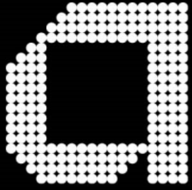

Research Institute - Insight

23 March 2023

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#US / #Monetary policy / #Inflation

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How far will the Fed cut rates?

We have the out-of-consensus view that the fed funds rate will return to zero. We stress test this view by considering how policy might behave under different growth, inflation, and r* forecasts. If, as we expect, a recession occurs, a return to zero is the most likely outcome. But risks are skewed to a shallower cutting cycle.

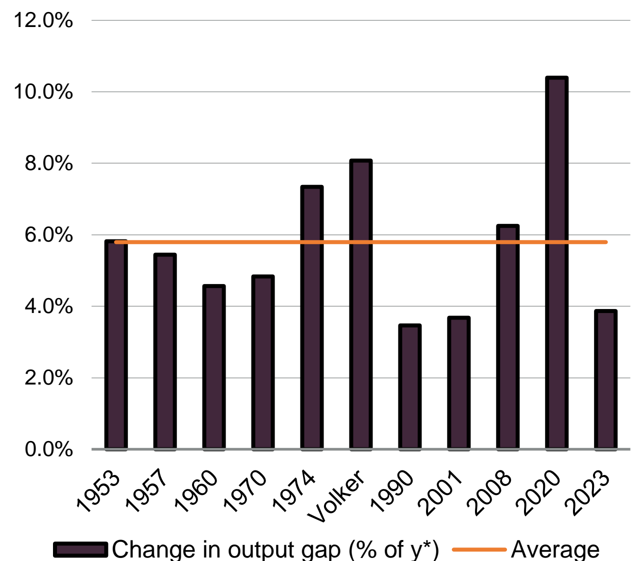
Key Takeaways

- Banking sector turmoil means interest rate cuts are being taken more seriously by the market than they were a week and a half ago.
- We first made a US recession and a sharp rate-cutting cycle our baseline in June 2022. Even after recent repricing, we have the out-of-consensus view that the fed funds rate will return to zero by 2025.
- We expect a US recession starting in Q3 this year, which takes 2% off US GDP, pushes unemployment up to 6%, and takes core PCE inflation to 1%.
- The average of a variety of policy rules conditional on these economic forecasts sees the appropriate fed funds policy rate falling to zero. History also suggests a cutting cycle of this magnitude is consistent with how policy makers respond to recessions.
- We stress test our base case policy rate forecast under different growth, inflation, and r* outcomes. Were the Fed able to engineer a soft landing, or inflation to prove much stickier amid a recession, a return to zero would no longer be appropriate. But it's uncertainty over the possibility of a much higher short-term r* which is the key risk to our cutting cycle forecast.
- Therefore, the weighted average fed funds rate across our baseline and alternative scenarios ends above zero but below the neutral rate. Nevertheless, this is still a deeper cutting cycle than is currently priced into markets.

Rates get back to zero in our base case

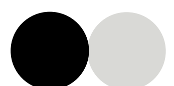
We expect a US recession that starts in Q3 this year, lasts three quarters, and takes 2% off GDP. Adjusted for slower trend growth, this is on the milder end of US recessions, but still pushes the unemployment rate up from below 4% to 6%.

Figure 1: The recession we forecast is historically quite mild when adjusted for slower trend growth



Source: Haver, abrdn, March 2023

This economic shock leads to a rapid slowdown in inflation, as labour costs moderate and margins are cut. We expect the core PCE inflation rate to bottom in late 2024 at 1%, before bouncing back to 2% by the end of 2025.



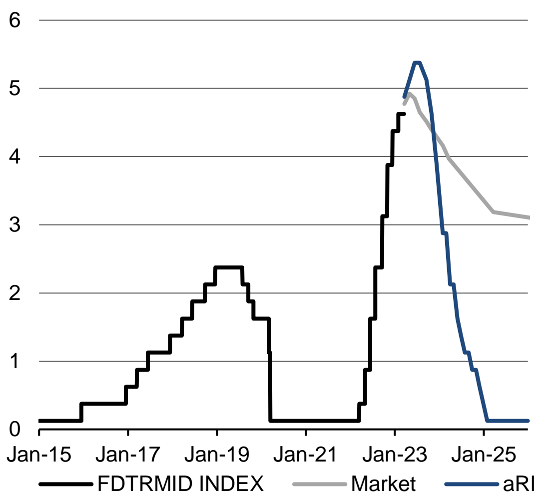
Resilient US activity data and upside inflation surprises at the start of 2023 appear at odds with this forecast at first.

However, they actually increase our conviction that a recession is necessary, because they add to the evidence of overheating.

Moreover, the banking sector turmoil following the collapse of Silicon Valley Bank (SVB) and the merger of UBS and Credit Suisse gives us rising conviction in the recession we are forecasting. The increase in financial stress, the tightening that is likely to occur to bank lending standards, and the broader knock to confidence, all make the recession more likely.

