ADVISORY
ASSET MANAGEMENT
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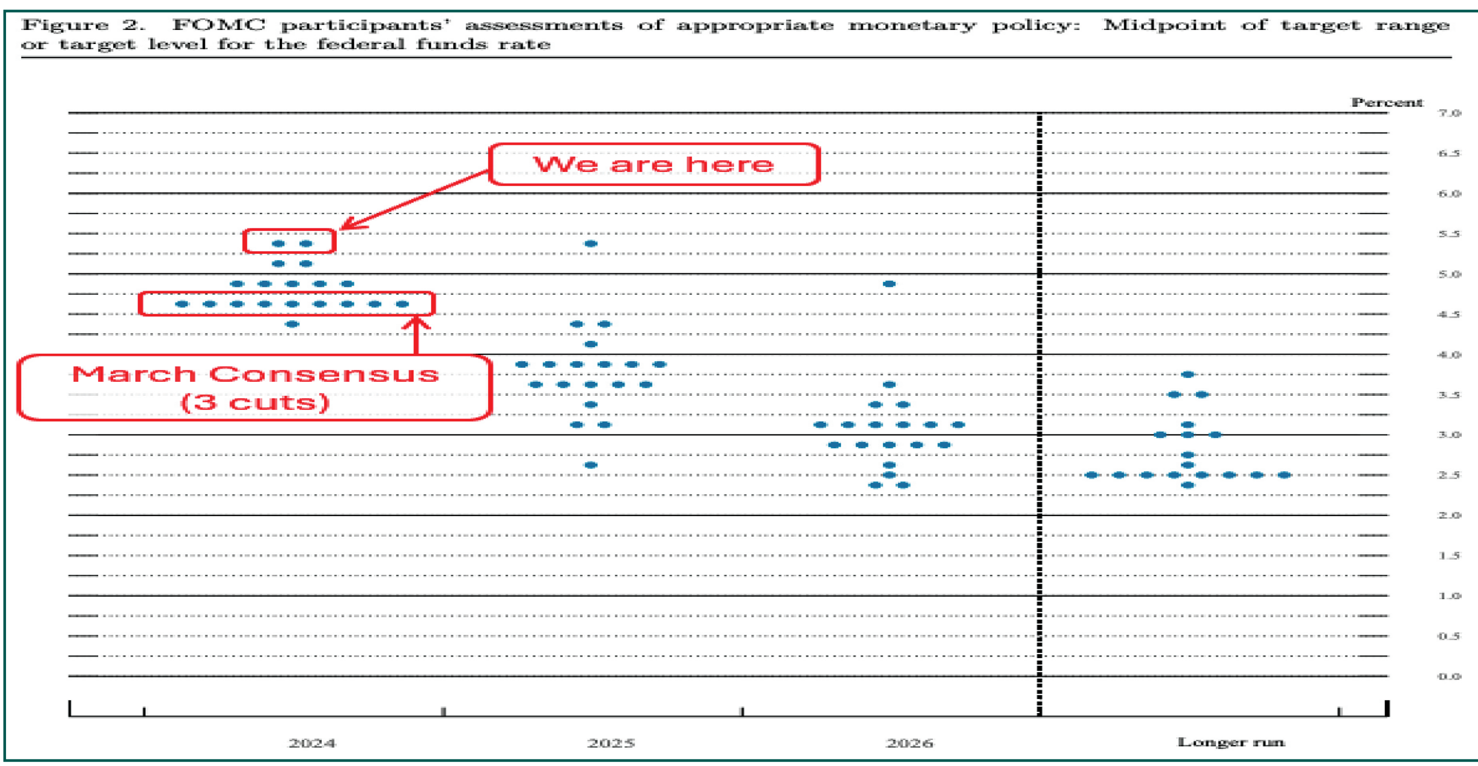
Connecting the Dots

Various members of the Federal Reserve have been out in force on the speaking circuit, offering their updated assessments of inflation and the economy. Following three disappointing, hotter-than expected months of inflation, the April data came in as expected and showed a slight ease in the annual rate of inflation. This was a welcome relief after the hot early-2024 data reintroduced the possibility of additional rate hikes. But now that inflation-watchers have their first 2024 “win”, the market appears a bit perplexed about what level of interest rates to expect come year-end. This is where the Fed’s talking heads can provide some insight into the timing of the initial cut and the scope of any subsequent cuts.

