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MARKET *view*

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Pressure on the Federal Reserve is mounting

> *"We expect the path to neutral interest rate to take longer than currently expected by market participants. We will not be further extending the duration in our bond portfolios for the time being."*

Volatile stock markets, falling US Treasury yields and a weakening US dollar signal growing unease in the capital markets. Specifically, the US Federal Reserve (Fed) has come under intense scrutiny. While the European Central Bank (ECB), the Swiss National Bank (SNB) and the Bank of England (BoE) have already lowered their interest rates this year, the Fed has maintained its key interest rate at a consistently high level of 5.25-5.50%, citing a robust labour market and solid economic growth. However, the sharp correction in the stock markets in early August 2024 triggered a significant decline in yields and interest rate expectations. While stock markets have largely recovered their losses from early August, interest rate markets remain largely unchanged and continue to price in aggressive rate cuts by the Fed. Indeed, futures contracts on the federal funds rate suggest that the Fed might cut rates by more than 100 basis points over its remaining three Federal Open Market Committee (FOMC) meetings this year.

What about the US labour market?

Historically, a surplus of job vacancies over unemployed individuals is a rare event. Nevertheless, the slowly decreasing gap is being monitored with concern: job growth has slowed this year, while the number of job openings has decreased. Against this background, the difference between the number of job vacancies and the number of unemployed individuals has returned to pre-pandemic levels, with a surplus of one million job vacancies.

The rise in the unemployment rate to 4.3% (seasonally adjusted) in July has also reached a trigger point according to the Sahm rule. This rule derives the probability of a recession from the change in the three-month moving average of the unemployment rate compared to the low of the last 12 months. If the 'trigger level' of 0.5 is exceeded, a recession is theoretically on the horizon. Since 1970, the Sahm rule has reliably predicted recessions as defined by the National Bureau of Economic Research (NBER), with one exception in 1976.

That being said, the current US unemployment rate remains well below its historical long-term average. Therefore, the reported US labour market figures were only a minor setback to already 'robust expectations', but they did cause some economists to gasp. In our opinion, there's no need for serious concern about a rapid increase in the unemployment rate as seen during the financial crisis or the global recession of 1982.

FIGURE 1: US PUBLIC DEBT OVER TIME

Source: Bloomberg

Indeed, as emphasised by Fed Chair Jerome Powell at the Jackson Hole Economic Symposium, higher unemployment does not necessarily signal an economic downturn. According to him, the rise in unemployment is not due to a high number of layoffs but rather reflects a significant increase in the labour supply and a slowdown in the previously rapid pace of hiring.

Nominal wage growth is decelerating, but at 4.7% in June, it remains well above the current inflation rate of 2.9%, thus driving price changes. While easing labour market conditions support the disinflation trend, Powell made it clear that the Fed is not seeking, nor does it welcome, a further cooling of the labour market.

On September 18, Powell will announce how the Fed plans to balance its dual mandate of price stability and a stable labour market promoting maximum employment. At Jackson Hole, however, the Fed Chairman was already convinced that the upside risks to inflation had diminished while downside risks to employment had increased. The time has come to adjust monetary policy.

According to market expectations, there was little doubt before Jackson Hole that the Fed would lower its key interest rate, but the extent of the rate cut is being strongly debated in the media. The markets are currently pricing in a 40%1 probability of a 50-basis points interest rate cut to 4.75–5.0%. A cut of 25 basis points can be considered almost certain. Meanwhile, the Fed's central bankers are keeping a low profile on the scale and speed of interest rate cuts, focusing instead on incoming data. However, a 100-basis point reduction in the key interest rate by year-end would require at least two cuts (50 bp). These priced-in expectations seem more like market 'wishful thinking', hoping for a tailwind, rather than a reflection of a prudent monetary policy by the Federal Reserve.

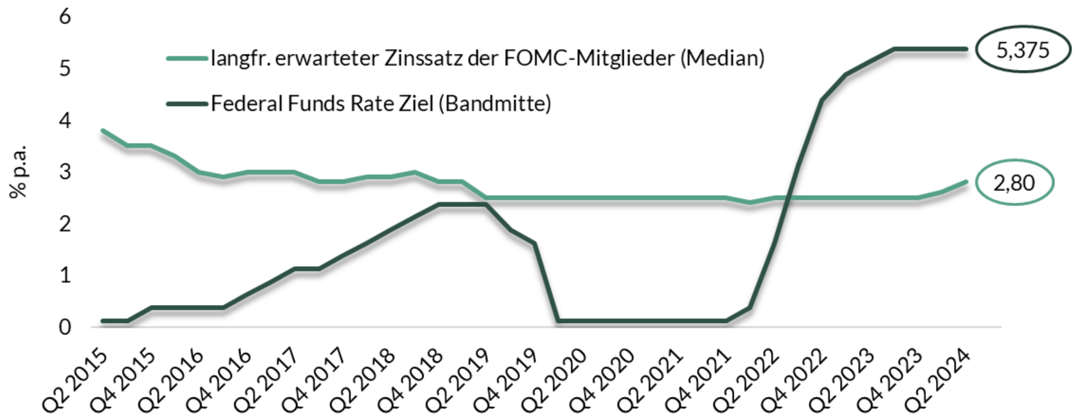
Capital markets appear very optimistic about interest rate developments not only in the short term but also beyond 2024. Compared to current rates, market participants foresee a reduction of approximately 240 basis points by the end of 2025, which could bring the Fed's benchmark rate to 2.75–3.00% next year.

The question of where the 'neutral' or 'natural' interest rate might lie in today's economic environment is hotly debated amongst economists. The neutral rate is the real (inflation-adjusted) interest rate at which an economy achieves full potential output while maintaining price stability. When a central bank sets its key interest rate above this rate, it is pursuing a restrictive monetary policy aimed at curbing economic growth and inflation. In practice, pinpointing the exact neutral rate is challenging. However, it's fairly certain that the Fed, the ECB and other central banks have raised their rates above this level in order to overcome the price shocks triggered by the pandemic and the war in Ukraine, and to stabilize prices.

The Federal Reserve itself outlines its current estimate of the neutral interest rate as part of its 'dot plot' projections, i.e. long-term interest rate expectations. At present, 13 of 19 FOMC members anticipate a long-term key interest rate between 2.5% and 3.0%.

We expect the path to neutral interest rate to take longer than currently expected by market participants. We will not be further extending the duration in our bond portfolios for the time being.

FIG. 2: US KEY INTEREST RATE DEVELOPMENTS AND LONG-TERM KEY INTEREST RATE EXPECTATIONS OF FOMC MEMBERS



Source: Datastream, period: 01/01/2015-30/06/2024; target range as of 05/09/2024: 5.25-5.50%; the expectations of FOMC members for the long-term key interest rate level can be interpreted as an estimate for the neutral interest rate (in nominal terms); this corresponds to a neutral (real) key interest rate level of 0.80% if inflation aligns with the 2% long-term target.

1 Derived from Bloomberg & CME FedWatch, as of 5 September 2024

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