As and when the economy tips into this recession, we expect the Fed to pivot towards easing. While market pricing does suggest that investors expect the Fed to start cutting rates, we hold the significantly out-of-consensus view that this cutting cycle will eventually take the fed funds rate back to zero.

Figure 2: Our baseline fed funds forecasts have a deeper cutting cycle than currently priced into markets

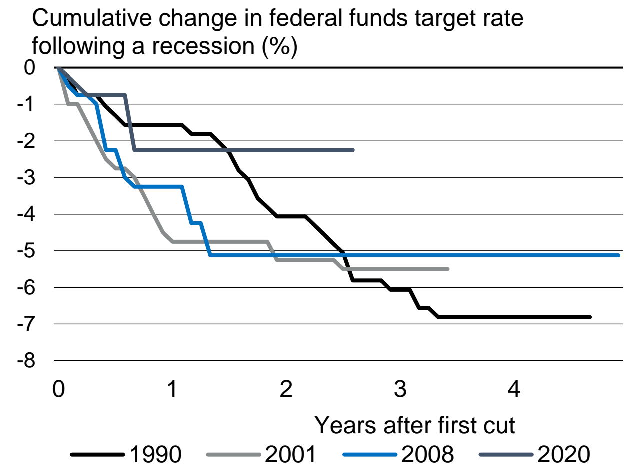


Source: Haver, Bloomberg, abrdn, March 2023

History suggests a return to the lower bound

An informal but instructive way of assessing the plausibility of rates returning to zero is to compare it with past cutting cycles. Figure 3 shows the US cutting cycles following the last four recessions back to 1990.

Figure 3: A large cutting cycle typically follows a recession



Source: Haver, abrdn, March 2023

In the 1990 and 2001 recessions, which were shallower in peak-to-trough depth than the one we are forecasting and comparable after adjusting for the change in trend growth over time, interest rates were cut 675 and 550 basis points respectively.

In the 2008 (related to the global financial crisis) and 2020 (related to the Covid pandemic) recessions, interest rates were cut by 525 and 225 respectively. But they would have been cut much further had the policy rate not hit the lower bound, and the Fed instead resorted to quantitative easing and other extraordinary policy measures to further stimulate the economy.

Looking at the historical record in this context, it seems clear that a cumulative cutting cycle of more than 500bps following a recession is typical. Given that we see the peak fed funds target range at 5.25-5.5%, a cutting cycle that takes rates back to zero is perfectly within the bounds of historical experience.

Policy rules also suggest a return to the lower bound

A more formal way of assessing the path of policy through the recession is by running our forecasts through monetary policy rules.

Even though they are far from an infallible guide to policy, they are a good way of systematically gauging the trade-off policy makers face between activity and inflation.

These rules typically take the form below, where the implied policy path is dictated by this trade-off, the equilibrium interest rate, and the extent to which policy setting is smoothed over time.

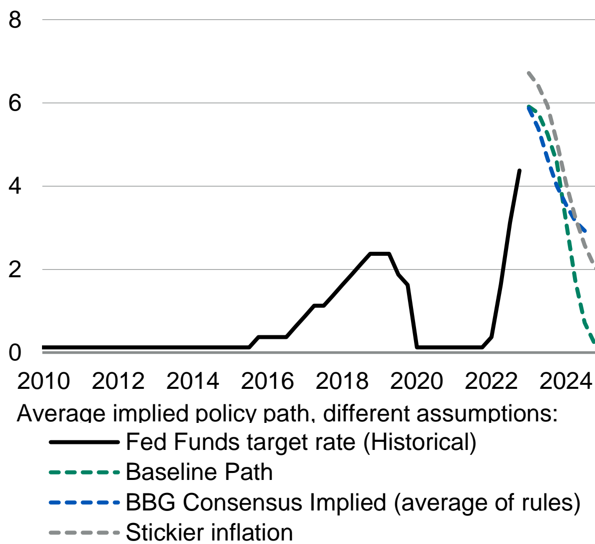
Basic Monetary Policy Rule:

$$\hat{r}_t = \rho\hat{r}_{t-1} + (1-\rho)[r_t^* + \pi_t^* + 1.5(\pi_t - \pi_t^*) + \beta(u_t - u_t^*)]$$

Where: $\hat{r}_t$ is the rule implied Fed funds rate, ρ is a smoothing parameter, r^* is the natural rate of interest, π^* is the target rate of inflation, π is the realised rate of core PCE inflation, u^* is the natural rate of unemployment, and u^* is the realised unemployment rate

Conditional on our economic forecasts, we find that the average across the various policy rule specifications we study imply a return to zero interest rates, as shown in the green dashed line in Figure 4.

Figure 4: Projected policy rate under different scenarios



Source: Haver, abrdn, March 2023

Stress testing the return to zero

The virtue of using policy rules as the framework for thinking about the path of policy is that it allows us to assess how policy makers might respond to different economic outcomes. In particular, we can consider the likely path of policy in the cases where: 1) a recession is avoided; 2) inflation is stickier; 3) r* is higher.

In the case of higher growth or inflation, the impact on policy is relatively straightforward.

