Situation analysis

June 12, 2024

Fed keeps rates steady, projects cuts will start late this year

Key takeaways

- The U.S. Federal Reserve held interest rates steady in an elevated range of 5.25% to 5.50% today to bring down inflation.
- The median Fed committee member projects one 0.25% rate cut later in 2024 and four 0.25% cuts in 2025, a modest change from the March projection for three cuts in both 2024 and 2025, and close to investor expectations.
- The Fed's statement acknowledged "modest further progress" toward its 2% inflation target after softer recent inflation and job opening data.

The Federal Reserve (Fed) held its target federal funds interest rate steady in a range of 5.25% to 5.50% following its regularly scheduled two-day meeting, as expected by investors and economists. The Fed uses interest rate policy to carry out its maximum employment, price stability and moderate long-term interest rate mandates. The Fed published updated committee member projections to one 0.25% rate cut in 2024 and four in 2025, though four members expect no cuts this year, seven project one cut and eight forecast two.

Leading up to today's meeting, investors anticipated between one and two rate cuts this year, close enough to the Fed's updated projections for a muted initial market response. Investors' cumulative 2024 rate cut expectations peaked at more than six cuts in January, bottomed near one cut, and currently stand between one and two. Over the long run, the Fed anticipates its policy rate to settle near 2.75%, a slight increase versus the prior member projections. The Fed's statement acknowledged "modest further progress" toward its 2% inflation goal, which echoes the ongoing deceleration in stubborn service inflation observed in this morning's Consumer Price Index (CPI) report. Fed Chairman Jerome Powell noted the labor market is back to pre-COVID levels and he views today's CPI report as "progress" but needs to see more good data before cutting rates.

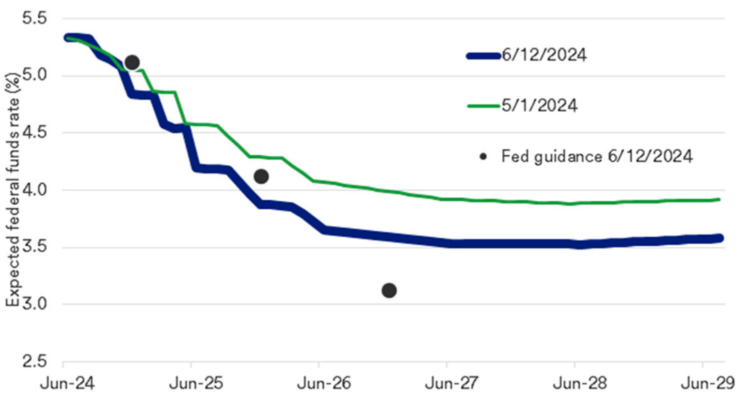
Considerable policy tightening from a near-zero federal funds rate in early 2022 to the current 5.25% to 5.5% helped drive Core Personal Consumption Expenditures Price Index (PCE), the Fed's preferred inflation gauge, from a peak above 5.5% in 2022 to 2.8% in April. Other inflation metrics, like the Core CPI, fell to 3.4% in May due to differing calculation methodologies, and are also well off its high of 9.1% in June 2022. Goods-related inflation remains well-contained, and the most recent CPI report released this morning indicates decelerating but still high service-related inflation.

The Fed released an updated Summary of Economic Projections (SEP), an every-other-meeting release of committee member forecasts, which indicates 2024 and 2025 inflation projections ticking slightly higher than May projections despite stable growth projections. Importantly, the median committee member's expected long-run expected policy rate moved higher to 2.75%. That projection had remained at or near 2.5% for more than four years from mid-2019 to late 2023. Some economists and investors have called for the Fed to revise its 2% long-run inflation goal upward somewhat, which also implies policy rates could settle in higher than the previous estimates of 2.5%. This critical debate will impact the level of interest rates and bond yields over time.

Starting this month, the Fed is allowing to runoff, or mature without replacement, up to $25 billion per month in Treasuries and $35 billion per month of mortgage bonds they currently own. This is a drop from $60 billion per month in Treasuries announced at the last committee meeting. Slowing balance sheet runoff incrementally improves market liquidity, which refers to the amount of money readily available to buy goods, services and financial assets in an economy.

Shorter-term liquidity measures had worsened in April when personal and corporate income tax payments were paid but have since stabilized and rebounded, supporting riskier asset prices.

