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Fed refrains from a hawkish shift

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Markets were mixed after the FOMC kept rates unchanged. We maintain our base case that the US economy is heading toward a soft landing, with economic growth moderating and inflation slowing in the months ahead, allowing the Fed to begin rate cuts in September. We recommend quality bonds and quality stocks.

The Federal Open Market Committee (FOMC) announced its unanimous decision to keep rates unchanged in a 5.25–5.5% target range. During the press conference that followed the FOMC's policy rate meeting, Fed Chair Jerome Powell remarked that inflation "eased notably but remains high" and "further progress is not assured" for a sustainable path toward the Fed's inflation target of 2%. The S&P 500 was 0.3% lower Wednesday, while the 10-year US Treasury yield declined by 5 basis points to 4.63%.

The outcome of the rate decision was widely expected and marked the sixth consecutive time the Fed paused since starting its 525-basis-point hike cycle in March 2022. The Committee also announced a slower pace of quantitative tightening (QT) with a new monthly cap on the US Treasury securities of USD 25bn starting 1 June (down from the USD 60bn pace through May). Mortgage-backed securities will continue to taper at a maximum of USD 35bn each month.

But while Fed Chair Jerome Powell noted the uncertain path forward for inflation, our base case remains that the US economy is heading toward a soft landing, with economic growth and inflation cooling off, and the Fed starting to cut rates in September. As a result, we recommend quality bonds and quality stocks.

Rate cuts are delayed not canceled. Thus far in 2024, inflation has exceeded the Committee's projections for the year as it nears the long-term goal of 2%. Since incoming data still has not provided the Committee with enough evidence and confidence that its current policy rate is sufficiently restrictive for inflation to return to 2% over time, Fed Chair Jerome Powell spoke of the need for additional time before the Committee cuts rates. Additionally, even though Fed Chair Jerome Powell sees the US economy as strong, he said it is "unlikely that the next policy move will be a hike." Fed officials started sounding more hawkish prior to the blackout period, consistently saying that rate cuts are unlikely anytime soon. After

Wednesday's US equity close, Fed funds futures markets adjusted their 2024 rate-cut expectations to 34 basis points (from 28 yesterday), with the first rate reduction priced to start in September.

Policy is restrictive and the economy is slowing. The US labor market is in a better balance than it was a couple of years ago, with many economic data series near pre-pandemic levels. The March release of the Job Openings and Labor Turnover Survey (JOLTS) showed weaker demand for US labor with fewer openings and less hiring. Additionally, the quit rate fell to 2.1%, which is lower than it was before the pandemic began. There are currently 1.3 job openings for every unemployed person, the lowest since 2021. With improved labor market supply and demand, we expect consumers to take a breather after a long period of robust spending, helping inflation and economic growth to slow somewhat in 2024.

The Fed does not see stagflation. There have been data releases showing slower economic momentum, including the moderation of first quarter GDP growth to 1.6% and the softer manufacturing activity as reported within today's release of the US ISM manufacturing index (a key survey of US factory sentiment). Yet, the Fed still sees the economy as strong. Additionally, during the press conference, Fed Chair Jerome Powell highlighted how the current environment is not stagflationary since first-quarter GDP growth ex inventories and net exports was 3.1%, inflation is below 3%, and unemployment is less than 4%. For stagflation, the economy decelerates alongside upside pressures on inflation and a rise in unemployment.

So, we maintain our base case for two 25-basis-point Fed rate cuts in 2024, likely starting in September. In our view, current economic conditions are consistent with a soft landing this year, even if this outcome isn’t without an occasional speed bump, as has occurred in April. As this outcome becomes more apparent in the data, we expect fixed income markets to recover and forecast 10-year US Treasury yields to decline to 3.85% by year-end compared with 4.63% currently. We also expect further modest gains for equities at the index level and forecast the S&P 500 to end the year at 5,200. This supports our most preferred view on quality stocks and fixed income and our focus on finding equity opportunities both within and beyond the technology sector.