Fed week – Is a rate cut on deck?

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Drew O'Neil discusses fixed-income market conditions and offers insight for bond investors.

The FOMC meets this week in what will be the one-year anniversary of the last change to the Fed Funds rate. Last July, the FOMC raised the Fed Funds rate 25 basis points to cap off a rapid series of rate hikes that saw the Fund Funds rate increase by a total of 525 basis points in less than a year and a half as they worked to fight the extreme levels of inflation that followed the COVID pandemic. We are approaching a turning point in policy decisions as the FOMC attempts to walk the fine line of hitting their inflation targets while maintaining a healthy labor market.

What are the expectations for the FOMC meeting this week?

The FOMC is not expected to make any changes to the Fed Funds rate at this meeting. However, they will likely attempt to lay the groundwork for rate cuts at upcoming meetings. Based on Bloomberg calculations, markets are currently putting the odds of a rate cut this week at ~4% while the odds for a cut at the following meeting in September are at 100%. The FOMC has made a concerted effort to be as transparent as possible with regards to their intentions and outlook for future policy decisions. Assuming FOMC members conclude that a September rate cut is likely, they will attempt to both foreshadow that decision and lay out the rationale that would lead to it without stating outright that a decision has already been made.

What is the outlook for FOMC policy changes through the end of the year?

As stated above, a change in policy is not expected at this week's meeting. Bloomberg calculations, which are based on where Fed Funds futures are trading (as opposed to guesses or forecasts from market commentators), have a 25 basis point cut priced in for September. Following the September meeting, odds of an additional 25 basis point cut in November are at ~78% and then ~72% for one last 25 basis point cut in December to close out the year. In all, markets are expecting 75 basis points of total cuts to the Fed Funds rate by the end of the year.

What is driving these policy decisions?

Entire papers have been written answering this question but simply put, the FOMC is attempting to balance their dual mandate of promoting maximum employment and stable prices. The lagging effect of monetary policy decisions make this balancing act as much an art as it is a science. Inflation is well below the 2022 highs and while it is approaching their goal of 2%, is still not there. On the other side of the equation is unemployment, which has been steadily rising since early 2023 and recently breached the 4% level, coming in at 4.1% for June at the last reading. Cutting the Fed Funds rate in theory should help to boost the economy and hopefully prevent unemployment levels from increasing to unacceptable levels. Walking the line of keeping employment at healthy

levels while not over-stimulating the economy to the point that inflation gets pushed back higher is what the FOMC is trying to do.

What is the takeaway for fixed income investors?

Markets are forward-looking. This means that yields typically react based on what market participants anticipate is going to happen well before the event (whatever it is) actually happens. This means that the corresponding yield moves that go along with the 75 basis points of expected Fed Funds cuts have consequently already happened. For example, the 1-year Treasury yield is down ~70 basis points off its highs in late 2023. And while longer-term yields do not necessarily move in tandem with short-term rates, the 10-year Treasury yield is ~80 basis points lower over that same timeframe. The move lower in yields is already transpiring well before the FOMC has made any policy changes. As an investor with a longer-term time horizon, extending out the maturities of your fixed income allocation likely makes sense right now as the opportunity to lock in some of the most attractive yields in 15+ years still exists but could diminish as markets price in lower rates in the future. Investors who have their fixed income allocations in money market funds or similar products have likely already seen the yield start to drop, a trend that will likely continue as the Fed Funds rate and short-term yields continue lower. Deploying this money into a longer-term fixed income strategy will lock in yields and cash flow regardless of what interest rates do going forward.

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