Market pricing of the expected path of the federal funds rate

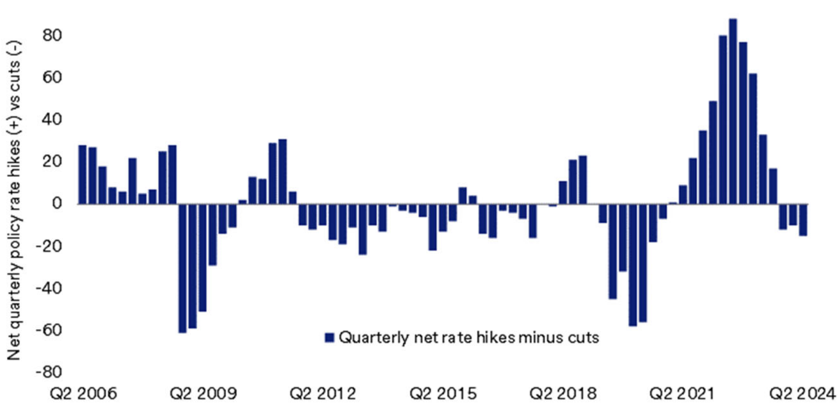


Source: U.S. Bank Asset Management Group Research, Federal Reserve, Bloomberg; 5/1/2024-6/12/2024

Stock prices rallied prior to the Fed's announcement today, after the CPI report increased confidence in rate cuts this year and next. Some segments of the equity market gave back a portion of gains after the Fed's projection for one rate cut this year versus investor expectations for one to two. Treasury bond yields fell, and the S&P 500 finished the day up 0.85%. Smaller companies represented by the Russell 2000 Index, which can be more sensitive to financing costs, rose 1.62% as bond yields fell. Ten-year Treasury bond yields fell 0.08% to 4.32% today, while two-year Treasury yields fell 0.08% to 4.76%. Funds that track the Bloomberg Commodity Index rose 0.62%.

Monetary policy, defined as central bank target interest rates, remains restrictive around the globe following aggressive rate hikes. However, global central bank rate cuts exceeded hikes starting in the fourth quarter of 2023, as inflation began trending lower. Investors anticipate modest rate cuts from other major central banks in addition to the Fed, with multiple cuts expected in 2024 from the European Central Bank (ECB) and Bank of England (BoE).

Global net central bank rate hikes (net hikes minus cuts), quarterly



Source: U.S. Bank Asset Management Group Research, Factset; 3/31/2006-5/1/2024

This year has been marked by solid performance of stocks (large U.S. stocks in particular) and inflation-sensitive assets like commodities, although gains have been trimmed recently. The relatively narrow rally in 2023 that boosted growthoriented stocks began to broaden late last year and early 2024. However, large technology companies have resumed market leadership with their outperformance, driving the S&P 500 Index to new all-time highs.

We retain a glass-half full viewpoint regarding corporate profits and are also wary that inflation may be more persistent. Robust consumer and business activity has translated to stronger-than expected economic data, while also contributing to sticky input costs and service-related inflation readings. Stimulative fiscal policy in the form of deficit spending has provided an additional tailwind to current conditions despite increasing government debt. We will keep you informed of our views as incremental data becomes available and as we update our assessment of market conditions.

As always, we value your trust and are here to help in any way we can. Please do not hesitate to let us know if we can help address your unique financial situation or be of assistance.

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Past performance is no guarantee of future results. All performance data, while obtained from sources deemed to be reliable, are not guaranteed for accuracy. Indexes shown are unmanaged and are not available for direct investment. The **S&P 500 Index** consists of 500 widely traded stocks that are considered to represent the performance of the U.S. stock market in general. The **Consumer Price Index** is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. It is one of the most frequently used statistics for identifying periods of inflation or deflation. The **Personal Consumption Expenditures (PCE) Price Index** is a measure of the prices that people living in the United States, or those buying on their behalf, pay for goods and services. It is known for capturing inflation (or deflation) across a wide range of consumer expenses and reflecting changes in consumer behavior. The **Russell 2000 Index** measures the performance of the 2,000 smallest companies in the Russell 3000 Index and is representative of the U.S. small capitalization securities market. The **Bloomberg Commodity Index** tracks prices of futures contracts on physical commodities in the commodity markets and is designed to minimize concentration in any one commodity or sector.

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