MACRO STRATEGY

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Flying Blind

May 16, 2024

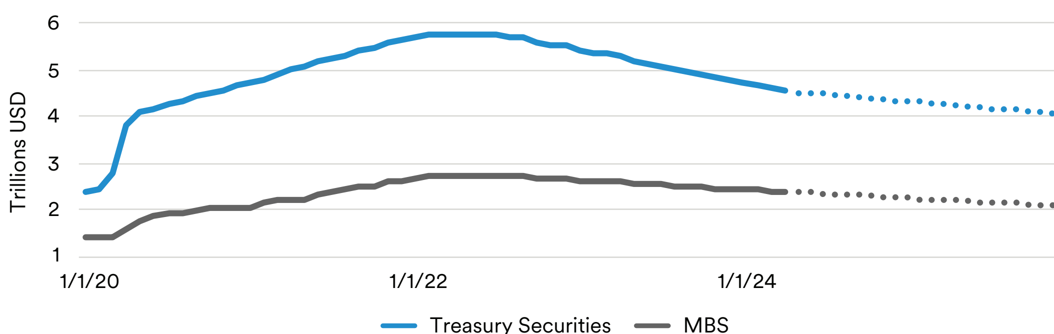
The U.S. Federal Reserve (the Fed) has reduced the pace of quantitative tightening (QT), the European Central Bank (ECB), and potentially even the Bank of England (BoE), could begin cuts as soon as next month, and the dot plot shows the Federal Open Market Committee (FOMC) cutting rates later this year.

As policymakers consider pivots, it is important to remember that there are no precise rules about the natural rate or policy timing. Slowing the pace of QT is intended to allow the Fed to reach an unknown optimal level of tightening without economic disruption. At the same time, Fed economists have often been over-optimistic about the pace of policy changes and the ECB has stirred some concerns over imported inflation caused by an asynchronous monetary policy.

QT: How Low Can They Go?

The FOMC reduced the pace of QT at the May meeting. The new cap allows $25 billion of Treasury securities to roll off each month, down from $60 billion. Including the recent pace of $15 billion a month reduction of mortgage-backed securities (MBS) means the total reduction will reach a monthly run rate of roughly $40 billion each month, $35 billion less than before.[1]

Chart 1 | Slowing the Pace of Treasury Roll-off



Source: Federal Reserve, Macrobond, MIM, as of May 2024.

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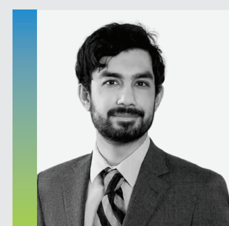

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At the new pace, QT would have to continue through 2026 to reach a level of excess reserves matching the pre-pandemic level of just over 7% of nominal GDP.

While the slowdown in pace theoretically reduces monetary policy tightness, the Fed's rationale is to ultimately lead to greater tightening by allowing the Fed to reduce its balance sheet gradually without causing economic disruption.

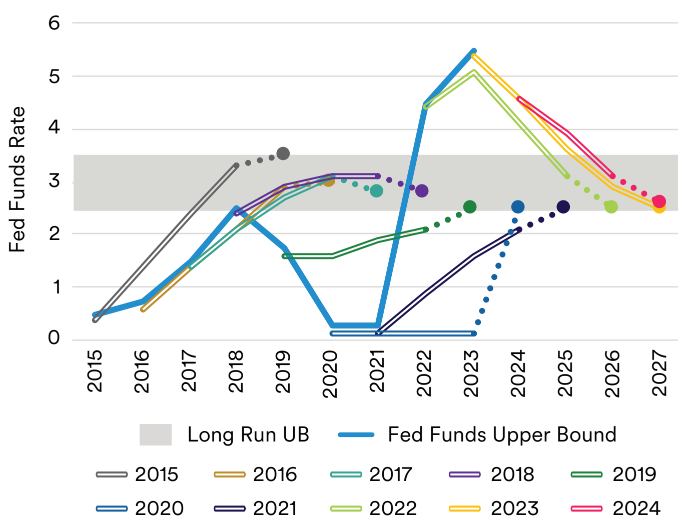
The Fed may slow the pace of QT further if it is forced to cut rates. That being said, the reason for the rate cut matters. If the cut is in response to abrupt or unexpected economic weakness, then further balance sheet reduction is likely to be quickly curtailed. If the cut is pre-emptive and is meant only to normalize monetary policy, ongoing balance sheet reduction is more likely.

Fed Funds: How Fast Can They Go?

It appears that we are better off taking the Fed seriously but not literally.

Chart 2 shows the actual fed funds rate (upper bound) alongside the median Summary of Economic Projections (SEP) forecasts for December of the relevant year. Their forecast for the longer-term neutral rate has been between 2.5-3.5 (shaded area) over the past 10 years.

Chart 2 | The SEP Cannot Be Taken Literally



Source: U.S. Federal Reserve, as of March 2024.

This longer-term perspective provides an interesting lens through which to interpret the most recent SEP forecast (March 2024).

The FOMC is currently quite optimistic about its ability to revert to its median neutral rate of 2.6% from the current rate of 5.3%.[2]

Historically, the FOMC has been correct about the future direction of the fed funds rate—except in 2019 when it obviously failed to forecast the pandemic.

