year-out prediction for a policy pivot would suffer lower accuracy, as the rapidly changing nature of potential risks would dictate a faster response from the FOMC, all else equal.

We define a policy pivot as a change in the FOMC's rate decision compared to the past few meetings. There are two key elements in our definition of a policy pivot. The first is that the FOMC has a different rate decision than the past few meetings. The second condition is that the FOMC keep the stance for the next few meetings, at least. There are three rate decisions that have been utilized by the FOMC, at least in the post-1990 era. The FOMC either (a) raises the target of the fed funds rate, (b) keeps the rate unchanged or (c) reduces the rate ([Figure 1](#)).

Historically, once the FOMC adopts a policy stance (a rate hiking stance, for example), it keeps that stance for at least several meetings. In the post-1990 era, the shortest duration of a policy stance was about six months, which occurred in 1995. The FOMC raised the fed funds rate to 6.00% from 5.50% in February 1995, and then kept that rate (a rate pause) until its June meeting. The FOMC reduced the rate by 25 bps in July 1995.

We use these conditions to identify periods of policy pivots. The last policy pivot date was in August 2023, as that was the first month after the fed funds rate peaked at 5.50% in July 2023. After 13 consecutive months, the fed funds rate is still at 5.50%. Essentially, August 2023 marks the end of the rate hike stance that started in March 2022. If the FOMC cuts rates in September 2024, then that would be the next policy pivot, as it would be the start of a rate-cut cycle (a policy normalization stance). Of course, this is assuming the FOMC will adopt a rate-cut stance for the near future.

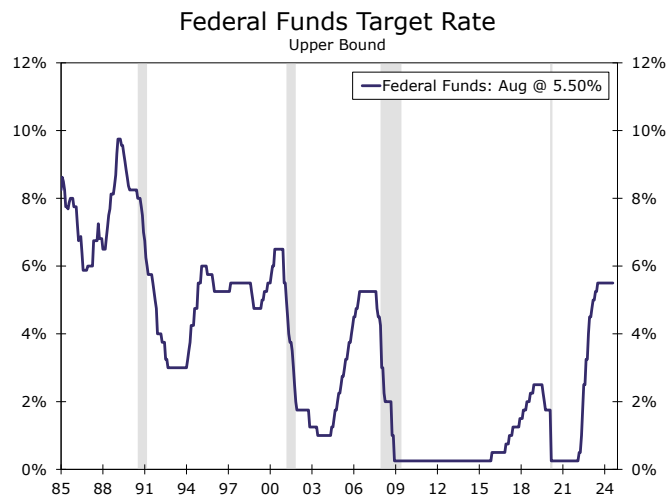
Episodes of the Monetary Policy Pivot in the Post-1990 Era

Our framework estimated that there are 26 episodes of policy pivots in the post-1990 period (for detail see [Table 1](#)). We concentrated on the post-1990 era, where the FOMC's communications about policy decisions are more transparent and shared with the public in a timely matter. One example of the FOMC's communications can be seen in the fed funds rate series, as the post-1990 data are smoother, and policy stances (from rate cuts to policy pauses, for example) can be identified with a reasonable confidence. ([Figure 1](#))

By our definition, there are four types of policy pivots: (1) pause-to-cut, which is the start of a rate-cut stance, (2) cut-to-pause, which is the end of a rate-cut stance, (3) pause-to-hike, which is the start

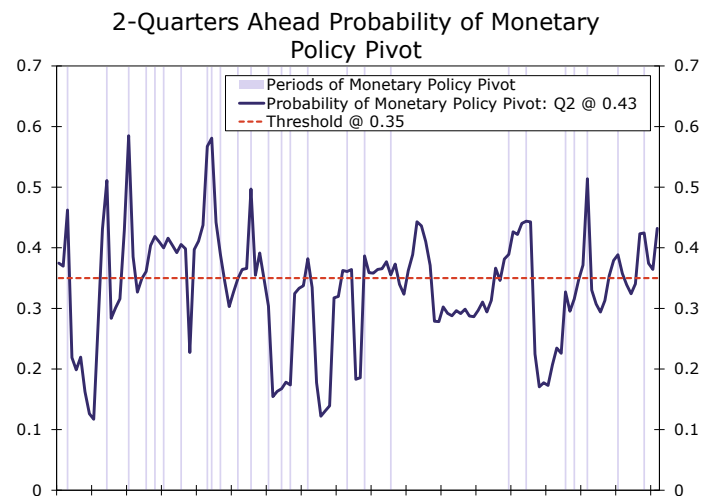
of a rate-hike stance and (4) hike-to-pause, which is the end of a rate-hike stance. There are eight episodes of pause-to-cut, six of cut-to-pause, seven of pause-to-hike and five of hike-to-pause. Most policy pivots in the post-1990 era included a pause stance (11 pivots are either cut-to-pause or hike-to-pause), while eight took an easing/rate-cut stance and seven took a tightening/rate-hike stance. Our forecast horizon is only two quarters out, therefore the *type* of policy pivot would be known to a forecaster. Thus, we only concentrate on predicting the *timing* of a policy pivot.

