



Bonds remain CIO's preferred asset class, and the Fed's actions support its view that the bond market has further to rally in 2024. (UBS)

Markets rally as FOMC pencils in three cuts in 2024

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The S&P 500 closed at a new high for the year and the yield on 10-year US Treasuries dropped sharply to close to 4% on Wednesday, after the Federal Reserve laid the groundwork for rate cuts in 2024.

The Federal Open Market Committee (FOMC) voted unanimously to keep rates unchanged in a 5.25–5.5% target range and to continue to significantly reduce its securities holdings. This decision was widely expected and marked the third consecutive time the Fed paused since starting its 525-basis-point hike cycle in March 2022.

The Fed's new economic projections pointed to a median of 75bps of rate cuts next year, more than the 50bps anticipated going into the meeting. The more dovish tone and comments from Fed Chair Jerome Powell supported the view that the hiking cycle is "at or near peak" since it is "not likely" the Committee will hike rates again.

By the US equity market close, the S&P 500 had gained 1.4% to 4,707 and the 10-year US Treasury yield had fallen to 4.02%. The rally extended into Thursday, with the 10-year yield falling below 4% for the first time since August to around 3.95%. S&P 500 futures were up 0.3%. The index is trading less than 2% from the record high struck at the start of 2022 and on a total return basis, the index is now at an all-time high.

But despite the dovish market interpretation of the Fed's actions, we note the following:

Market expectations for rate cuts continue to run ahead of the Fed's own projections. Investors expect slower growth and cooling inflation (toward the Committee's 2% goal) will allow the central bank to bring rates lower in 2024. As of Thursday, fed fund futures showed the market is pricing in 160bps of cuts in 2024, with a roughly 90% chance the first cut will be in March. This compares with market expectations prior to the meeting for 115bps of cuts in 2024, and a 48% chance the first cut would occur in March. Our view is that the market is pricing too fast a pace of cuts. We think

the experience of this rate cycle is that it pays to listen to the Fed. Our base case forecasts the Fed will refrain from further rate hikes and will start trimming rates by the middle of 2024, delivering 75bps in cuts by the end of next year.

A lot of good news is already priced into equities. The Fed acknowledged that growth is slowing. GDP is on track to grow at a 2.6% rate in 2023 due to strong demand from consumers and a stronger supply chain (revised up from September's projection of 2.1%). But this is expected to slow in 2024, with the median estimate for GDP revised down to 1.4% (from 1.5% in September). While the prospect of rate cuts is supportive for US equities, the bar for significant further index level gains is relatively high, in our view. With the Fed effectively acknowledging that the economy is in a "late cycle" stage, we continue to prefer to focus on quality companies best placed to deliver earnings growth as the economy slows.

The path to a softish landing may not be smooth. The FOMC was careful not to rule out further hikes—Fed Chair Powell indicated "participants did not want to take the possibility of further rate hikes off the table"—and decisions will continue to be based on the "totality of the incoming data and balance of risks." The Fed outlined a benign outlook. However, recent experience—with equities declining and 10-year US Treasury yields breaching 5% as recently as October—serves as a reminder that further inflections in market sentiment cannot be ruled out in the face of a data-dependent Fed.

So overall, we continue to recommend seeking quality in both bond and equities. Bonds remain our preferred asset class, and the Fed's actions support our view that the bond market has further to rally in 2024. We forecast the 10-year US treasury yield to end 2024 at 3.5%. We remain most preferred on high-quality bonds—specifically high grade (government) and investment grade, particularly in the five-year segment. Within equities, we continue to recommend a bias toward quality—companies with strong returns on invested capital, resilient operating margins, and relatively low debt on their balance sheets.

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