Bond Blog

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PGIM FIXED INCOME

The Fed to Play It By Ear with Data Dependence

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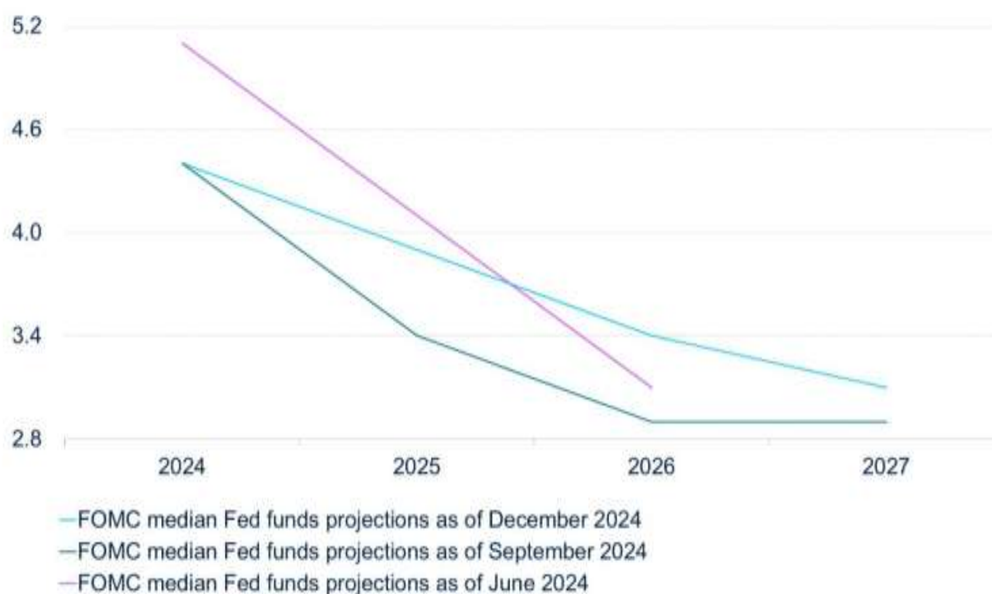
For the Federal Reserve, 2024 is ending with more intrigue than when it started. Thursday's delivery of the third consecutive rate cut this year lowered the Fed funds target by 25 bps to 4.35%. Yet, the Committee also delivered a year-end surprise by signaling less accommodation moving forward as it anticipates both higher inflation and higher growth next year. As a result, the Fed signaled only 50 bps of additional cuts in 2025, or half of what it expected in September.

In yet another shift in market narratives, the Fed raised its terminal rate to 3.1%, or 75 bps above the 2021 lows. The shift higher suggests that the current policy stance is not as restrictive as previously anticipated. Furthermore, given the dissent by one Committee member who voted to hold rates steady, Chairman Powell's focus on "data dependence" will remain a key aspect in forging consensus amongst the FOMC as inflation has proved stickier than expected, while the unemployment rate has slowly edged higher.

While the Fed's reduction in its policy target was indicative of a weakening labor market, it's reasonable to think additional cuts will come from a further reduction in inflation. The moves in the Summary of Economic Projections seem to suggest the Fed will now change policy with a focus on both components of its dual mandate.

FIGURE 1: The Fed's latest policy rate projections brought some significant shifts in the Fed's policy projections over 2024 (%)



Source: Haver Analytics.

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Chairman Powell still noted there are some challenges on the labor front, e.g., lower hiring and quit rates as well as slowing labor demand. However, sticky inflation forced its way back into the conversation given that its improvement stalled in recent months (Figure 1 reflects this year's change in policy rate projections). To that end, the Fed lifted its 2025 inflation forecast by even more than expected - core PCE went from 2.2% to 2.5% - and the Committee's two expected rate cuts in 2025 would bring the median Fed funds forecast to 3.9% by the end of next year, up from its projection of 3.4% only three months ago.

The Fed's fear that inflation may remain above target manifested in Chairman's Powell's reaction to questions regarding potential tariffs. While not totally dismissive of the idea, Powell seemed reticent to address the matter given the lack of details on their potential economic impact.

Given December's "hawkish cut," we believe the Fed will "skip" at the January FOMC meeting and wait for more data before definitely resuming, or potentially ending, this cutting cycle.

Front-End Flattener

Chairman Powell's relative hawkishness immediately impacted the U.S. fixed income complex. The market had priced 50 bps of 2025 cuts, which was quickly reduced to 30 bps following the press conference. With fewer anticipated cuts, the curve notably bears flattened with the front end selling off 10-15 bps while the long end cheapened by 8 bps. Risk assets wobbled as equities sold off 3.0% and U.S. high yield spreads widened.

Given the Fed's shift to less accommodation paired with continued focus on both sides of the dual mandate, we believe the market will have more intense emphasis on economic events in the new year.

Source(s) of data (unless otherwise noted): PGIM Fixed Income, PGIM Fixed Income, as of December 18, 2024.
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