Corporate &
Investment Banking

WELLS FARGO

Michael Schumacher, CFA
michael.schumacher@wellsfargo.com

Angelo Manolatos
evangelos.s.manolatos@wellsfargo.com

Jack Boswell
jack.t.boswell@wellsfargo.com

William Gibbons
william.gibbons@wellsfargo.com

Macro Strategy

The Fed Has Eased... What Next for Rates?

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Key Takeaways

- The market prices the Fed to ease a total of 240bps in the first year of its new cycle, about midway between the 150bps we think it would do in a soft landing and 350bps for a hard landing.
- **The sharp drop in U.S. front-end yields during recent months is in line with the moves leading into the initial cuts of the 1995 and 2001 Fed easing cycles.** Historically, the market has struggled to rally following the first cut of a soft landing cycle in the 90 days following the first cut. In hard landings, yields have tended to fall in the 90 days following the first cut even in milder recessions such as 2001.
- **Two areas of the USD swap curve we think can steepen more than implied by forwards are 2s/5s and 10s/30s**. In our view, 2s/5s should steepen 35-40bps in six months, while the forward implies 23bps of steepening. Although fiscal and U.S. election concerns have taken a backseat to monetary policy recently, they are likely to resurface shortly before the November election. We expect the 10s/30s curves in swaps and also cash Treasuries to steepen significantly, probably more than 10bps, if either party sweeps.

History of Fed Easing Cycles

Several of the initial conditions for the easing cycle that the Fed launched today line up closely with the Fed's cycles since the late 1980s:

- Core PCE annualized 3mo rate. Usually it is 1.8-2.4%. Now it is 2.2%.
- Real Fed funds. It typically is 3.00-4.50% at the advent of a cycle. This go-round, it is 3.30%.
- The 10yr Treasury yield generally is modestly higher than the 2yr yield. This time, the difference is +7bps.

Figure 1 - Fed Easing Cycles at a Glance

Fed eases		Cycle	Core PCE	Fed funds			FF Changes (bps)			Day before 1st Cut		Treasury, IG and S&P Changes				
			Run	Before cycle		Ending			Total				(bps)		S&P 500 (%)	
First	Last	Months	Rate	Real	Nominal	Rate	First	1 Year	Cycle	2yr	10yr	2yr	10yr	IG OAS	Total	Annual
5-Jun-89	4-Sep-92	39	3.9	5.85	9.75	3.00	-12	-150	-675	8.48	8.43	-461	-203		28	8
6-Jul-95	31-Jan-96	7	2.4	3.60	6.00	5.25	-25	-75	-75	5.76	6.18	-84	-60		16	30
29-Sep-98	17-Nov-98	2	1.0	4.50	5.50	4.75	-25	-25	-75	4.43	4.59	13	28		9	
3-Jan-01	25-Jun-03	30	2.0	4.50	6.50	1.00	-50	-475	-550	4.86	4.92	-358	-151	-77	-24	-10
18-Sep-07	16-Dec-08	15	1.8	3.45	5.25	0.25	-50	-325	-500	4.07	4.47	-342	-221	395	-38	-32
31-Jul-19	16-Mar-20	8	1.8	0.70	2.50	0.25	-25	-225	-225	1.85	2.06	-149	-134	123	-21	-31
18-Sep-24			2.2	3.30	5.50		-50			3.60	3.65					

Source: Bloomberg LP, Wells Fargo Macro Strategy

The U.S. / Fed have managed only one soft landing in 30+ years. Aside from that case (1995-96) and the mini cycle of 1998, the Fed has moved 175-475bps in the first year of an easing cycle. The average year-one move is about 310bps in these recession/hard landing scenarios.

The market prices 240bps of easing for the first year of the cycle, about midway between the moves we think it would do in a soft landing and hard landing. We view market pricing for the next year in particular as a weighted average of hard and soft landing scenarios. In our view, in a hard landing the Fed would push the funds target below 2.00%, suggesting a move of 350bps. Since U.S. soft landings are rare, we make the analysis more robust by incorporating data from soft landing cycles experienced by the European Central Bank, Bank of England and Bank of Canada. The resulting median is 125bps, with an annualized pace of 170bps. We split the difference, and assume the Fed would ease about 150bps if it pulled off a soft landing this time around.

