HongLeong Bank

15 January 2024

Global Markets Research

Research Alert

What happens when the Fed cuts?

History suggests the Fed starts cutting rates 5-8 months after pause, by 300bps on average
Fed dot plot suggest a 75bps cut to 4.50-4.75% by end-2024; we expect first cut in mid-2024
Bigger gains for long-end UST; softer Dollar; mixed impact on the equity markets
BOE lagged the Fed by 1-8 months in its rate cuts; ECB by 4-13 months

Overview

In our previous article "What happens when the Fed pauses?" dated 24 October 2023, our study shows that the US Fed Funds Rate has a strong 0.97 correlation with the 2Y UST yields and 0.93 vs the 10Y UST yields based on the month-end data for the last 50 years. Data also showed that the Fed Funds Rate has a correlation of 0.61 with the US equities market (using the broader S&P 500 as a benchmark). Correlation with the USD is relatively weaker, with our calculation suggesting 0.40 between the Fed funds rate and Dollar Index (DXY) and a 0.67 correlation to the USD/MYR, the latter partially skewed due to the pegging of the Ringgit from 1998 to 2005.

History suggests that Fed cut rates 2-15 months after pause, by 75-1150bps

Our article also showed that historically, Fed has cut rates as soon as 2 months and as slow as 15 months after pausing, but with a historical average of 5-8 months as the impact from the past interest rate hikes trickled in. Past data also showed the pause is usually followed by an average of above 300bps rate cut subsequent to that. The cuts ranged between 75 to 1150bps in the past 50 years, but at a narrower range of between 75-550bps in the past 4 cycles.

Just a recap, Fed last raised its benchmark rates by 25bps to 5.25-5.50% in the July 2023 FOMC meeting and has subsequently stayed pat since then. Using history as a guide, this suggests that Fed rate could have been lowered as soon as September 2023 but as slow as October 2024, but more likely within the December 2023-March 2024 time frame. This is, in fact, in line with market expectations that the first rate cut will begin in March 2024 (Please refer to Figure 1), vs ours of mid-2024.

At the same time, past data suggests that Fed funds rate could be lowered back to zero (-550bps), 2.50% (-300bps) or 4.50% (-75bps). 4.50% and 2.50%, are in fact, in line with Fed's median term projection for 2024 and longer-run. Based on the simple monetary policy rules by the Federal Reserve Bank of Cleveland, meanwhile, Fed funds rate could end-2024 at 3.91% (based on median rate).

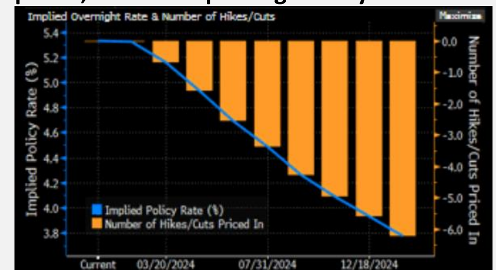
Summary of Federal Funds Rates Based on Seven Simple Policy Rules (Percent)

	2023.3	2023.4	2024.1	2024.2	2024.3	2024.4	2025.1	2025.2	2025.3	2025.4
Maximum	5.26	6.86	8.50	10.26	11.74	13.01	14.25	15.44	16.57	17.66
75th Percentile	5.26	5.19	5.08	4.82	4.62	4.47	4.59	4.42	4.26	4.07
Median	5.26	5.08	4.82	4.47	4.11	3.91	3.67	3.52	3.38	3.28
25th Percentile	5.26	4.11	3.72	3.72	3.50	3.07	3.21	2.97	2.78	2.63
Minimum	5.26	2.78	2.44	2.21	2.11	1.93	1.88	1.80	1.81	1.80

Notes: Dates use YYYY.Q format. Federal funds rates are quarterly averages. Pink denotes data.

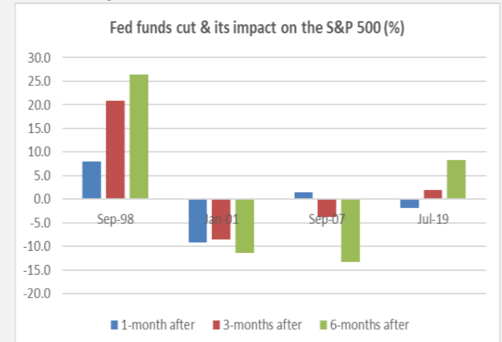
Source: https://www.clevelandfed.org/indicators-and-data/simple-monetary-policy-rules

