Revisiting what happens when the Fed cuts?

History suggests that the Fed cut rates by 300bps on average after a pause

Softer USD; steeper UST curve; mixed impact on the equity markets

JPY, EUR, CHF, TWD, THB, SGD and PHP outperformed the USD three months after a cut

A September Fed rate cut is imminent but how deep is the cut?

With Fed Chair Jerome Powell commenting at his keynote speech at the annual Jackson Hole Symposium that it is time for policy to adjust, and that the central bank is confident that inflation is on a sustainable path back to the Fed's 2.0% target, as well as mentioning that further cooling in the labour market is unwelcomed, ***market has fully priced in a rate cut at the September FOMC meeting, and pencilled in a total of at least 100bps rate cut by end 2024 and another 125-150bps cuts by end 2025.*** The anticipated cuts, however, are much deeper than Federal Reserve Bank of Cleveland's simple monetary policy rule, who has signalled that the Fed Fund Rate could end-2024 at 4.93% (median rate in Table 1 below) and 2025 at 4.09%, reflecting only 45bps and 84bps cuts respectively for 2024 and 2025, about half of what the markets are pricing in.

Table 1: Federal Funds Rates Based on Seven Simple Monetary Policy Rules (%)

	2Q24	3Q24	4Q24	1Q25	2Q25	3Q25	4Q25
Maximum	5.33	5.49	5.69	6.05	6.52	7.04	7.60
75th Percentile	5.33	5.19	5.18	4.84	4.66	4.52	4.59
Median	**5.33**	**5.09**	**4.93**	**4.64**	**4.36**	**4.14**	**4.09**
25th Percentile	5.33	3.75	3.97	3.46	3.28	3.19	3.19
Minimum	5.33	2.90	3.04	2.92	2.82	3.04	2.98

Source: https://www.clevelandfed.org/indicators-and-data/simple-monetary-policy-rules

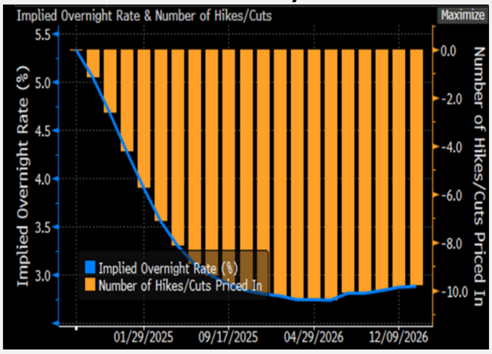
History suggests that the Fed starts cutting rates 2-15 months after a pause; by 75-1150bps but an average 300bps

While market expectations appear aggressive at this juncture, they are not without basis. Using the above simple monetary policy rule as a guide, the Fed funds rate could end-2024 at 3.04% and 2025 at 2.98% respectively based on the minimum rate. In our previous article *"What happens when the Fed cuts?" dated 15 January 2024*, we have also highlighted that past data showed that a pause is usually followed by an average of 300bps rate cut subsequent to that. The cuts ranged between 75 to 1150bps in the past 50 years, but at a narrower range of between 75-550bps in the past 4 cycles. This suggests that Fed funds rate could be cut back to zero (-550bps), 2.50% (-300bps) or 4.50% (-75bps). 2.50% is in fact in line with Fed's median term projection for the longer run rate.

We are expecting a 25bps rate cut in the September FOMC meeting and a total of 75bps by end 2024. This is premised upon our view that although the latest non-farm payroll (NFP) data has cooled and disappointed, both the layoff number and SAHM rule does not flag recession risks at all. Wage growth also remained elevated and grew at a faster than expected pace in August.

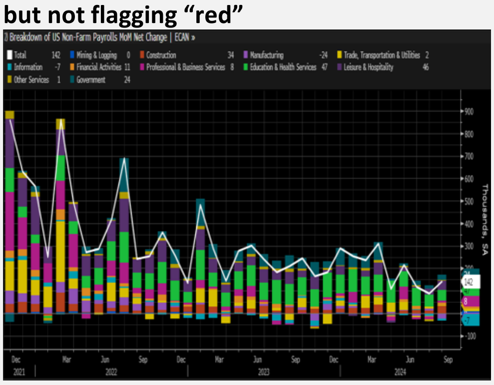
Just a recap, the Sahm Recession Indicator signals the start of a recession when the 3-month moving average (3MMA) of the national unemployment rate rises by 0.5ppts

Figure 1: Fed Funds Futures is pricing in close to 4 ½ rate cuts this year



Source: Bloomberg

Figure 2: Labour market has disappointed but not flagging "red"



Source: Bloomberg

or more relative to the minimum of the three-month averages from the previous 12 months. This was triggered in July 2024 but not repeated in August, suggesting that the economy is unlikely fall into a technical recession, as seen in August 2003.

We have also pointed out before that the Fed cut rates as soon as 2 months and as slow as 15 months after pausing, suggesting that Fed rate could have been lowered as soon as September 2023 (did not materialize) and as slow as October 2024. The current view of the first rate cut starting September 2024 is falling well within the 15 months.

What to expect after the FOMC starts cutting rates…

1. **Bonds – yields to correct slightly higher before resuming move lower**
   In terms of Treasuries, the gap between the 2Y and 10Y yields widened from 14-60bps to 17-106bps three months after the cuts in the past three of four cycles. We expect yields to be correct slightly higher in the near term, given the dichotomy between what the Fed is likely to do and say at the FOMC on 18 September and what is currently priced into the futures market, before heading lower further out as the economy continues to moderate and inflation eases. As it is, we expect the 2Y and 10Y yields to close 2024 at 3.75% and 3.80% respectively.

