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Aggressive and Shallow or Gradual and Deep?

Chair Powell will not push back against strong market expectations of easing. Fed funds futures are discounting a near 29 basis point (bp) decline in the September contract, which implies roughly a 15% chance of a 50 bp rate cut.

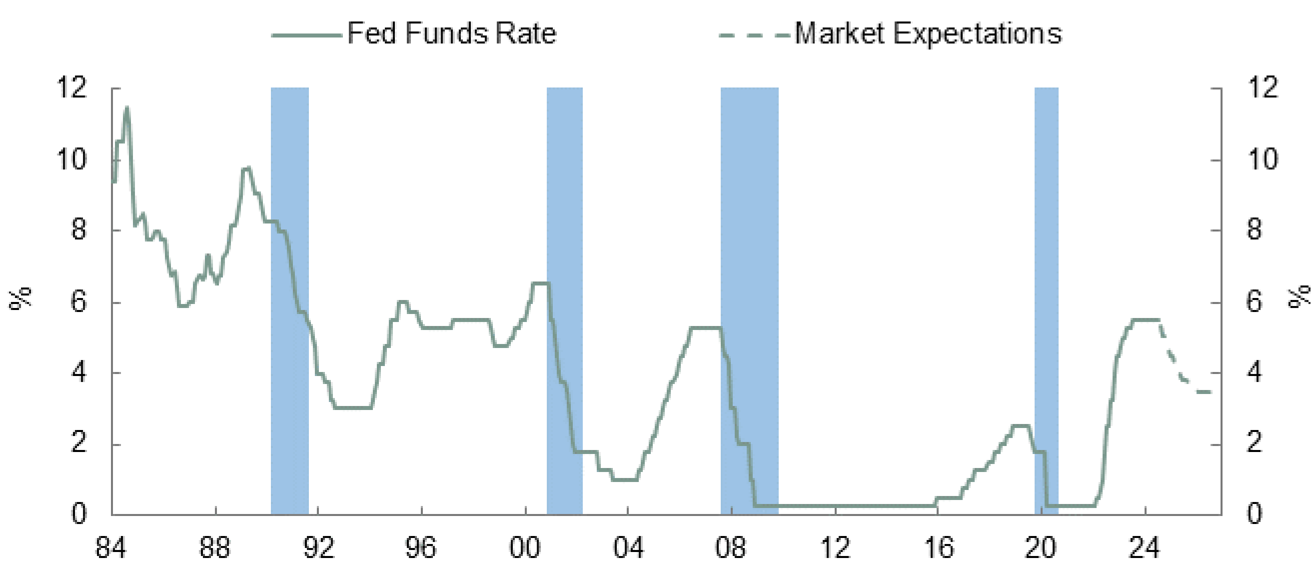
The last time the Fed started an easing cycle by going half of a point was September 2007. Interestingly that period also marked a long time in between policy changes — it was 15 months from the June 2006 rate hike versus 14 months from the last hike in July 2023. But the Fed's reasons for cutting so aggressively are different than today.

Then, the short-term funding markets were under severe stress. The spread between short-term commercial paper and the fed funds rates widened significantly as did other money market barometers such as treasury bills and Eurodollar financing. Policymakers stated at the time that they wanted to initiate a large rate cut to alleviate these strains.

Today, no such stresses exist in the financial markets at least not in any meaningful way. In fact, **financial conditions are super accommodative by the Fed's own calculations**. In turn, this is blunting the effects of relatively high interest rates. However, if all of a sudden the economy looks fragile, say nonfarm payrolls print negative, the situation could quickly change. If so, risk premium would likely to show up in the corporate credit market where spreads in both investment grade and high yield are historically low relative to treasury yields. Stock prices would move sustainably lower. But we are not there yet.

It is much likelier that the Fed will begin cutting rates gradually rather than aggressively. So unless the economy abruptly turns over, it is doubtful the Fed will cut rates by 25 bps for eight consecutive FOMC meetings as the fed funds futures market currently implies — see chart below. In the past, monetary easing cycles have been lumpy not smooth or linear. The Fed often skips meetings.

Ultimately, the funds rate will likely have to go below neutral, which we estimate is around 3%, consistent with the FOMC's current central tendency of 2.5% to 3.5%. This means **the futures market is too optimistic in the near-term regarding how much the Fed will cut rates but then too pessimistic on where the funds rate bottoms**. Unfortunately, we do not expect the Chair to elucidate much on this policy specificity.



Source: Federal Reserve, Haver, SMBC Nikko

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