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Amundi ASSET MANAGEMENT

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INVESTMENT TALKS

Fed to Commence its Easing Cycle

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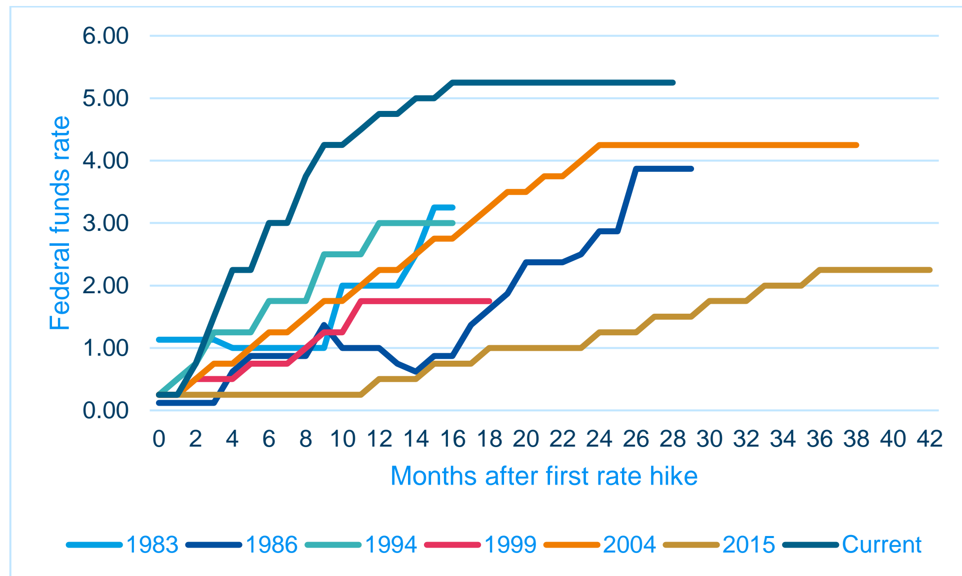
- *This month's actions by the US Federal Reserve to begin its easing cycle will cap a remarkable period of restrictive monetary policy that has not been experienced since the early 1980s.*
- *Financial markets are anticipating significantly more policy easing than seen in recent easing cycles, which will have financial market implications.*
- *While US fixed income yields are reasonably attractive relative to the past 15 years, some fixed income markets have already moved ahead of the Fed this cycle, and we suggest caution in projecting prior easing cycle market performance onto the current market.*

As expected, the US Federal Reserve will begin its easing cycle this month, capping a remarkable period of restrictive monetary policy that has not been experienced since the early 1980s. The tighter policy stance has helped cool inflation and moderate economic activity. Now, the Fed hopes to ease off the policy brake in a way that preserves continued disinflationary progress towards its long-term 2% inflation target while also supporting its second mandate of "maximum employment". In this note, we highlight the uniqueness of this monetary policy cycle, how financial markets are anticipating significantly more policy easing than seen in recent easing cycles, and the financial market implications.

Aggressive tightening cycle

The Federal Open Market Committee (FOMC) meets on September 17-18, 2024 and is expected to cut interest rates for the first time in 14 months. Market expectations are lofty, pricing in a 47% probability of a 50bp rate cut as of 9/16/24. This has been a unique tightening cycle, with the current cycle marking the highest the Fed has held rates at their peak before cutting since 1983 (see Exhibit 1).

Exhibit 1: Fed's most aggressive tightening cycle since 1983



Source: Amundi US, Bloomberg, as of 9/15/24

Policy beyond "sufficiently restrictive"

This aggressive tightening cycle has raised the logical question of whether Fed policy has become overly restrictive. In recent meetings, the Fed has come to believe that policy is "sufficiently restrictive" and the time has come to begin to ease its policy stance. Based on the Taylor Rule Prescription models, the Fed's current policy is between 75-200bp away from the neutral Fed funds rate.

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We draw three conclusions from these models. First, all but one of the models tell us that policy rates should be lowered. Second, they suggest a higher trough in the Fed funds rate compared to prior cycles. Finally, it is possible the "neutral" Fed Funds rate should be higher. This is consistent with various market interpretations as well Fed funds futures that predict the rate troughing around 3.25%.