Were the Fed to manage a soft landing then of course a sharp cutting cycle would be unnecessary and rates would not fall to zero. In fact, in this scenario rates would only gradually return to neutral once excess demand had been squeezed from the system.

This can be seen clearly in the dashed blue line in Figure 4, which runs the Bloomberg consensus economic forecasts — which we think of as reflecting something like a soft-landing scenario — through various policy rules. The rules suggest that under these forecasts a cutting cycle is likely, but a much shallower one back to around the neutral rate.

Even if the economy does tip into recession, rates may not fall to zero if inflation proves to be much stickier. In our sticky inflation scenario, backward-looking inflation expectations mean inflation is much less responsive to the slack opened up in a recession. In this case inflation stays high even as unemployment increases.

The dashed grey line in Figure 4 shows that in this scenario rates would get even higher in the near term in response to this inflation, before falling into accommodative territory to deal with the recession. Rates never get to zero because policy makers have to balance rising unemployment against above-target inflation.

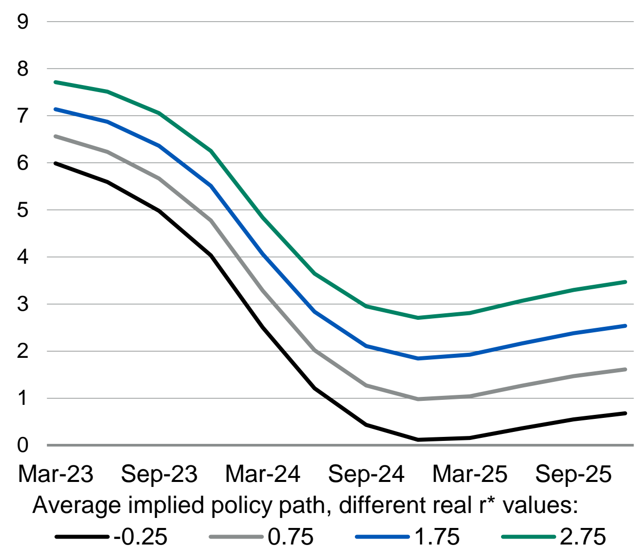
Finally, a higher r*, or equilibrium real interest rate, which defines the level of interest rates where policy switches from stimulative to restrictive, could also stop policy rates being cut to zero. This is because policy becomes stimulative at a higher level, which could mitigate the need to cut rates as much.

There has been a lot of debate in the policy community about the extent to which the recent strength of US data reflects the lags in monetary policy transmission or a higher r*. We think that lags are the key explanation, with the failure of SVB showing that the full impact of last year's monetary tightening is only now being felt.

But if a high r* was the explanation for recent growth and inflation resilience, this would mean that rates would need to be even higher to generate the recession we think is necessary, and that any cutting cycle would be shallower.

Figure 5 shows how policy would respond to our growth and inflation forecasts under different specifications for r*. It is clear that were r* to be even modestly higher in the short run, then a return to the lower bound would be much less likely.

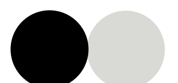
Figure 5: A higher r* would imply more rate hikes then keeping rates above zero in the cutting cycle



Source: Haver, abrdn, March 2023

It is important to stress that r* is extremely difficult to measure in real time.

So we acknowledge uncertainty over a possibly higher level of r* is one of the biggest sources of risk both to our terminal hiking cycle forecasts and cutting cycle forecasts.



All this goes to show that the judgement on the likely path of policy is less an independent judgement in and of itself, and more just flows from other judgements about how the economy will evolve.

No adverse reaction to zero by policy makers

One caveat is that, even if the economy does behave in line with our forecasts, rates may not fall to zero if central banks have a very different reaction function than we expect. That is, the way they respond to any given growth and inflation combination is different to the past.

The least convincing form of this argument is that policy makers are just much more averse to taking interest rates to zero *qua* zero.

The thought seems to be that policy makers have concluded the period of zero rates after the financial crisis and the pandemic was a policy error, which was responsible for the current period of high inflation. And so even in a recession, the Fed will not set policy this accommodative.

We think this argument is a misreading of the lessons policymakers have drawn from the period of zero interest rates. There is little sense in the policy community that rates at zero was an aberration that should never be repeated.

Moreover, we note that the Fed is already under some political pressure around the unemployment it is likely to cause as it tries to restore price stability. Amid a recession, with rising unemployment, we think the Fed would come under even more pressure to ease policy. So we don't think political economy factors will mitigate against a sharp cutting cycle.

A more convincing argument is that the Fed's average inflation target (AIT) regime requires that it delivers a sustained period of sub-2% inflation to average-out the prolonged period of inflation overshooting. If this were the case, then policy may not be as accommodative as expected as the Fed does not feel it needs to stimulate the economy as much to force inflation higher during a recession.

While this might be true of a genuine price-level target, the Fed's average inflation target is clearly intended to be asymmetrically administered. This means the Fed will focus far more on making up for inflation undershoots through stimulative policy, than making up for overshoots through tighter policy. So we don't see AIT as a constraint on the depth of the cutting cycle.

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