Fed holds US interest rates steady, but with a surprise dovish spin for 2024

The Federal Reserve has held the policy rate unchanged at 5.25-5.5% for the third consecutive meeting. They recognise the economy is slowing and that inflation pressures are easing and have pencilled in an extra rate cut in their own projections. While 75bp is less than markets priced ahead of time, it has emboldened expectations for big rate cuts in 2024

Fed holds policy steady, but anticipates significant easing may be required in 2024

The Federal Reserve has kept the policy rate unchanged at 5.25-5.5%, as widely expected, but there is a dovish pivot in that we have an acknowledgement that growth "has slowed from its strong pace in the third quarter" plus a recognition that "inflation has eased over the past year". Fed Chair Jay Powell went even further in the press conference, saying growth had slowed "substantially". The accompanying statement also adds the word "any" to the sentence "in determining the extent of *any* additional policy firming that may be appropriate to return inflation to 2 percent over time", offering the clearest hint yet that there is an acceptance on the committee that interest rates have peaked. It was a unanimous decision.

Meanwhile, their dot plot of individual forecasts has an extra rate cut in for 2024 so they now have 75bp of easing pencilled in versus 50bp in their September update. But note, too, that the final rate hike predicted in September is no longer there so the Fed funds rate is now expected to be 4.6% at the end of 2024 versus 5.1% previously. While not fully reflecting the 110bp of cuts priced by markets ahead of the meeting, this shift in viewpoint from officials has given the market the greenlight to push for more - the Fed is viewed as a pretty conservative institution that heavily weighs up the implications of what it says - and this is a surprise shift in outlook from them.

It may well be that Governor Chris Waller's viewpoint on inflation is shared more widely than thought. He noted that if inflation continues to cool "for several more months – I don't know how long that might be – three months, four months, five months – that we feel confident that inflation is really down and on its way, you could then start lowering the policy rate just because inflation is lower". After all, you don't need to wait for a recession before you cut interest rates.

Below is the updated table of their forecasts versus what they were saying in September. Ahead of time, both we and the consensus expected the Fed to come out with slightly higher GDP and inflation numbers for 2024 by 0.1ppt.

Federal Reserve officials' median economic projections versus what they said in September

	2023	2024	2025	2026	Longer run
Change in real GDP (Dec Fed forecast)	**2.6**	**1.4**	**1.8**	**1.9**	**1.8**
Previous Fed projection (Sep)	2.1	1.5	1.8	1.8	1.8
Unemployment rate (Dec Fed forecast)	**3.8**	**4.1**	**4.1**	**4.1**	**4.1**
Previous Fed projection (Sep)	3.8	4.1	4.1	4.0	4.0
Core PCE inflation (Dec Fed forecast)	**3.2**	**2.4**	**2.2**	**2.0**	**-**
Previous Fed projection (Sep)	3.7	2.6	2.3	2.0	-
Federal funds rate (Dec Fed forecast)	**5.4**	**4.6**	**3.6**	**2.9**	**2.5**
Previous Fed projection (Sep)	5.6	5.1	3.9	2.9	2.5

We look for 150bp of cuts in 2024, starting in May

This dovish shift has come earlier than we expected and we have seen 10Y Treasury yields plunge 17bp on the day. Despite some evidence of moderation, the economy is performing well, the jobs market remains tight and core inflation remains at 4%, double the Fed's target. Officials will want to see more evidence that the Federal Reserve's interest rate increases and the associated tightening of credit conditions are slowing the economy as desired so there is little prospect of an imminent rate cut.

In terms of the outlook for the economy and monetary policy, the consumer is key and with real household disposable incomes flatlining, credit demand falling, and pandemic-era accrued savings being exhausted for many, we expect a marked slowdown in activity through 2024. Inflation is starting to look better behaved and slowing housing-related inflation coupled with a steep fall in energy costs means we could get close to the 2% inflation target in the second quarter of next year. The Fed is seemingly buying into the argument that they can cut interest rates because falling inflation will push up real borrowing costs, but given our more cautious outlook for growth, we think the Federal Reserve will end up being more aggressive on rate cuts than both they and the market are currently expecting.

We look for 150bp of rate cuts in 2024, starting in May, with a further 100bp in early 2025 relative to the Bloomberg collated consensus expectations of 100bp in 2024 and a further 100-125bp in 2025.

The recent fall in market rates gets some validation from the Fed, and room now for more

The one thing that Chair Powell can't control is the dot plot. He has one dot, just like the rest. The market looks at the median outcome, and hey presto it's gleaned a Fed that is leaning into rate cuts in 2024, at least more than they were. That's been the dominant market impulse and has resulted in an additional rate cut being discounted by the market too, now at 125bp. The entire curve has shifted lower, led by real rates. The 2/10yr curve has gapped steeper, too.

This is a meaningful outcome. The question now is whether the 2yr can really break free and head lower as a driver of the yield curve, steepening it out from the front end. That traditionally happens on a 3-month run ahead of an actual rate cut. We're on the cusp of this, but not quite there just yet.

It's been a remarkable ongoing market move, especially as it has been interlaced with some tailed auctions, indicative of some resistance to the falling market rates narrative (at the long end). But there's been little from Chair Powell and the FOMC to stand in the way of this. Recent data has not really validated the dramatic fall in yields. But today, the Fed has helped to do so. A far more hawkish Fed had been anticipated.

The question ahead is where fair value lies for the 10yr. We think it's 4%. It's premised on the view that the funds rate gets to 3% and we are adding a 100bp curve to that. We are about to sail below 4% though as a theme for 2024, with 3.5% the target. But the move below 4% towards 3.5% will be an overshoot process.

FX: Dollar short-term outlook flips

The dollar was trading weaker across the board after the market's dovish expectations for rate cuts next year received some validation with a sharper-than-expected downward revision to the 2024 dot plots. The two-year USD swap rate is down by over 20bp from before the meeting, meaning that the dollar has lost a non-negligible portion of the rate advantage it had against some key FX peers.

The EUR-USD two-year swap spread is now around 113bp; although below the November peak, it is a material re-tightening that, if compounded by a successful rate pushback by the European Central Bank tomorrow, could favour a continuation of the rally in EUR/USD that we are observing after the FOMC.

We still think that there is one remaining key ingredient to make a dollar downtrend truly sustainable, and that is a material deterioration in US activity data. We still suspect that there will be occasions for the dollar to rebound on evidence of further resilience in the US outlook. However, that may be a story for January now. The dollar is unfavoured by seasonality in December, and if the ECB manages to move rates in the opposite direction, then ending the year below 1.10 in EUR/USD may well be a success for the dollar bulls.

Authors

James Knightley
Chief International Economist
james.knightley@ing.com

Padhraic Garvey, CFA
Regional Head of Research, Americas
padhraic.garvey@ing.com

Francesco Pesole
FX Strategist
francesco.pesole@ing.com

Disclaimer