The Fed's Reaction Function

The Fed has a lot of room to ease. Following today's move, the real Fed funds rate sits approximately 140bps above the Federal Reserve's current estimate of neutral (using year-over-year core PCE Inflation). Moreover, the real Fed funds rate going into this meeting was over 200bps higher than when the Fed began "insurance" cuts in mid-2019. Our economics team expects the core PCE deflator to finish this year near its current level (2.7%) and settle into the 2.25% area in 2025. If this forecast is realized **and** the Fed wants to bring its real policy rate near 90bps by the end of 2025 (faster than the dots project), it will need to ease 225bps cumulatively. The market, however, already prices substantial Fed easing. December 2025 SOFR futures trade at 2.93%, which translates to an implied real fed funds rate around 70bps.

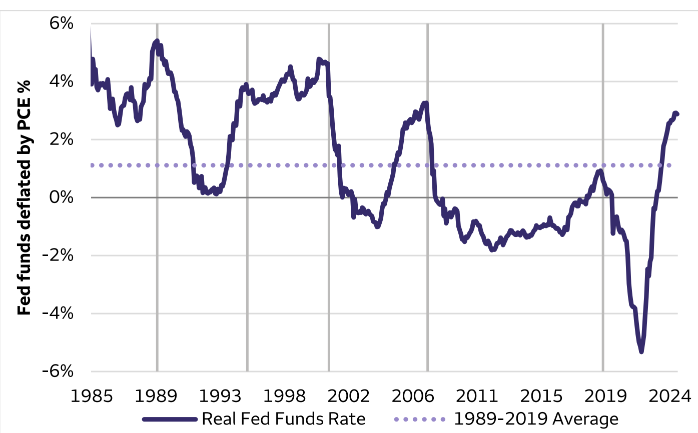
The brand new 2024 cycle joins the 50bp club — the Fed also started the 2001 and 2007 cycles with 50bp eases. Between early January and mid-May of 2001 the Fed delivered five straight 50bps rate cuts. It followed with another 225bps of easing between June and December (3x25bps and 3x50bps).

In September 2007, the Fed began with a 50bps cut and then stepped down to two 25bps eases. However, it then followed with hefty easing. In January 2008, the Fed eased by 125bps (75bps then 50bps). In March 2008, the central bank eased by 75bps and then in April did another 25bps (to 2%). The Fed then paused for nearly five months, before lowering the funds target to the effective lower bound (0-0.25%) with three moves (50bps, 50bps then 75bps).

In both the 1995 and 2019 cycles, the Fed started with a 25bps ease. The next two moves also were 25bps. In 1995-96 this was finito, for a total move of 75bps. However, the Fed's mellow start in 2019 ended when it had to move much more aggressively to combat Covid.

In 1989, the Fed cut a total of 150bps in 1989 to a policy target 8.25%. Easing resumed in July 1990; the Fed cut 125bps that year in a sequence of five 25bps moves. In 1991, the central bank delivered a whopping 300bps of easing and in 1992 the Fed cut by 100bps to an end-point fed funds target of 3%.

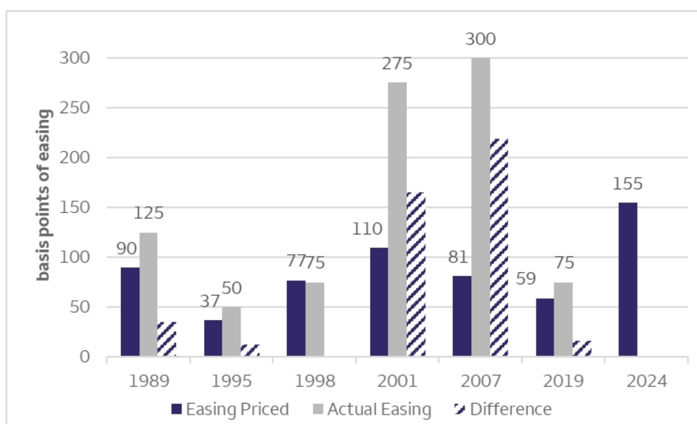
Figure 2 - Elevated Real Fed Funds Rate Leaves Fed With Ample Room To Ease



Source: Bloomberg LP, Wells Fargo Macro Strategy

Vertical lines denote start of cutting cycle

Figure 3 - Historical Pricing Prior Day Prior to Cycle Versus Realized Cuts (in first 6 months)



