Fed Watch: Hot inflation delays rate cuts

Raiffeisen Research

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Disinflation hopes have been put to rest by the hotter than expected US inflation figures for March. This has implications for the Fed and financial markets. While we expect the mid-term disinflation trend to remain intact, an imminent cooling of inflation dynamics which could save a June rate cut seems out of reach. We now expect the Fed to cut in September, see US Treasury yields to stay high in the short-term before retreating over the mid-term and assess the US dollar to remain well-supported not only by a diverging Fed/ECB path but also by geopolitical risks.

Interest Rates and Yields Outlook - Quarterly Profile (in %, eop)

	12/4/2024	Q2'24	Q3'24	Q4'24	Q1'25	Q4'25	Q4'26
Federal Funds Rate	5.50	5.50	5.25	5.00	4.75	4.00	3.00
SOFR	5.31	5.30	5.10	4.85	4.60	3.85	2.85
USD SOFR 3M OIS	5.32	5.30	5.05	4.80	4.55	3.80	2.80
Treasury Yield 2Y	4.90	4.80	4.45	4.25	4.00	3.45	2.80
Treasury Yield 10Y	4.52	4.45	4.30	4.10	3.90	3.45	2.90
USD SOFR 10Y OIS	4.14	4.10	4.00	3.80	3.65	3.20	2.65
EUR/USD	1.06	1.05	1.08	1.08	1.10	1.12	1.15

Source: LSEG, RBI/Raiffeisen Research

Disinflation despite tight labour markets - too good to be true?

During the second half of 2023, **all appeared to be set for the Federal Reserve** to reach its 2% inflation target without causing too much damage to the US economy. Beginning with June, both CPI and PCE inflation figures by and large hinted at **favourable price dynamics**, while **economic growth performed remarkably well** given the challenging environment, even managing to outpace expectations in the third and the fourth quarter. This strength was supported by a **robust labour market**, which did lose some of its tightness throughout the last year, but did not slump by any means, thereby supporting consumption and the economy in the process. Thus, despite an ongoing strength of economic activity and the labour market, a **gradual cooling of inflation appeared to be a realistic prospect**. A best-case scenario became visible on the horizon.

Disinflationary momentum shifted in January, however. Both CPI and PCE data came in well above market expectations in January, and furthermore hinted at a rather broad-based resurgence in price pressure. In February, inflation was less broad based compared to the prior month, but price momentum remained at a strongly elevated level. Furthermore, the described pick-up in inflation was observable in both headline and core inflation (which excludes prices for energy and food). Especially the upswing in the latter component (see chart below) fueled doubts regarding the sustainability of the disinflationary process observed during the second half of 2023. Ultimately, the March CPI data released last week turned out to be the **last nail in the coffin** for any hopes of a straight path toward the 2% inflation target. By coming out above expectations once again, the data not only completed the picture of a **stubborn inflationary momentum**

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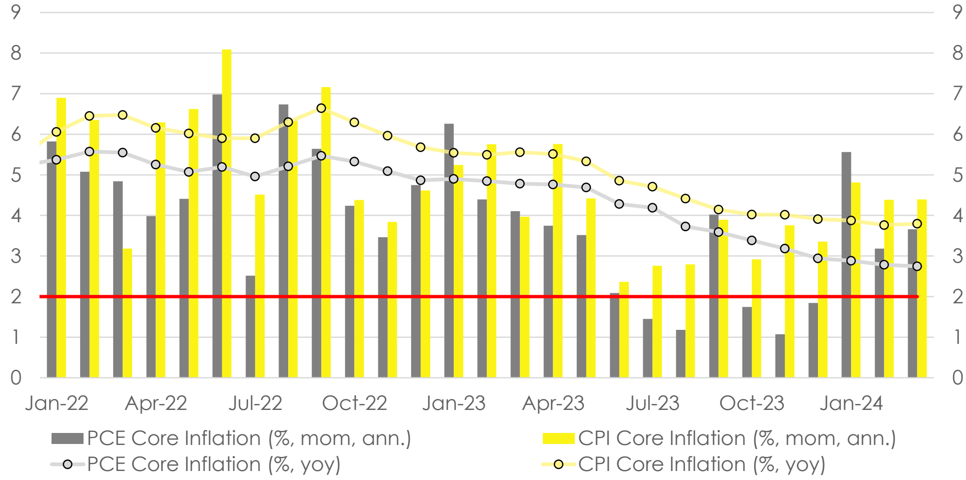
in the entire first quarter of 2024, but it also indicated that statistical factors alone are not a plausible explanation for the hot data releases of the first two months of the year.