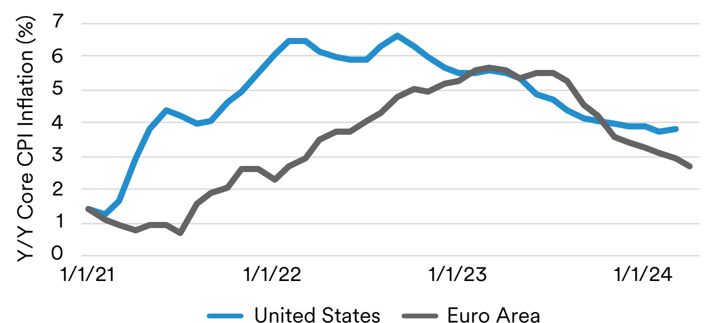
But it has also often been overly optimistic about how quickly it would be able to reach its neutral rate. Again, a major deviation occurred due to the pandemic, when at the end of 2020 the FOMC indicated that it would continue to keep the fed funds rate at zero for as long as needed to stabilize the economy.

The Fed may indeed be overly optimistic about the speed with which it approaches the neutral rate. It appears best to take the SEP as simply an indication of direction of travel, without taking too literally the number of rates hikes or cuts they provide in their forecasts.

ECB: *Wie Gross Wird Die Zinssenkung Sein?*

In recent months, progress on U.S. inflation has stalled to 3.8% year-over-year for core CPI, leading the FOMC to continue maintaining a high policy rate. Meanwhile, the ECB is poised to begin rate cuts in June, and Eurostat data show euro area core inflation fell to a 26-month low of 2.7% year-over-year in April.[3] The BoE could also start cutting rates as soon as its June meeting, absent negative surprises from upcoming inflation or wage growth data.

Chart 3 | U.S. Inflation Progress Has Slowed Versus Europe



Source: BLS, Eurostat, Macrobond, MIM, as of April 2024.

Historically, other central banks have synchronized with the Fed in their monetary policy pivots.

The possibility of the ECB easing first has raised concerns of euro depreciation and excess upward pressure on euro area consumer prices.

This effect is likely to be moderate. Estimates of this so-called exchange rate passthrough effect range from a 0.12 to 0.8 cumulative percentage point effect on headline inflation over three years, given a 1% depreciation of the trade-weighted exchange rate.[4] These estimated inflation effects are not likely large enough to disrupt the euro area's inflation agenda.

One area of caution is that the strongest inflation effects have typically been seen when the domestic country (in this case the euro area) has initiated relatively looser monetary policy.[5] However, on net, we believe stable euro area growth and stronger net exports can bolster the euro, and that the ECB can focus its attention on domestic concerns such as remaining (somewhat stickier) services inflation rather than the likely short-term divergence from Fed monetary policy.

Lastly, it is worth noting that an ECB cut would indicate an asynchronous rather than a truly divergent policy, as we might see if (for example) Europe was in expansion while the U.S. was in contraction.

U.S. Outlook Summary

We expect growth in 2024 to be softer than 2023 but remain healthy. First quarter GDP, although lower than expectations, showed strong residential investment and weaker but still healthy consumption, especially in services. We expect corporate investment to be healthy in 2024, backed by strong profit margins and a growth outlook less clouded by recession.

Residential investment has improved since the beginning of the year, with residential investment contributing 50 basis points (bps) to Q1 2024 growth after contributing negatively to GDP in 2023.[6]

The government sector, while pulling back vis-à-vis 2023, is still expected to contribute quite a bit to growth as industrial policies at the federal level and continued tax revenue growth at the local level induce spending.

We expect the Fed to cut rates by a total of 75 bps by year end, although if it is not able to cut by July due to persistent inflation, this could decrease to 50 bps. We have revised our inflation forecast for 2024 from 2.8% to 3.1%, given higher recent inflation data but do not expect a further escalation in inflation.

MIM Forecast

U.S.	2023*	2024	2025
GDP	2.5	2.0	2.0
CPI	3.2	3.1	2.8
10 Year	3.88	4.50	4.20
Policy rates (upper bound)	5.50	4.75	4.00
Unemployment	3.7	4.4	4.3

Note: GDP is annual average growth rate, CPI is Q4 year/year, 10 year is year-end, policy rate is the upper bound year-end rate. Our core PCE forecast for 2024 is 2.5%.
*Denotes actual data; the rest are forecasts.

Source: BEA, BLS, U.S. Treasury, Federal Reserve, Bloomberg, MetLife Investment Management. As of April 2024.

Risks to the Outlook

Although we remain optimistic, we recognize a number of factors that keep us cautious. Consumer delinquency rates are high and rising quite sharply, credit remains tight, and unemployment is rising for some segments of the population.

On the other side of the equation, persistent inflation has reemerged as a risk. Inflation—while unlikely to return to 2022 levels—has been decelerating more slowly than in the last half of 2023. Fed officials doubt that inflation will return to 2% before 2026, and recent data makes it harder to return to below 3% in 2024. Stubborn or rising inflation would alter the Fed's rate cut path and potentially economic growth.

Endnotes

1. Source: U.S. Federal Reserve, May 2024.
2. Source: Summary of Economic Projections, U.S. Federal Reserve, March 2024.
3. Source: Eurostat, as of April 2024.
4. ECB, "Exchange rate pass-through in the euro area and EU countries," Occasional Paper Series No. 241, April 2020.
5. Ha, Jongrim, M. Marc Stocker, Hakan Yilmazkuday, "Inflation and Exchange Rate Pass-Through," Policy Research Working Paper No. 8780, March 2019.
6. Source: Bureau of Economic Analysis, April 2024.

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