What if the Fed doesn't cut interest rates this year?

Earlier this year, many investors were convinced the U.S. Federal Reserve was on track to reduce interest rates four times by the end of 2024. Back then, it struck me as wishful thinking. Today, given higher-than-expected inflation, I think it's even more unlikely. I believe there's a strong chance we will get no rate cuts at all this year — and that markets should be fine without them.

To be fair, I should note that not everyone at Capital Group holds this view. As is often the case, we have multiple viewpoints on the investment team and among our economists. That's the heart of The Capital System.™

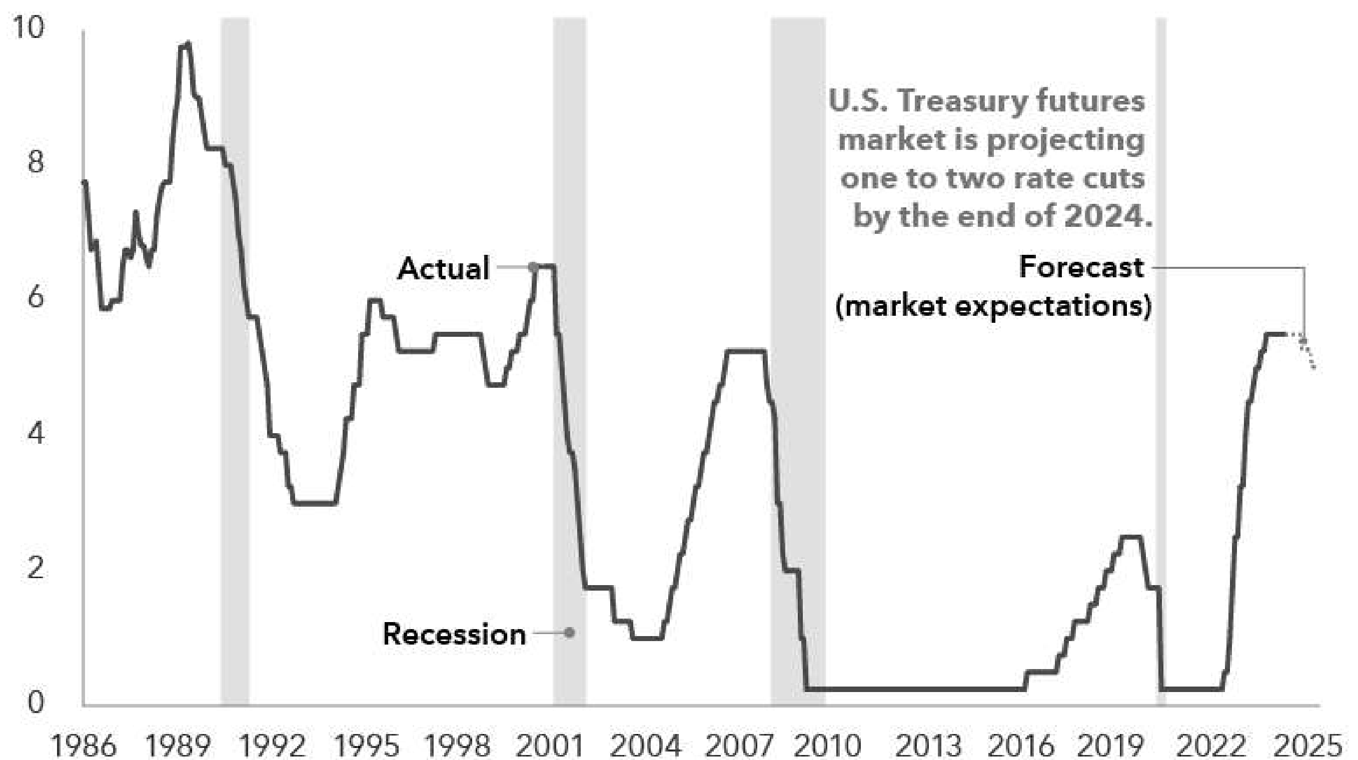
For some investors who have been eagerly awaiting a rate cut, this may sound akin to canceling Christmas. However, if the Fed decides to stand pat it's not necessarily a bad outcome, depending on the reason. In my view, there are three solid reasons to keep the federal funds rate right where it is throughout 2024.

1. The U.S. economy can handle it

The U.S. economy continues to grow at a healthy pace despite a dramatic rise in the fed funds rate to its current range of 5.25% to 5.50%. That's a 23-year high. And yet the International Monetary Fund (IMF) is now predicting that the U.S. economy will expand this year at more than twice the rate of other major developed countries. Last week, the IMF raised its forecast for U.S. economic growth to 2.7% on an annualized basis, compared to 0.8% for Europe and 0.9% for Japan.

