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# THE CASE FOR 2024 RATE CUTS: GROWTH IS NO REASON NOT TO CUT

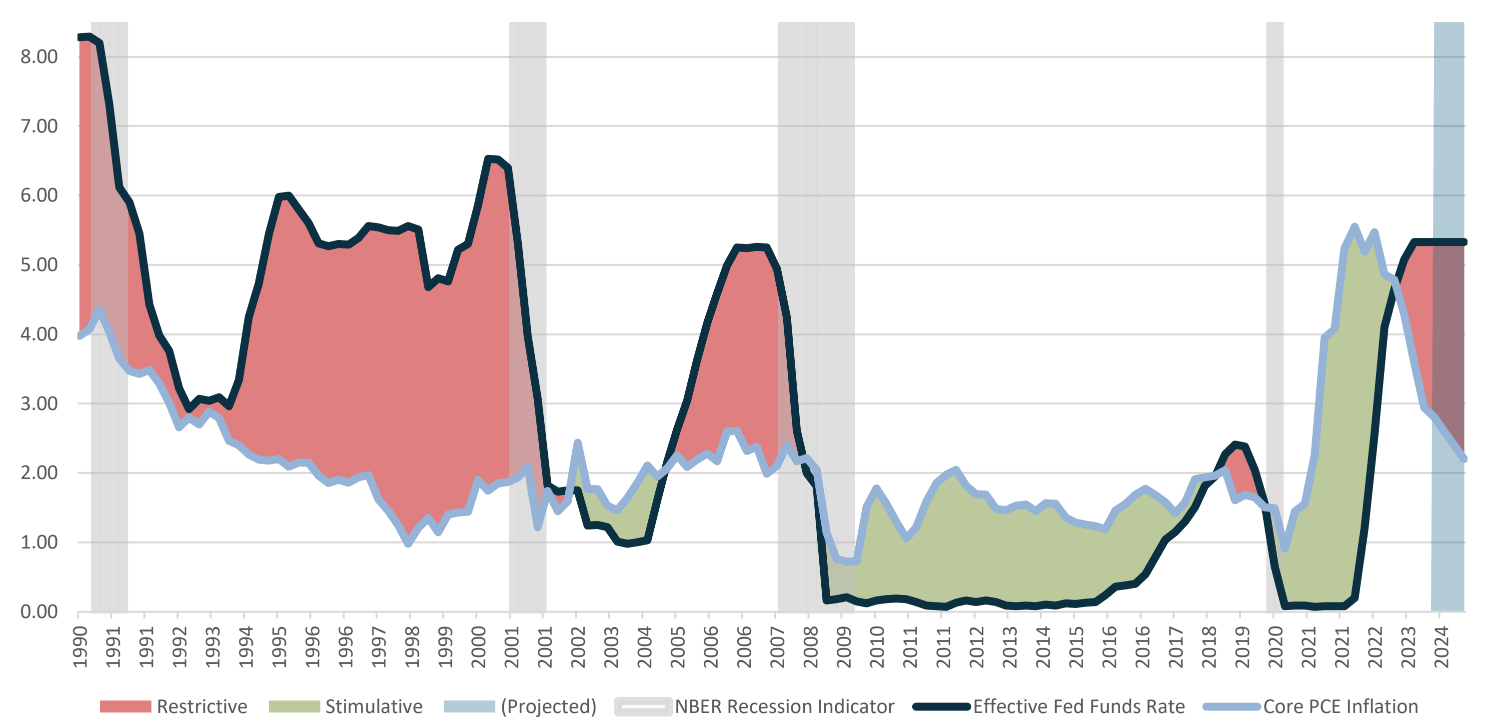
Drew Peterson, CFA, CIPM®, Corporate Bond Research Analyst and Macro Strategist

## Why Cut Fed Funds At All?

After months of discussions about how deeply the FOMC would cut rates in 2024, nothing speaks to the rapid shift in market sentiment better than the number of questions we've fielded recently about why the Fed should cut rates *at all* this year. Growth remains strong despite a Fed Funds Rate ("FFR") that's higher than any time since the dot-com era; the market is belatedly realizing that in a "soft landing" scenario, rate cuts aren't actually all that pressing. So, why cut? This is a reasonable question, and a big part of the reason we came into the year expecting two to three rate cuts in 2024 rather than the market's seven. **We do believe rate cuts are coming, however; the key to understanding why has to do with the relationship between the Fed Funds rate and inflation.**

The purpose of hiking rates is to drive down aggregate demand by making it more expensive to borrow, which in turn should reduce inflation. If borrowing costs less than the rate at which prices are expected to increase, it probably makes sense; if borrowing costs more than anticipated price increases, it likely doesn't. **It's logical, then, to think less about the "nominal" or absolute level of rates, than the "real" rate, or how much it exceeds or falls short of inflation.** While the nominal rate only changes when the Fed decides to change it, the real rate also changes with inflation, and as inflation falls then the real rate increases. Nominal rates have been on hold since the Fed last hiked in late July to 5.33%. Real rates, however, relative to Core PCE inflation, have more than doubled from 1.14% to 2.48% in that time. If inflation continues to fall, which we expect it will, then the Fed risks becoming a victim of their own success. At 2% inflation, an unchanged Fed rate would push real rates up to 3.33%. This will further tighten monetary conditions and could begin to jeopardize the soft landing the Fed has carefully engineered. The Fed will likely need to cut rates merely to maintain policy in real terms.

