

# THE FED GOES BIG

REVIEW OF THE WEEK  
23 SEPTEMBER 2024

## INTEREST RATES HAVE FINALLY DROPPED IN THE US AFTER A DOUBLE-BARRELLED CUT. BUT WILL THEY FALL AS FAST FROM HERE AS INVESTORS EXPECT?

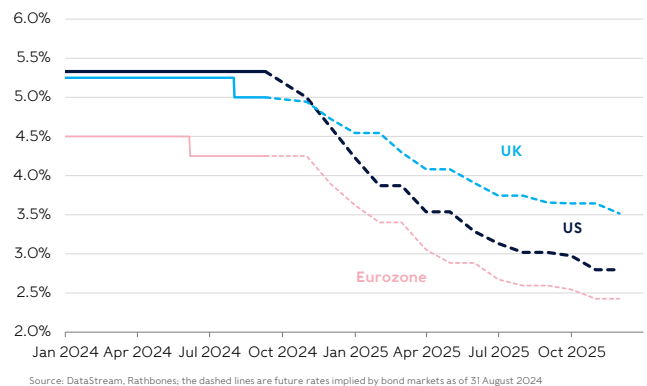
The US Federal Reserve (Fed) delivered a 'jumbo' cut to interest rates of half a percentage point, taking the benchmark borrowing rate to the range of 4.75% to 5.00%. While a decrease was expected by virtually everyone, the question was the quantum. Opinion was fairly evenly split on whether it would be 0.25% or 0.50%.

Digesting the news, the US stock market wobbled a bit at first but ended the week up. This is what you would expect, given a fall in rates tends to be good for the prices of stocks as long as there's no whiff of recession in the air. When prevailing rates fall, it makes companies' expected returns look more attractive relative to cash and other lower-risk assets, encouraging people to buy them. However, if recession is in the offing, the calculation changes. Because downturns tend to mean fewer sales and worse profits (and even a swing to losses in some cases), they hit stock prices hard.

Counterintuitively, US government bond markets took the news slightly negatively – the 10-year Treasury yield ended the week about 10 basis points (10 hundredths of a percent) higher, meaning that its price fell. Typically, a fall in a central bank's benchmark borrowing rate would boost that nation's government bond prices, pulling down its yield. Yet US Treasury yields, both short-term and longer-term, had fallen significantly ahead of the Fed's decision. After the cut, many investors focused on the Fed committee's plans for future rate cuts: was this the start of a rapid fall or would rates take a while to fall?

Bond investors and the Fed committee were not seeing eye to eye on that question before last week's monetary policy meeting and they certainly haven't aligned themselves since. Despite the big first step in cutting rates, the Fed has outlined a relatively slow path from here. The latest iteration of the 'dot plot', which maps committee members' forecasts for interest rates, shows the average member expects the benchmark rate to be about 4.75% by the end of the year. Investors, as implied by interest rate markets, believe it will be 4.25%. Similarly, the average Fed member thinks the rate will be somewhere around 3.25% by the end of next year; investors assume it will be comfortably below 3.0%.

## OVERLY AGGRESSIVE RATE CUTS PRICED IN FOR NEXT YEAR



Now, Fed members have been wrong before! Yet so have investors. For now, we think the Fed's more sedate pace of cuts is the most prudent forecast. While the US jobs market has cooled substantially over the past few months, it's still nowhere near 'bad' territory. And it's hard to argue that the US economy is tanking either: the last official GDP growth was 3.00% in the second quarter and the unofficial-but-less-lagging 'nowcast' estimate from the Atlanta Fed suggests Q3 growth is 2.9%.

While we expect the US economy will slow from here, we think a recession is not the most likely outcome. If we are correct, that should be good for stock prices, as rates fall and profits aren't upended by a contracting economy. It should benefit bonds as well, although they have already posted gains in anticipation, so they may be a bit rockier in the coming months – at least until they come to an agreement with the Fed's view of the world.

## A sterling run

At its monetary policy meeting last week, the Bank of England (BoE) kept its benchmark rate where it was, at 5.00%. Unlike the Fed, which must weigh equally full employment and price stability (which it interprets as core PCE inflation of 2% over the long term), the BoE's primary objective is a 2% target for CPI inflation, with a secondary aim to support economic growth. While UK CPI inflation remained at 2.2% in August, services inflation re-accelerated from 5.2% to 5.6%. Core inflation (which strips out volatile energy and food prices) also increased, from 3.3% to 3.6%.

## REVIEW OF THE WEEK

While the BoE doesn't set out its rate forecasts like the Fed, the policy committee has been pretty clear that it still expects rates to fall steadily from here. However, that drop may be slower than elsewhere as everyone waits for services inflation to cool. Investors are assuming that rates will hit 3.5% by the end of 2025. We think that it's at least as likely that rates won't fall as fast in the UK as markets imply. Unless, that is, a recession or other shock arrives, which, as the last two months of retail sales reminds us, is unlikely to be around the corner.

Because the prevailing UK interest rate is shaping up to be relatively high and fall slower than elsewhere, it's helped boost the value of the pound. Sterling is buying €1.197 and \$1.332, the highest the pound has been against either the euro or the dollar in two and a half years. Just a shame it got there *after* the summer holidays. Hopefully it remains strong when it comes time to book holidays for some winter sun!

*If you have any questions or comments, or if there's anything you would like to see covered here, please get in touch by emailing [review@rathbones.com](mailto:review@rathbones.com). We'd love to hear from you.*

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