In addition to speeches and official Federal Open Market Committee (FOMC) meetings, the Fed releases a quarterly “Dot Plot”, officially known as the Summary of Interest Rate Projections. The last Dot Plot was released at the March FOMC, and the next update will be June 12th. Looking at the Dot Plot from March, we can see that a 15-4 majority of FOMC members were still expecting two or more rate cuts in 2024, with the consensus forecast calling for three cuts.

Exhibit 1. FOMC “Dot Plot” Summary of Interest Rate Projections, March 2024



Source: Federal Reserve, Comments by Vestbridge Research.

However, recent commentary from FOMC officials paint a different picture from two months ago. Consider the below quotes:

- **Christopher Waller, Governor of the Federal Reserve Board:** "We want to see several months of good data on inflation before we can be assured that it's on a sustained downward path." *[Source: CNBC interview]*

- **Raphael Bostic, President of the Federal Reserve Bank of Atlanta:** "At this point, I think it's one. But as months pass, I may move to two or I might move to zero and we'll just have to see where the chips fall." *[Source: Yahoo Finance interview]*

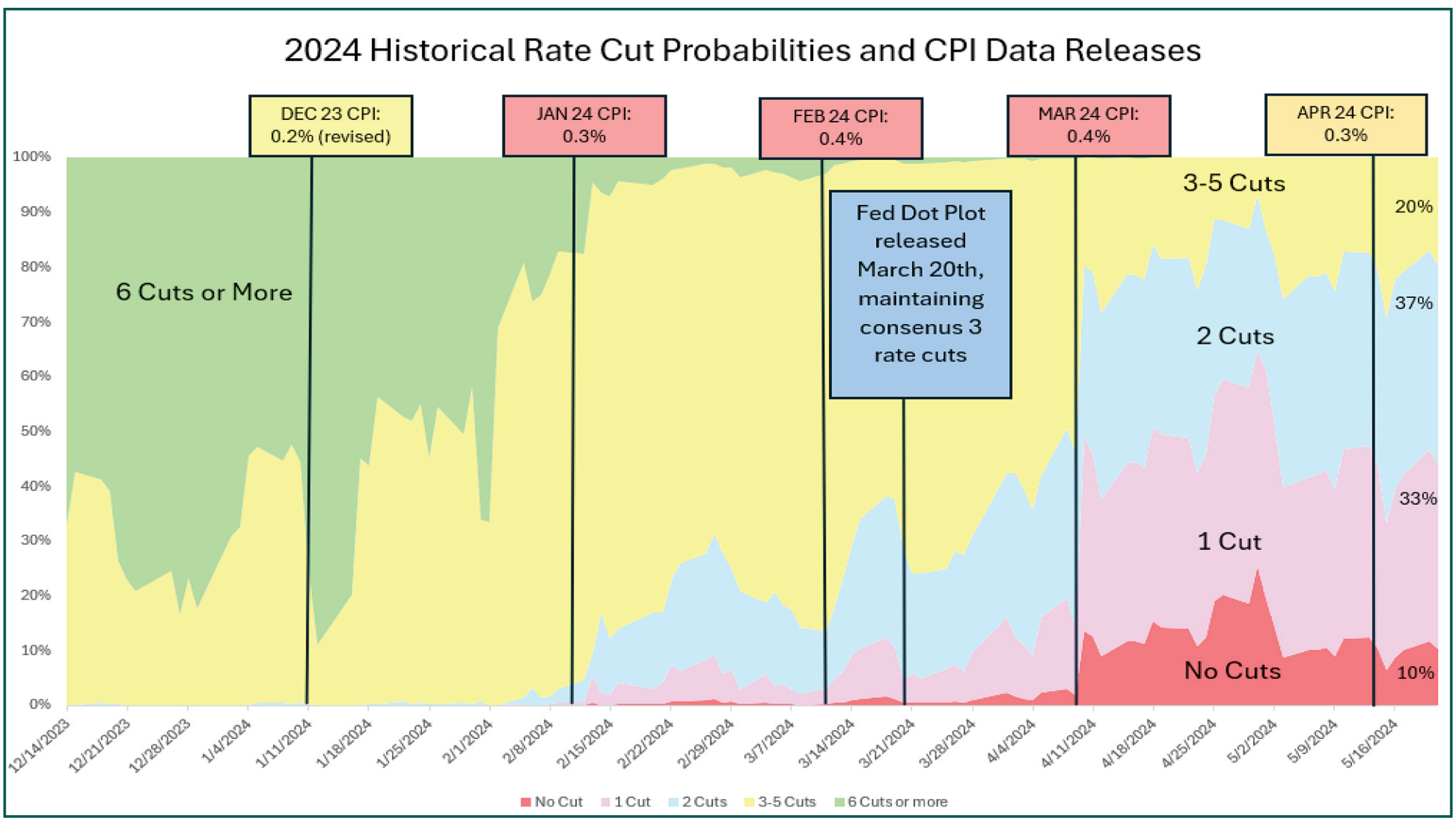
- **Loretta Mester, President of the Federal Reserve Bank of Cleveland:** "I don't see three rate cuts this year as likely ...." *[Source: Bloomberg TV interview]*