Real Fed Funds Rate Will Become More Restrictive As Inflation Falls




Source: National Bureau of Economic Research, Bureau of Economic Analysis, Federal Reserve Bank of New York, Appleton Partners

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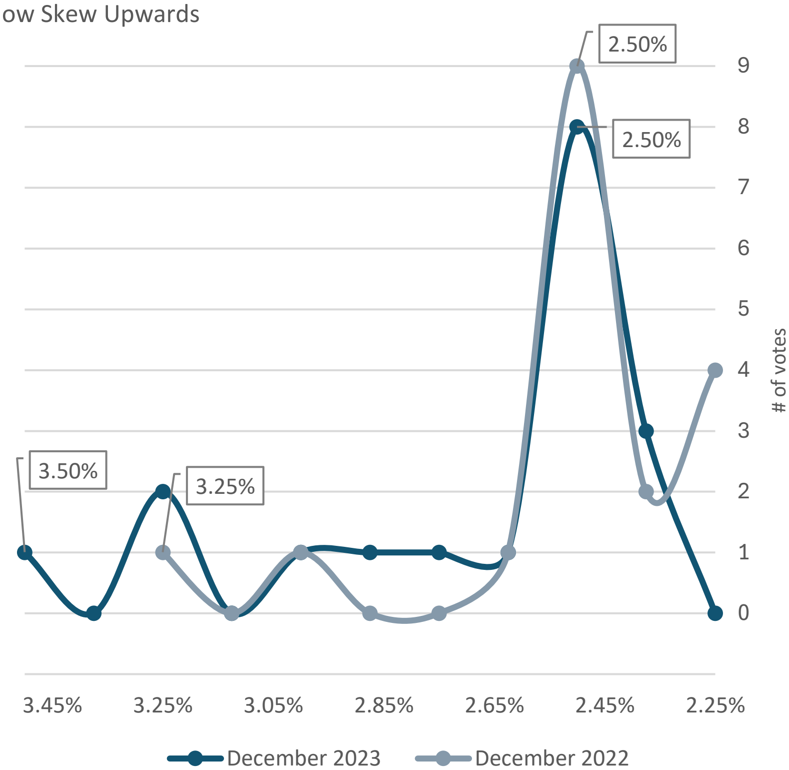
## How Far Will The Fed Cut?

Looking at the December 2023 Summary of Economic Projections "dot plot," **the Fed still shows a long-term median forecast of 2% inflation with a 2.5% Fed Funds Rate. This implies a "neutral" real rate of 0.50%.** Economists believe the neutral rate changes over time, and while 0.50% has been the prevailing estimate in the post-Great Financial Crisis era, this was closer to 1.5-2.0% in the '90s, and the post-GFC may be an anomaly. Sure enough, the individual dots in the "dot plot" show a growing upwards skew, with seven of the 18 voting members expecting rates to settle higher than 2.5%, and the highest dot at 3.75%, a significant change since the start of 2023. The '90s were a period of above-trendline productivity growth, and heightened productivity today is a popular theory for why growth has held up as well as it has at current rates, so this shift is plausible. If nothing else, the fact that we're not flirting with recession with a Fed Funds rate of 5.25-5.50% and six-month trailing inflation at the Fed's target gives weight to the idea that the neutral rate may have risen.

Median Unchanged, but FOMC Long Term Rate Expectations Now Skew Upwards




Source: Federal Reserve, Appleton Partners

**Without a good way to directly measure the real neutral FFR, we expect the FOMC to find it iteratively, slowly lowering rates and watching how the economy responds.** We expect this process to last years and would not be surprised if in 2026 we find the Fed on hold at 3-3.5% with 2% inflation, consistent with a neutral rate 0.50-1.00% higher than today's estimate.

**So, we still see compelling reasons for the Fed to begin cutting rates in the second half of 2024 even with 2% inflation and strong growth**; falling inflation is itself making policy more restrictive with time, when considering rates from a real and not nominal standpoint. We think that at some point the Fed could shift their language to talk about real rates to explicitly recognize this, and that rate cuts would then be construed as a way of maintaining a given level of policy, rather than providing accommodation. However, we also believe there's a reasonable chance this cutting cycle may end at a higher level than the markets expect.

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