Source: Bloomberg LP, Wells Fargo Macro Strategy

Market moves during easing cycles

Yields tend to stop falling after the first cut of a "soft-landing" easing cycle. We aggregate post-1989 soft landing cycles from the US, UK and Canada in Figure 6 and Figure 7. On average, 2y and 10y domestic government bond yields declined 12bps and 6bps, respectively, in the five working days following the first cut before stabilizing. However, a majority of these cycles started before the advent of forward guidance, so we attribute these yield drops to a surprise factor. Three months following the first cut in these soft landing cycles, the average change in the 2y yield is 7bps lower while the 10y yield is 6bps higher, implying 2s10s is 13bps steeper on average. During the lone US soft landing cycle in this analysis, 1995-96, the 2yr US Treasury yield actually rose 34bps in the month following the initial cut. The takeaway is the market historically priced in a bottom for yields as the first cut came into clearer view. Repricing lower after the central bank's first move required further catalysts to shift the perceived pace of rate cuts for the cycle.

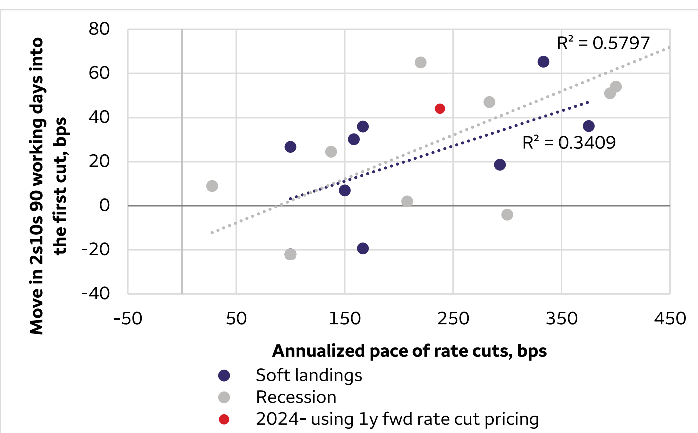
In US hard landings, yields have tended to fall after the first Fed rate cut. On average, 2yr yields in US hard landingsfell 52bps in the first three months of an easing cycle.The biggest such drops were in 2001 and 2007. The 2001 recession was mild, but the real Fed funds rate was 4.50% when the cycle began, its highest pre-cycle level since 1989. Furthermore, the Fed launched the 2001 cycle with a surprise inter-meeting 50-bp cut, which almost certainly caused the market to price quite a bit of additional easing.

In our view, U.S. front-end yields are likely to fall modestly (around 10bps) over the next month or two, then stall. Implied easing for 2024 is in line with the realized pace of easing in past cycles, but markets should be factoring this in. The decline in U.S. front-end yields over the past few months mirrors the drops in 1995 and 2001(Figure 8). However, 2024 is a standout with 155bps priced over the first six months of easing prior to the meeting. That is more easing than the start of all previous US cutting cycles since 1989 (Figure 3).

Our historical analysis suggests that clients proceed cautiously as they position for U.S. Treasury and swap curves to steepen, particularly in the 2y/10y area. In some instances 2y/10y has continued steepening after the first cut, but the degree of pre-FOMC steepening this time around suggests the market has front-loaded it. As we discuss in the next section, we expect steepening moves in 2y/5y and 10y/30y to outpace forwards over six to 12 months, but we are skeptical that 5y/10y steepening will top forwards.

The magnitude of steepening in 2s/10s into the first cut of a central bank cutting cycle depends on the perceived depth of the easing cycle. Figure 4 shows the move in domestic 2s/10s 3m into the first cut for the ECB, BoE, BoC & Fed versus the realized pace of rate cuts for the cycle. The chart shows the extent of steepening into the first cut is correlated with the pace of *realized annualized rate of cuts. We use the current 1y forward (240bps) to proxy realized cuts in the new cycle. The chart shows that the 44bps move in Treasury 2s/10s over the past 90 working days is in line with the historic relationship. However, Figure 5 shows the steepening in 2s/10s into this first Fed cut is essentially the largest of any soft landing easing cycle in our global sample.