- **Mary Daly, President of the Federal Reserve Bank of San Francisco:** "While I don't see evidence of the need to hike rates, I am not confident that inflation is falling toward 2% and see no urgency to cut rates." *[Source: Public speech]*

With just 5 FOMC meetings remaining, it seems fairly certain that the Fed's consensus view of 2024 year-end rates will shift upward when the June Dot Plot is revealed. What is uncertain is the magnitude of the shift. Will the Fed project unchanged rates for 2024? One cut? Two cuts? Will any FOMC members move their dot upwards to project a hike?

These are uncertainties that won't be resolved until June 12th, but we can glean some insight into where the market is betting the dots will land by looking at the Fed Funds futures market, which is tracked daily by CME Group's incredibly useful "FedWatch" tool. We can see a visual narrative of just how much the market view on 2024 interest rates has changed by looking at the data, as shown below.

Exhibit 2. Historical Fed Funds Futures Probabilities



Source: Data from CME FedWatch as of 5/22/2024, Chart by Vestbridge Research.

At the onset of 2024, the market viewed six or more rate cuts as the most likely outcome, which was more aggressive than the Fed. By the time January CPI came in hot, the market had virtually given up on six rate cuts but still expected at least three. This was in line with the Fed's Dot Plot, but shortly thereafter, the March CPI confirmed that the early-2024 uptick in inflation was more than a seasonal anomaly. After that moment, the odds of the various scenarios have become much more evenly distributed. To summarize, the market looks quite uncertain in anticipation of the June Dot Plot.

The good news is that any clarity from the Fed, even a downgrade to a single rate cut consensus, may be received with optimism from the market. Knowing with a degree of certainty that rates will come down eventually this year is preferable to not knowing whether the next move will be a hike or a cut. One could argue that the only truly bearish outcome would be a "no cut" Dot Plot, which the market only considers a 10% likelihood.

Investors should expect a hawkish revision to the Dot Plot in June, but not panic if that change is merely a shift from three cuts to one or two. The Fed has already told us where the puck is going, and the market has, to a degree, priced that data in. The June Dot Plot will merely provide visual confirmation.

Thank you, as always, for the opportunity to serve you.

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