Inflation momentum picked up in the new year



Last data point for PCE inflation based on Nowcast by Cleveland Fed, red line depicts inflation target
Source: LSEG, Cleveland Fed, RBI/Raiffeisen Research

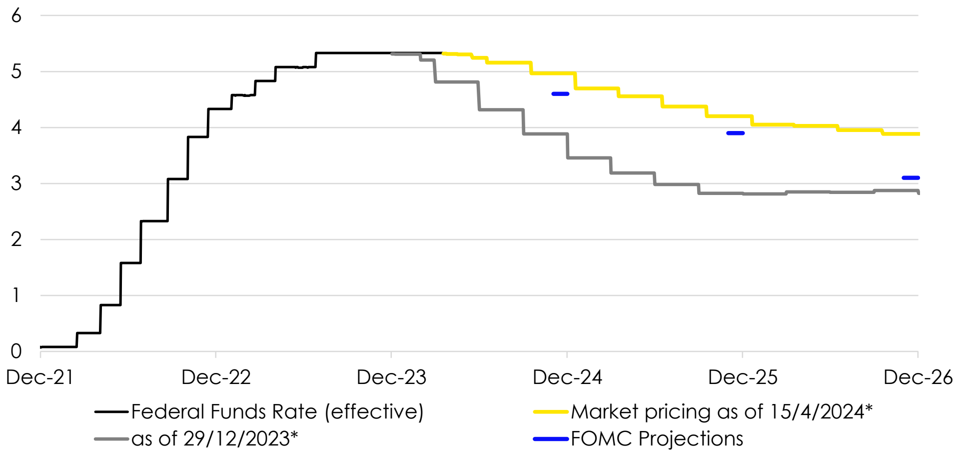
It should be emphasised that **PCE inflation**, the preferred price-measure of the Federal Reserve, in general came in **less elevated than its CPI counterpart** in the recent past (except for a strong surge in January). This is to a large extent caused by the fact that shelter prices, which have been a main driver of inflation stickiness, have a smaller weight in PCE inflation than in CPI inflation. Data on PCE inflation in March has not been released yet, but estimates based on already available data suggest that inflationary dynamics will again be more muted than they have been in the CPI measure. Nevertheless, this does not change the fact that especially **core services inflation came out more persistent than hoped for in both indicators**, ultimately raising fears of inflation remaining too high for too long. The still ongoing strength of the economy - and the labour market - further fuels these worries, as especially strong wage developments can contribute further to sticky inflation. While the disinflationary path does not appear to be endangered in its entirety as of now, the fact that inflation has turned more persistent than previously assumed has **major implications for the Federal Reserve**, as it acts data dependent. The ultimate question for the central bank is **when inflationary momentum will start to cool again**, and if a sustained progression toward the 2% target will be realistic once this happens.

Is the Fed back at 'high-for-longer'?

To put it clear, we do think the **March inflation data matter for the Fed**. In response to the higher than expected inflation releases, for three months in a row, we have **shifted our expectation of a first rate cut** by the Fed from June 2024 **to September 2024**. This means two, instead of three, rate cuts in 2024. Until the June meeting, the Fed will only receive one additional month of inflation figures, which given where the economy, the labour market and inflation stand, cannot provide enough confidence on the disinflation process for the Fed to lower its guard. July would be the next possibility for the Fed to act. Until the July meeting, the Fed will have a complete picture on the second quarter. Should inflation momentum revert to H2'23 levels, a rate cut in July cannot be ruled out. Should inflation momentum, however, recede only moderately in Q2'24, the Fed might want to wait until September to gain more confidence on the disinflation process. For the Fed, the consensus flipping from three to two rate cuts in 2024 will meet little resistence, we think. The FOMC's March projections have already reflected 9 out of 19 FOMC members believing the federal funds rate to be between 4.75 and 5.0%, or higher, at year-end 2024. The median projection, however, remained at the range of 4.5 to 4.75% (three rate cuts from now). Would the opinions be assessed as of today, we would expect the median projection to move one notch higher (to two rate cuts from now).

Market expectations towards the Fed's rate outlook have changed materially year-to-date. At the start of the year interest rates markets priced between five to six rate cuts of 25 bp each in 2024 (147 bp in total). Now the expectation shifted to a pricing of between one to two rate cuts (40 bp in total). The market has shifted from disinflation euphoria at year-end 2023 to worries about inflation persistence as of today. Overall, we do, however, see today's market pricing as closer to the fundamental picture compared to earlier in the year. As always, the market is also reflecting risks from a baseline view. This risks currently seem to be seen to the upside rather than downside (less rather than more rate cuts by the Fed). We, however, see the risks to our update baseline projection of two rate cuts in 2024, as fairly balanced.