Figure 1



Source: Federal Reserve Board and Wells Fargo Economics

Figure 2



Source: Federal Reserve Board and Wells Fargo Economics

A Probit Approach To Predict the Probability of Monetary Policy Pivots

The major benefit of identifying periods of policy pivots is that we can build a regression to generate the probability of a policy pivot in the near future. For example, we identified 26 episodes of policy pivots in the 1990-2024:Q2 period, and then we created a dummy variable where a value of one represents a pivot occurring and zero is otherwise. Using the dummy variable, a probit regression is developed to predict the two-quarters-out probability of a policy pivot. [Part III](#) of the series presented four-quarters-out probabilities of the three growth scenarios of soft-landing, stagflation and recession. We employ those probabilities as predictors of the probit regression.

[Figure 2](#) shows the two-quarter-out probability of a policy pivot, and the bars represent actual periods of policy pivots (based on our framework; see [Table 1](#) for detail about those pivots). Using the average probability of 35% as a threshold (dotted line in [Figure 2](#)), the framework accurately predicted all episodes of policy pivots in the post-1990 era.

As seen in [Figure 2](#), the probability of a policy pivot started trending upward in Q2-2021 and breached the threshold in Q3-2021. The framework suggested starting a rate hike cycle sooner than Q1-2022, with a possibility of a rate hike in 2021. Neither the FOMC nor the Blue Chip consensus provide an explicit probability of a policy pivot, but the FOMC's SEP and the Blue Chip consensus did not predict a rate hike in 2021 (i.e., no policy pivot in 2021). However, both forecasts did predict rate hikes in 2022. In retrospect, our framework would have helped decision makers determine appropriate timing for the rate-hike cycle back in 2021-2022.

The policy pivot probability jumped in Q2-2023 (from 34% to 42%), and then peaked in Q3-2023, which is consistent with the most recent policy pivot of Q3-2023—a hike-to-pause pivot. Q4-2023 and Q1-2024 noted a declining trend (but still above the threshold line) which may have cautioned analysts that a policy pivot to rate cuts were potentially further away. The latest probability (Q2-2024) of 43% indicates that a rate cut cycle may start soon (within the next two quarters), which is consistent with financial markets participants' expectations for the upcoming September FOMC meeting. Given the historical accuracy of our framework, we believe the toolkit would provide useful insights for decision makers, as it can be updated in real time to gauge the likely duration of the upcoming easing cycle.

A Policy Pivot Is Most Likely, but What About the Pace/Duration of the Easing Cycle?

In summary, the latest probability (Q2-2024) of 43% indicates that a rate cut cycle may start soon (within the next two quarters), which is consistent with both the FOMC and Blue Chip forecasts, as they are also predicting a policy pivot in 2024.

FOMC members provide their near-term (as well as long-run) fed funds rate forecast. The June 2024 SEP suggests one 25 bps rate cut in 2024 and four more cuts throughout 2025. The FOMC employs its fed funds forecast (along with their other forecasts) to signal its near-term policy stance. In the short run, significant changes in the forecast would send undesirable signals and raise questions about the accuracy of the fed funds forecast. Therefore, in our view, accurately predicting the near-term path of the fed funds rate is vital for effective policymaking as well as policy communication. The next installment of the series will present a new approach to predict the fed funds rate two-quarters-out (up to four FOMC meetings ahead).

Table 1

Episode	Date of Policy Pivot	Type of Policy Pivot
1	Jul-1990	Pause to Cut
2	Oct-1992	Cut to Pause
3	Feb-1994	Pause to Hike
4	Feb-1995	Hike to Pause
5	Jul-1995	Pause to Cut
6	Feb-1996	Cut to Pause
7	Mar-1997	Pause to Hike
8	Sep-1998	Pause to Cut
9	Dec-1998	Cut to Pause
10	Jun-1999	Pause to Hike
11	Jun-2000	Hike to Pause
12	Jan-2001	Pause to Cut
13	Jan-2002	Cut to Pause
14	Nov-2002	Pause to Cut
15	Jun-2003	Pause to Cut
16	Jun-2004	Pause to Hike
17	Jul-2006	Hike to Pause
18	Sep-2007	Pause to Cut
19	Jan-2009	Cut to Pause
20	Dec-2015	Pause to Hike
21	Dec-2016	Pause to Hike
22	Jan-2019	Hike to Pause
23	Aug-2019	Pause to Cut
24	Apr-2020	Cut to Pause
25	Mar-2022	Pause to Hike
26	Aug-2023	Hike to Pause

