CIO expects further modest gains for equities at the index level and forecast the S&P 500 to end the year at 5,200. (UBS)

CIO maintains base case for two 25-basis-point Fed rate cuts in 2024

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The Federal Open Market Committee (FOMC) on Wednesday unanimously voted to keep rates unchanged in a 5.25–5.5% target range, in line with expectations.

US equities initially rallied and 10-year Treasury yields fell 10 basis points after Federal Reserve Chair Jerome Powell said "it is unlikely that the next rate move will be a hike," suggesting a high hurdle to further raise rates. But that optimism faded into the close on Powell's warning that "further progress is not assured" on sustainably meeting the Fed's 2%inflation target.

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

But, while Powell noted the uncertain path forward for US inflation, our base case remains that inflation and economic growth will cool off, allowing the Fed to begin cutting 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, Powell spoke of

the need for additional time before the Committee cuts rates while also seemingly ruling out another hike. Fed officials had started sounding more hawkish prior to the blackout period, consistently saying that rate cuts are unlikely anytime soon. As of Wednesday's US equity close, Fed funds futures markets were pricing 34 basis points of rate cuts in 2024 (compared with 28bps the previous day), with the first reduction expected in September.

Policy is restrictive and the economy is slowing. In response to a question, Chair Powell stated that policy was restrictive, and noted that interest-rate-sensitive sectors of the economy were slowing and that the labor market is in a better balance than it was a couple of years ago. Many labor market data series are near pre-pandemic levels. Powell pointed to the March Job Openings and Labor Turnover Survey (JOLTS)—released on Wednesday—which 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. In addition to improved labor market supply and demand, we expect consumers to take a pause 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 softer manufacturing sentiment as reported in Wednesday's release of the US ISM manufacturing index. Yet, the Fed still sees the economy as strong. Additionally, during the press conference, 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%. In a stagflationary environment, the economy decelerates alongside upward pressure on inflation and a rise in unemployment.

Putting all this together, we maintain our base case for two 25-basis-point Fed rate cuts in 2024, likely starting in September. We believe current economic conditions are consistent with a soft landing this year, even if this outcome is not without an occasional speed bump—as 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% as of Wednesday's close. 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 preference for quality stocks and fixed income and our focus on finding equity opportunities both within and beyond the technology sector.

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Original report - **Fed refrains from a hawkish shift, 2 May 2024.**

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