Most widely anticipated easing cycle in history

The prospective 2024 Fed easing cycle may end up being just as unique as the tightening process that brought policy to its current state. Based on our analysis, this is poised to be the most anticipated easing cycle in post-modern monetary policy history, with Fed Funds futures currently pricing in 250 basis points of rate cuts by September 2025. For comparison, market expectations at the start of the prior five Fed easing cycles averaged around 75 basis points of rate cuts in the subsequent 12 months, approximately a third of what is already discounted into short-term interest rate markets.

Financial market implications

While US fixed income yields are reasonably attractive relative to the past 15 years, we suggest caution in projecting prior easing cycle market performance onto the current market. Typically, fixed income markets have performed strongly during prior Fed easing cycles as investors add long-term Treasury yields and spread duration. However, as we highlight in this note, financial markets are already factoring in aggressive Fed easing. Moreover, the chart below, which presents Fed funds futures (expectations - grey line) and the federal funds effective rate (reality - blue line), highlights that financial markets do not have a successful track of record forecasting the Fed's policy path (see Exhibit 2).

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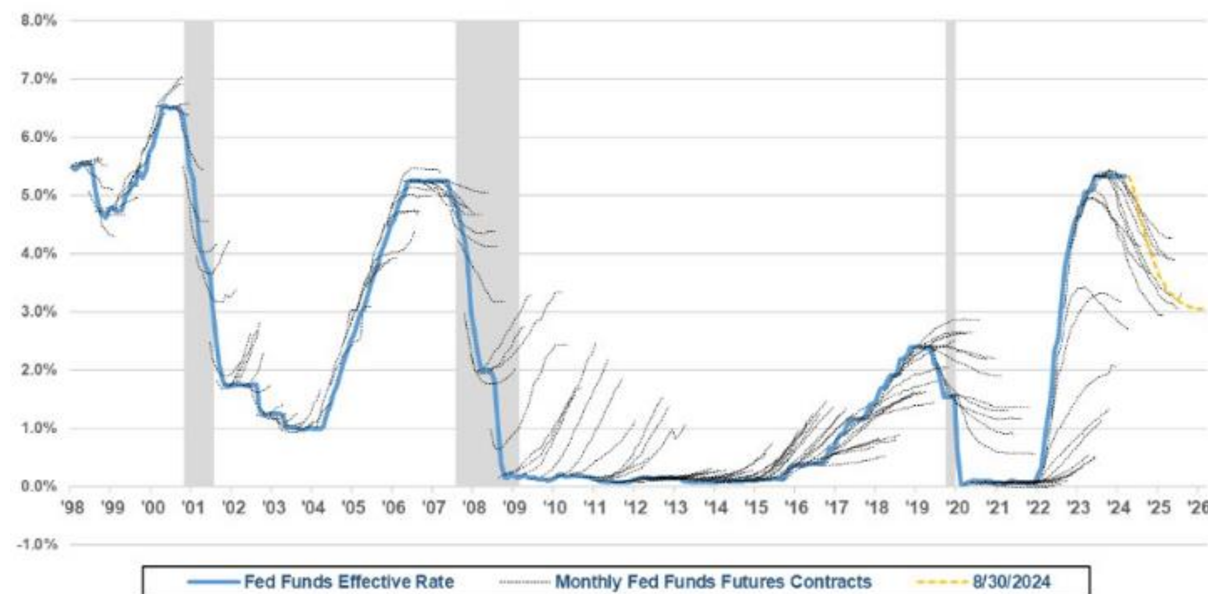
Exhibit 2: Historical Fed funds futures contracts vs. federal funds effective rate



Source: Amundi US, Bloomberg, as of 9/15/24

Definitions

- **Basis points (bp):** One basis point is a unit of measure equal to one one-hundredth of one percentage point (0.01%)
- **Federal funds rate**: The interest rate at which banks lend money to each other overnight, set by the US Federal Reserve.
- **US Federal Reserve**: The central banking system of the United States, created on December 23, 1913, with the enactment of the Federal Reserve Act.
- **Volatility:** A statistical measure of the dispersion of returns for a given security or market index. Usually, the higher the volatility, the riskier the security/market.

Important information

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