The end point of the Fed's easing cycle is often overlooked, and CIO thinks the destination of rates matters more for the investment outlook, not the beginning of the journey. (UBS)

# Focusing on the end of the Fed's easing cycle

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**With the release of the Federal Reserve's preferred gauge of inflation at the end of this week and a flurry of policymakers scheduled to speak in the coming days, market debates over when the US central bank will start cutting interest rates are likely to continue.**

Since the beginning of the year, investor expectations on Fed cuts have been one of the major drivers of market sentiment.

However, the end point of the Fed's easing cycle is often overlooked, and we think the destination of rates matters more for the investment outlook, not the beginning of the journey.

**Equities have risen despite the oscillations in market expectations.** The S&P 500 has risen nearly 15% so far this year and made 31 all-time highs along the way. This is despite significant shifts in market expectations—from nearly seven Fed cuts starting in March to just below two, with the first one potentially in September. Investor enthusiasm over artificial intelligence has certainly contributed to the rally, but solid economic growth and earnings have been instrumental. Whether the first Fed cut happens in September or December likely won't make any material difference to the strong fundamentals underpinning the rise in equities.

**A market-implied neutral policy rate serves as an indication of the 10-year Treasury yield.** Fluctuations in the 10-year Treasury yield have closely paralleled moves in the market-implied neutral federal funds rate (the end point of the cutting cycle), making expectations for how much the Fed will cut in the next few years an important investment reference. In addition, with the Fed's Jackson Hole Economic Policy Symposium in late August titled "Reassessing the Effectiveness and Transmission of Monetary Policy," we believe the restrictiveness of current policy is likely to receive more attention in coming months.

**The weakening in economic data means the Fed is squarely on the path to easing.** Recent data on consumer confidence, job vacancies, manufacturing sentiment, credit card spending, and various housing figures all point to a moderation in economic activity. Most importantly, inflation prints over the past two months suggest a return of the disinflation trend. This weakening in data, which is likely to continue in the coming months, should be sufficient to justify Fed rate cuts. We see little room for the macroeconomic backdrop to change course significantly to alter a first cut later this year.

Overall, we think markets are underestimating the likely number of Fed cuts over the cycle. Fed officials put their estimate of the longer-run fed funds rate at 2.75% in their latest "dot plot" projection, compared with around 4% as current market pricing suggests. For investors, this means those holding cash or money market funds need to consider other options for their liquidity, including bond ladders, structured investment strategies with capital preservation features, and a diversified fixed income allocation.

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