December 18, 2024

Fed expects less rate cuts in 2025 and 2026

The Bottom Line:

- The Fed cut rates by 25 basis points as widely expected, but also signaled more a more gradual easing cycle going forward alongside upwardly revised growth and inflation forecasts.
- That's broadly in line with our own forecast, that expects much of the ongoing resilience with domestic demand will persist into the new year, and that interest rates will need to stay elevated to offset resulting inflationary pressures.
- Our base case projections expect one more 25 basis point cut in January before pausing at a 4% to 4.25% range for the rest of the year.

The Details:

- The Fed's policy statement today was little changed comparing to their last meeting in November (which saw a similar sized cut), but with the addition that "the extent and timing of" additional adjustments will depend on incoming data.
- Powell later in the press conference spelled out the change in wording as a signal of the Fed being "are at or near a point at which it will be appropriate to slow the pace of further adjustments". That's in line with our forecast that only expects just one more cut in January.
- Changes to FOMC participant projections reinforced the overall hawkish shift. The GDP growth profile was revised slightly higher to 2.1% in 2025 while the unemployment rate was revised lower to 4.3%. The bigger change lies within the inflation forecast – projection for the preferred core PCE measure was raised to 2.5% in 2025 from 2.2% previously.

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- In the dot plot, the end of year Fed Funds landed at 3.9% for 2025, 50 bps higher than the 3.4% expected in September. That implies two more 25 basis point cuts from where rates are today. In 2026, the FOMC expects to cut by another 50 bps, to 3.4%.
- Back to inflation, the growth rate in CPI for both goods and services excluding food, energy and rent have picked up in recent months relative to lower readings in the summer. Powell brushed that aside as mostly residual impact from high inflation period in 2021 and 2022, and said inflation should be on the expected course lower, especially given the gradual cooling in labour market which is not a key source of inflation these days.
- The longer-run estimate of "neutral" level of interest rates was slightly higher at 3% (up from 2.9%), which is mostly expected to be reached by the end of 2027.
- In justifying the cut in the fed funds rate today, Powell reiterated that labour markets have cooled and the Fed does not want them to soften further. But he also said explicitly that interest rates likely need to remain at restrictive levels to keep inflation on a downward trajectory.
- Finally and similar to the tone adopted by BoC governor Macklem in their meeting last week, Powell continued to push back against discussing the impact of potential tariffs, referencing high levels of uncertainties with regard to the shape and form the policies could take on.
- Similar to the Fed, we continue to expect ongoing strength in the U.S. economic backdrop will mostly persist into 2025 (thanks to large amounts of government spending), labour markets will continue to normalize but not crumble and rates will stay high for longer to offset.

FOMC projections summary

	Current (Oct) projections			
	2024	2025	2026	2027
GDP growth	2.5 (2)	2.1 (2)	2 (2)	1.9 (2)
PCE deflator	2.4 (2.3)	2.5 (2.1)	2.1 (2)	2 (2)
Core PCE deflator	2.8 (2.6)	2.5 (2.2)	2.2 (2)	2 (2)
Unemployment rate (Q4)	4.2 (4.4)	4.3 (4.4)	4.3 (4.3)	4.3 (4.2)
Appropriate EOY fed funds rate	4.4 (4.4)	3.9 (3.4)	3.4 (2.9)	3.1 (2.9)
Change in bps from current level	0.0	-50	-100	-130

*Previous median in parentheses

Source: Haver, RBC Economics