2. **Equities - legs for further gains**
   The impact on the equity markets after a Fed pause (Figure 4), meanwhile, will depend on whether the previous hikes tilted the US economy into/near recession, and a soft or hard landing. When the hikes did not tilt the economy into a recession, equities generally rallied. For example, S&P 500 gained between 1.9-26.5% three to six months after the Fed cut in 1998 and 2019 when GDP growth averaged above 2.0% q/q. On the other hand, S&P lost between 3.8-13.4% in 2001 and 2007 when GDP growth averaged less than 2.0%.

   Notwithstanding the election result which could throw a curve ball to the whole equation and in anticipation of a soft-landing for the US economy, this suggests that S&P 500 has further miles to run post-rate cut.

3. **US Dollar - softer**
   Theoretically, lower interest rates tend to depreciate the value of its currency, in this context the USD. Indeed, the DXY slid between 1.2-2.1% three months after the first cut in the past three of four cycles. Taking the past as a guide, ***any slide in the Dollar Index (DXY) could be limited to 99.54 (based on September 11 closing), a shade lower than our in-house forecast of 100.87 for end-2024.***

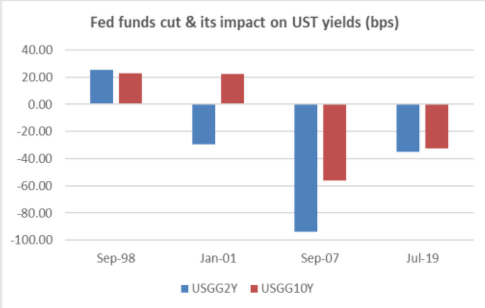
   Based on our observations on other currencies, ***potential winners from the Fed's easing cycle include haven currencies like JPY and CHF, as well as EUR amongst G10, and TWD, THB, SGD and PHP amongst the regionals***. These currencies have strengthened three out of the past four easing cycles three months after a rate cut in the US (Refer to Figure 6). ***MYR appreciated in two of the four easing cycles,*** depreciated in one and was unchanged during the January 2021 cycle as it was pegged.

House View and Forecasts

FX	As at 11-Sept	3Q-24	4Q-24	1Q-25	2Q-25
DXY	**101.68**	**102.41**	**100.87**	**99.86**	**98.86**
EUR/USD	1.1012	1.11	1.12	1.10	1.08
GBP/USD	1.3043	1.29	1.30	1.30	1.29
USD/JPY	142.36	145	143	140	137
AUD/USD	0.6674	0.66	0.66	0.67	0.68
USD/MYR	**4.3298**	**4.50**	**4.40**	**4.35**	**4.30**
USD/SGD	1.3041	1.33	1.32	1.30	1.28

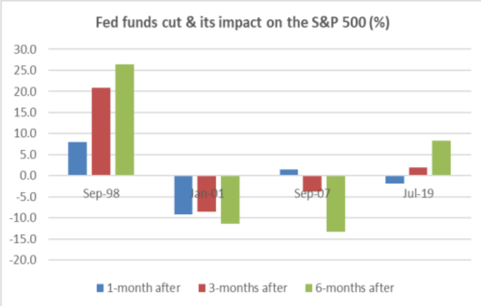
Rates, %	Current	3Q-24	4Q-24	1Q-25	2Q-25
Fed	**5.25-5.50**	**5.00-5.25**	**4.50-4.75**	**4.25.-4.50**	**4.00-4.25**
ECB	3.75	3.50	3.25	3.00	2.75

Figure 3: UST curve tends to steepen three months after the Fed cuts



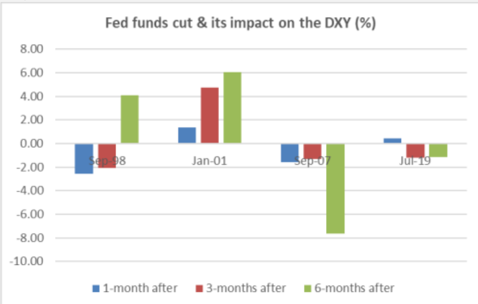
Source: Bloomberg

Figure 4: Impact of US interest rate cut on S&P 500 dependent on the state of the economy



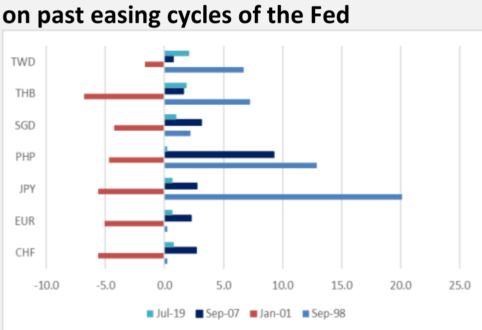
Source: Bloomberg

Figure 5: Softer USD post rate cuts



Source: Bloomberg

Figure 6: Potential currency winners based on past easing cycles of the Fed



Source: Bloomberg

BOE	5.00	5.00	4.75	4.50	4.25
BOJ	0.25	0.25	0.25	0.40	0.40
RBA	4.35	4.35	4.35	4.10	3.85
BNM	**3.00**	**3.00**	**3.00**	**3.00**	**3.00**

Source: HLBB Global Markets Research

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