Market's Fed pricing has shifted from disinflation euphoria at year-end 2023 to worries about inflation persistence as of today



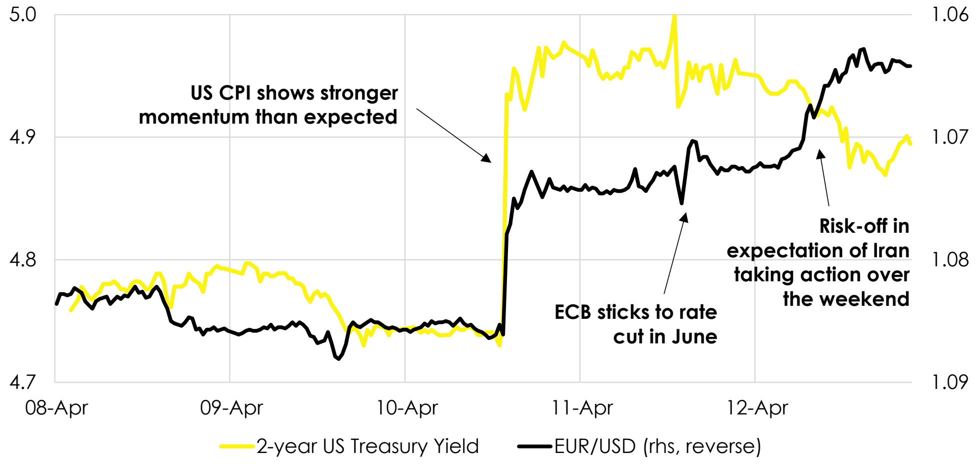
** based on short term forwards of the EFFR OIS curve. FOMC Projections are from March 2024.*
Source: LSEG, RBI/Raiffeisen Research

Implications for markets and updated projections

For **US Treasury yields** the March US CPI inflation release was a shock. While the market reaction does not seem in proportion with the extent of the inflation surprise at first sight, it is a shift to a new narrative of more persistent inflation which is behind the market reaction. In accordance with our updated projection for the federal funds rate, we have also **adjusted our projections** for Treasury yields to the upside. As we continue to see the mid-term disinflation trend intact, and with it the Fed's rate cutting cycle (yet postponed), we project yields to decline over the medium-term. Yet, the scope for yield declines in the short-term we deem to be rather limited from current levels.

This is also due to the fact that US Treasury yields act as one of the most important **global safe haven assets**. With the expectation of the, in the end realized, **Iranian attack on Israel** over the past weekend, yields declined in a clear risk-off sentiment. While it is not easily predictable how the geopolitical tensions in the Middle East develop further, it seems likely that a safe-have premium for US Treasury yields stays with us over the next few weeks. Thus, yields might be influenced by macro volatility affecting the market pricing towards the Fed and safe-haven demand from geopolitical volatility.

US inflation dynamics and geopolitical risks are shaping markets as of late



Frequency: 30m
Source: LSEG, RBI/Raiffeisen Research

For **EUR/USD** the current mix of events is clearly US dollar supportive. On the one hand, the postponed rate cutting cycle by the Fed in light of the ECB staying full on course with its June rate cut should shift short-term money market differentials - and thus arbitrage opportunities - in favour of the US dollar. On the other hand, the possibility of geopolitical risks materializing further is also a US dollar positive factor, not to speak of the US presidential election gaining attention, which we see as a negative factor for the euro should Trump gain in opinion polls. Our outlook for EUR/USD is thus rather subdued with some further downside in the short-term (Q2: 1.05) and only a moderate upside over the rest of the year (H2: 1.08) once the Fed joins the rate cutting club.

US Interest Rates and Yields Outlook

in %, end-of-period	12/4/2024	Q2'24	Q3'24	Q4'24	Q1'25	Q4'25	Q4'26
Federal Funds Rate							
Upper Target	5.50	5.50	5.25	5.00	4.75	4.00	3.00
Effective	5.33	5.35	5.10	4.85	4.60	3.85	2.85
Money Market Rates							
USD SOFR	5.31	5.30	5.10	4.85	4.60	3.85	2.85
USD SOFR 1M OIS	5.32	5.35	5.10	4.85	4.60	3.85	2.85
USD SOFR 3M OIS	5.32	5.30	5.05	4.80	4.55	3.80	2.80
USD SOFR 6M OIS	5.28	5.25	4.95	4.70	4.45	3.70	2.75
USD SOFR 12M OIS	5.18	5.00	4.70	4.45	4.20	3.45	2.70
Interest Rate Swap Rates							
USD SOFR 2Y OIS	4.81	4.70	4.35	4.15	3.90	3.35	2.70
USD SOFR 5Y OIS	4.30	4.25	4.10	3.85	3.70	3.25	2.70
USD SOFR 10Y OIS	4.14	4.10	4.00	3.80	3.65	3.20	2.65
Government Bond Yields							
UST Yield 2Y	4.90	4.80	4.45	4.25	4.00	3.45	2.80
UST Yield 5Y	4.55	4.50	4.35	4.10	3.90	3.45	2.90
UST Yield 10Y	4.52	4.45	4.30	4.10	3.90	3.45	2.90
UST Yield 30Y	4.63	4.60	4.45	4.25	4.10	3.65	3.10
FX							
EUR/USD	1.06	1.05	1.08	1.08	1.10	1.12	1.15

Source: LSEG, RBI/Raiffeisen Research

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