Figure 1: Fed Funds Futures is pricing in the first rate cut in March, 8 months after pause; We are expecting in May



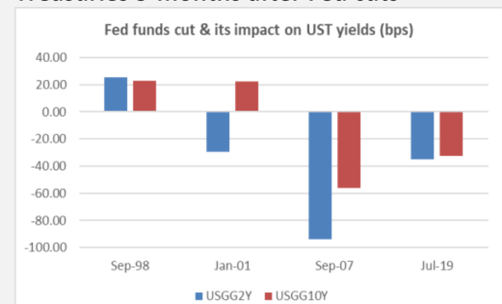
Source: Bloomberg

Figure 2: Impact of Fed fund rate cut on S&P 500 dependent on the state of the economy



Source: Bloomberg

Figure 3: Higher gains for long-end Treasuries 3-months after Fed cuts



Source: Bloomberg

Higher gains for long-end UST after a cut; softer Dollar, performance of the equity markets dependent on the state of the economy

From a theoretically perspective, lower interest rates tend to depreciate the value of its currency, in this context the USD, while steepening the UST yield curve as investors flee to value long-dated bonds to hedge against volatility in the equities market, be it Wall Street or emerging markets. Indeed, the DXY slid between 1.2-2.1% and the gap between the 2Y and 10Y yields widened from 14-60bps to 17-106bps three months after the cuts in the past three of four cycles.

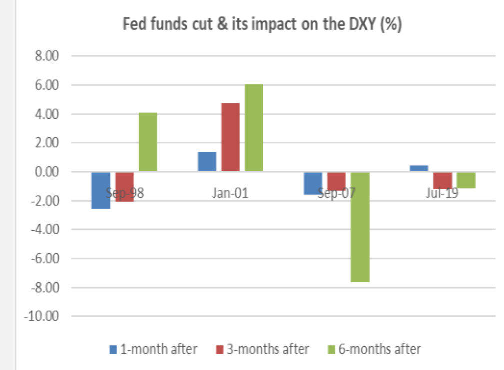
The impact on the equity markets after a Fed pause, meanwhile, will depend on whether the previous hikes tilted the US economy into/near recession, and a soft or hard landing. When the hikes did not tilt the economy into a recession, equities generally rallied. For example, S&P 500 gained between 1.9-26.5% three to six months after the Fed cut in 1998 and 2019 when GDP growth averaged above 2.0% q/q. On the other hand, S&P lost between 3.8-13.4% in 2001 and 2007 when GDP growth averaged less than 2.0%.

Conclusion

The US economic activity has slowed, job gains have moderated but remained resilient, justifying our expectations that the FOMC can engineer a soft landing for this cycle. Inflation has eased over the past year but remains elevated. Volatile oil prices, inflation expectations and upward momentum in m/m CPI due to services costs are not encouraging. Coupled with our soft-landing view, our take is that the first Fed rate cut will start towards mid-year/May and will end-2024 with a 75bps cut to 4.50-4.75%. In tandem with the rate cuts, also we expect USD and 10Y UST yields to drift lower, ending 2024 at 98.33 and 3.70-3.90% respectively (Current hovering around 102 and a tad below 4.00%).

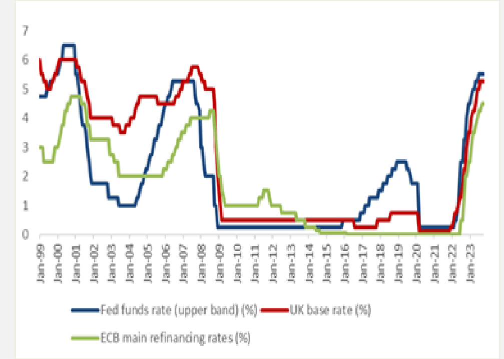
In tandem with this, we also expect ECB and BOE to follow suit, with the Eurozone expected to out dove Fed with a 100bps cut to 3.50% given that it is the sick man amongst the majors and carries higher recession risks. For BOE, a 75bps rate cut is expected to 4.50%, but we anticipate the first rate cut to begin in 3Q given risks of a stagflation. In fact, for the past 20 years, the Bank of England has lagged the Fed by 1, 3 and 8 months in its rate cuts, and the European Central Bank by 4 and 13 months. The only exception was during the 2019 cycle where the main refinancing rates were already at 0%.

Figure 4: Softer USD post rate cuts



Source: Bloomberg

Figure 5: Fed usually leads ECB and BOE



Source: Bloomberg

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