The resilience of the U.S. economy, in the face of much higher interest rates, has been one of the biggest surprises of the past two years. It wasn't long ago that many investors and economists thought we would be heading into a recession. Now it appears the U.S. economy could grow at a rate above the IMF forecast, potentially hitting 3.0% as American consumers continue to spend, the labor market remains tight, and manufacturers invest in newly diversified supply chains in the post-pandemic era.

Market expectations for Fed rate cuts this year have declined



Sources: Capital Group, Chicago Mercantile Exchange, Federal Reserve Bank of St. Louis, National Bureau of Economic Research. Upper bound of target range is used since 2008. Actual data and market expectations as of April 18, 2024.

This type of solid growth isn't normally associated with rate cuts. In fact, the U.S. economy appears to have adjusted quite well to a higher interest rate environment. Even with home mortgage rates around 7.1%, as of April 18, total home sales and home prices have been rising in early 2024.

Given this resilience, there is reason to worry that the U.S. economy could overheat if the Fed lowers rates prematurely, which could reignite inflationary pressures.

Which brings me to my next reason.

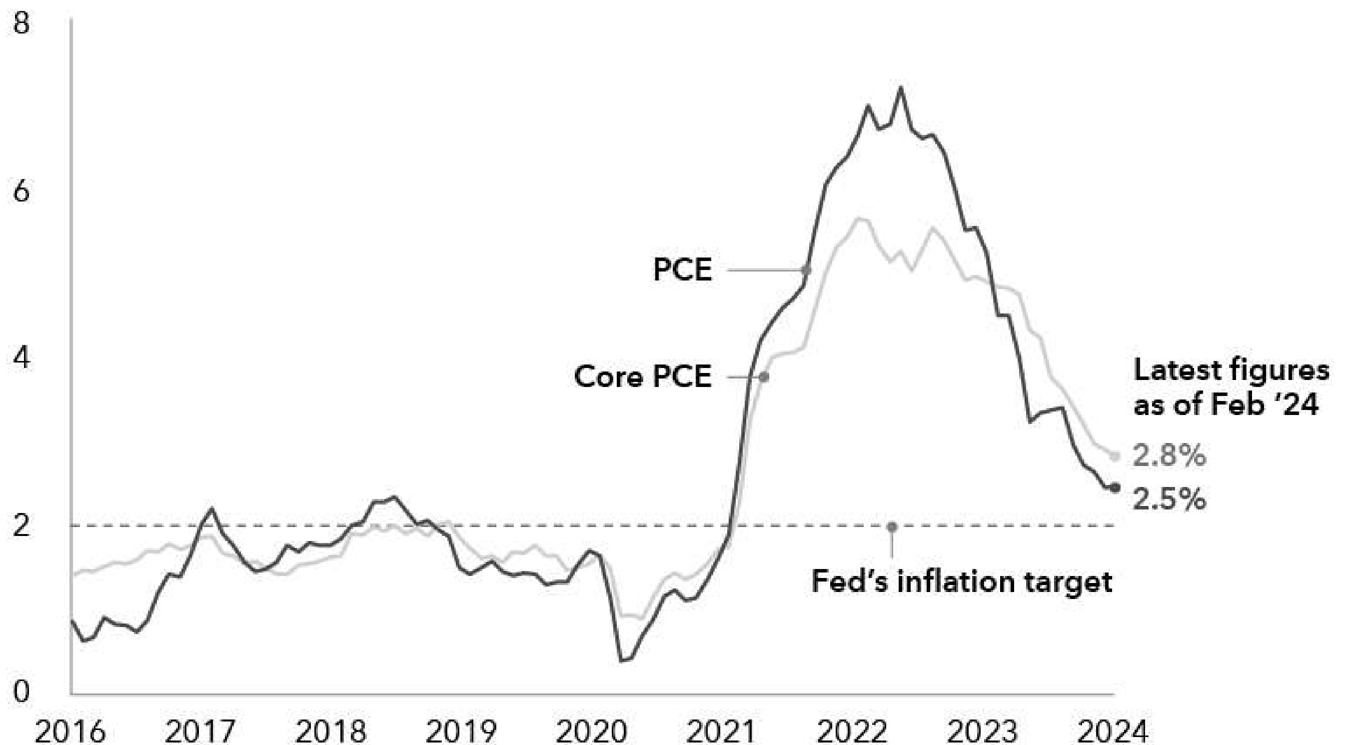
2. Progress on inflation is stalling

There's no question that the Fed's battle against inflation has gone well, but it isn't over. Consumer prices have fallen from the highs of June 2022, but remain significantly above the Fed's 2% target. Going that final mile — from 3.0% to 2.0% — could be the toughest part of the journey. And I think it will take longer than Fed officials expect.