Please note: Pause to Cut= start of a rate cut stance

Cut to Pause= end of a rate cut stance

Pause to Hike= start of a rate hike stance

Hike to Pause= end of a rate hike stance

Source: Federal Reserve Board and Wells Fargo Economics

Subscription Information

To subscribe please visit: www.wellsfargo.com/economicsemail

Via The Bloomberg Professional Services at WFRE

Economics Group

Jay H. Bryson, Ph.D.	Chief Economist	704-410-3274	Jay.Bryson@wellsfargo.com
Sam Bullard	Senior Economist	704-410-3280	Sam.Bullard@wellsfargo.com
Nick Bennenbroek	International Economist	212-214-5636	Nicholas.Bennenbroek@wellsfargo.com
Tim Quinlan	Senior Economist	704-410-3283	Tim.Quinlan@wellsfargo.com
Sarah House	Senior Economist	704-410-3282	Sarah.House@wellsfargo.com
Azhar Iqbal	Econometrician	212-214-2029	Azhar.Iqbal@wellsfargo.com
Charlie Dougherty	Senior Economist	212-214-8984	Charles.Dougherty@wellsfargo.com
Michael Pugliese	Senior Economist	212-214-5058	Michael.D.Pugliese@wellsfargo.com
Brendan McKenna	International Economist	212-214-5637	Brendan.Mckenna@wellsfargo.com
Jackie Benson	Economist	704-410-4468	Jackie.Benson@wellsfargo.com
Shannon Grein	Economist	704-410-0369	Shannon.Grein@wellsfargo.com
Nicole Cervi	Economist	704-410-3059	Nicole.Cervi@wellsfargo.com
Jeremiah Kohl	Economic Analyst	212-214-1164	Jeremiah.J.Kohl@wellsfargo.com
Aubrey Woessner	Economic Analyst	704-410-2911	Aubrey.B.Woessner@wellsfargo.com
Delaney Conner	Economic Analyst	704-374-2150	Delaney.Conner@wellsfargo.com
Anna Stein	Economic Analyst	212-214-1063	Anna.H.Stein@wellsfargo.com
Ali Hajibeigi	Economic Analyst	212-214-8253	Ali.Hajibeigi@wellsfargo.com
Coren Miller	Administrative Assistant	704-410-6010	Coren.Miller@wellsfargo.com

Required Disclosures

This report is produced by the Economics Group of Wells Fargo Bank, N.A. ("WFBNA"). This report is not a product of Wells Fargo Global Research and the information contained in this report is not financial research. This report should not be copied, distributed, published or reproduced, in whole or in part. WFBNA distributes this report directly and through affiliates including, but not limited to, Wells Fargo Securities, LLC, Wells Fargo & Company, Wells Fargo Clearing Services, LLC, Wells Fargo Securities International Limited, Wells Fargo Securities Europe S.A., and Wells Fargo Securities Canada, Ltd. Wells Fargo Securities, LLC is registered with the Commodity Futures Trading Commission as a futures commission merchant and is a member in good standing of the National Futures Association. WFBNA is registered with the Commodity Futures Trading Commission as a swap dealer and is a member in good standing of the National Futures Association. Wells Fargo Securities, LLC and WFBNA are generally engaged in the trading of futures and derivative products, any of which may be discussed within this report.

This publication has been prepared for informational purposes only and is not intended as a recommendation, offer or solicitation with respect to the purchase or sale of any security or other financial product, nor does it constitute professional advice. The information in this report has been obtained or derived from sources believed by WFBNA to be reliable, but has not been independently verified by WFBNA, may not be current, and WFBNA has no obligation to provide any updates or changes. All price references and market forecasts are as of the date of the report or such earlier date as may be indicated for a particular price or forecast. The views and opinions expressed in this report are those of its named author(s) or, where no author is indicated, the Economics Group; such views and opinions are not necessarily those of WFBNA and may differ from the views and opinions of other departments or divisions of WFBNA and its affiliates. WFBNA is not providing any financial, economic, legal, accounting, or tax advice or recommendations in this report, neither WFBNA nor any of its affiliates makes any representation or warranty, express or implied, as to the accuracy or completeness of the statements or any information contained in this report, and any liability therefore (including in respect of direct, indirect or consequential loss or damage) is expressly disclaimed. WFBNA is a separate legal entity and distinct from affiliated banks, and is a wholly-owned subsidiary of Wells Fargo & Company. © 2024 Wells Fargo Bank, N.A.

Important Information for Non-U.S. Recipients

For recipients in the United Kingdom, this report is distributed by Wells Fargo Securities International Limited ("WFSIL"). WFSIL is a U.K. incorporated investment firm authorized and regulated by the Financial Conduct Authority ("FCA"). For the purposes of Section 21 of the UK Financial Services and Markets Act 2000 (the "Act"), the content of this report has been approved by WFSIL, an authorized person under the Act. WFSIL does not deal with retail clients as defined in the Directive 2014/65/EU ("MiFID2"). The FCA rules made under the Act for the protection of retail clients will therefore not apply, nor will the Financial Services Compensation Scheme be available. For recipients in the EFTA, this report is distributed by WFSIL. For recipients in the EU, it is distributed by Wells Fargo Securities Europe S.A. ("WFSE"). WFSE is a French incorporated investment firm authorized and regulated by the Autorité de contrôle prudentiel et de résolution and the Autorité des marchés financiers. WFSE does not deal with retail clients as defined in MiFID2. This report is not intended for, and should not be relied upon by, retail clients.

SECURITIES: NOT FDIC-INSURED - MAY LOSE VALUE - NO BANK GUARANTEE