Fed Chair Jerome Powell admitted as much last week when he said: "We'll need greater confidence that inflation is moving sustainably towards 2.0% before it would be appropriate

to ease policy." That was right after the March inflation report came in hotter than anticipated, and it caused markets to adjust the previously more ambitious rate-cut expectations. The January and February inflation readings were also above expectations, so this isn't just a one-month blip in the numbers.

Inflation has come down a lot, but it's still above the Fed's 2.0% target



Sources: Capital Group, Bureau of Economic Analysis, Federal Reserve Bank of St. Louis. The Core PCE index excludes food and energy. Latest figures available as of April 19, 2024.

Ultimately, if the Fed doesn't cut this year, it will likely be because inflation isn't falling as quickly as anticipated by central bank officials. In my view, that is a likely scenario. Much of the recent decline in inflation has occurred in the consumer goods sector, where prices have been falling at the fastest pace in nearly 20 years. I don't think that is sustainable, particularly with the U.S. dollar no longer strengthening at the pace witnessed over the past year.

In addition, higher home prices may have a greater impact on rental inflation than in the past, given recent changes in data-gathering methodology. Outside of housing, service sector inflation is headed in the wrong direction, climbing at an annualized rate above 6.0% over the past six months. This is largely a function of solid wage growth due to a strong labor market. The U.S. unemployment rate has moved up slightly to 3.8%, but that's still near a 50-year low.

One might think inflation in the range of 2.5% to 3.0% is close enough, but the Fed has repeatedly stressed the importance of that 2.0% goal. In the pre-pandemic era, when disinflationary pressures were the problem, Fed officials felt that inflation rates of 1.5% or 1.6% were too low. So we should probably assume that 40 or 50 basis points above target is, therefore, too high today.

Putting these factors together, I think inflation could continue to edge down somewhat, but it's probably going to be a tough grind from here.

3. Financial markets are fine with the status quo

U.S. and international stock markets hit a series of record highs in the first quarter of 2024. April has been less enthusiastic, largely due to inflation worries and rising tensions in the Middle East. But still, it's clear that stocks in aggregate have been able to overcome the fear that higher interest rates would kill the bull market that started early last year. While more interest rate sensitive fixed income investments have seen weaker returns this year as rate expectations have shifted, more credit-driven bond sectors have felt a tailwind as earnings and economic growth have surprised to the upside. And ultimately, bond investors benefit from higher yields as income returns to the fixed income markets.

A market rally in the wake of higher rates is not unusual. Looking back over the past 30 years, stocks and bonds have generally done well in periods following a Fed rate-hiking campaign. In fact, since 1994, both asset classes were significantly higher one year after the end of a Fed tightening cycle, with the exception of U.S. stocks from May 2000 to May 2002, a period marred by the dot-com implosion.

Over the past 30 years, stocks and bonds have usually powered through rate hikes

Two-year annualized returns (%) following the end of prior hiking cycles

Sources: Capital Group, Bloomberg Index Services Ltd., RIMES, Standard & Poor's. Returns above represent total returns. As of April 18, 2024. Past results are not predictive of results in future periods.

Over time, markets tend to adjust to the prevailing interest-rate environment. Markets can react violently at the beginning of a rate-hiking campaign, as we saw in 2022, when stocks and bonds both tumbled. But once we reach a new level of stability, as long as it is within a reasonable range, markets have often been able to resume their long-term growth trajectory, influenced more by corporate earnings and economic growth than monetary policy.

Given these conditions, I think it is increasingly likely that we won't see any movement from the Fed this year. Could I be wrong? Of course. The bond market is currently pricing in one to two rate cuts before the end of December. And while my base case is for no cuts, recent Fed comments suggest one or two (of 25 basis points each) are certainly within the realm of possibility. It is also conceivable that the Fed could act even more aggressively if we start to see substantial negative impacts of tighter monetary policy on the economy.

We will learn more after the Fed's upcoming policy meeting. I do think Fed officials want to cut rates. They have made it clear that they believe current policy is restrictive and, therefore, it's a reasonable conclusion that they are leaning toward bringing rates down.

As investors, however, I think we need to question that assumption. We need to consider the possibility that, in light of recent healthy growth, maybe Fed policy isn't restrictive. Maybe that's why we haven't had a recession. And maybe that's why we won't get a rate cut in 2024.

Rather than being a negative, however, the absence of a rate cut this year could simply reflect the fact that the U.S. economy is doing quite well — and that history suggests it could be an excellent time to be invested in both equities and credit-oriented fixed income for investors willing to take a long-term perspective.

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