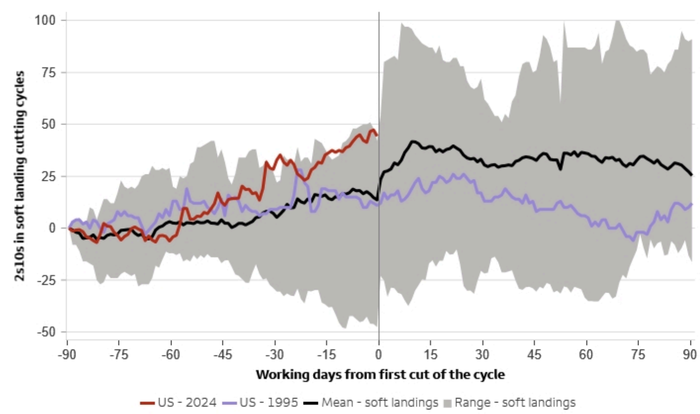
Figure 4 - The Move in 2s10s 90 Days Into the First Cut Depends on the Pace of Annualized Rate Cuts



Source: Bloomberg LP, Wells Fargo Macro Strategy

Excludes US 1998 cycle

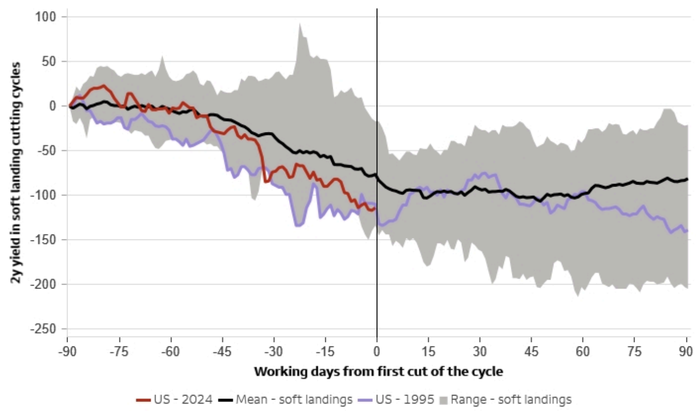
Figure 5 - 2s10s Swap Curve Into Soft Landing Cycles



Source: Macrobond, Wells Fargo Macro Strategy

Using soft landing cycles from US, Canada & UK (1989-present)

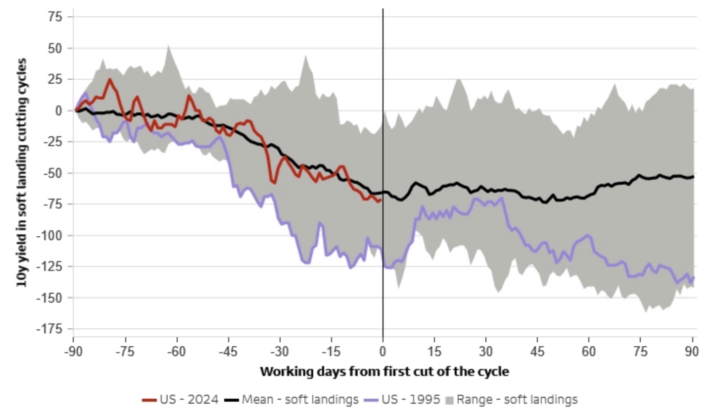
Figure 6 - 2yr Yield Into Soft Landing Cycles



Source: Macrobond, Wells Fargo Macro Strategy

Using soft landing cycles from US, Canada & UK (1989-present)

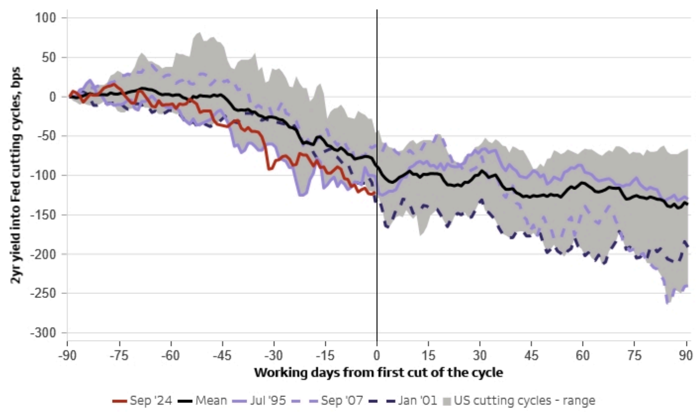
Figure 7 - 10yr Yield Into Soft Landing Cyles



Source: Macrobond, Wells Fargo Macro Strategy

Using soft landing cycles from US, Canada & UK (1989-present)

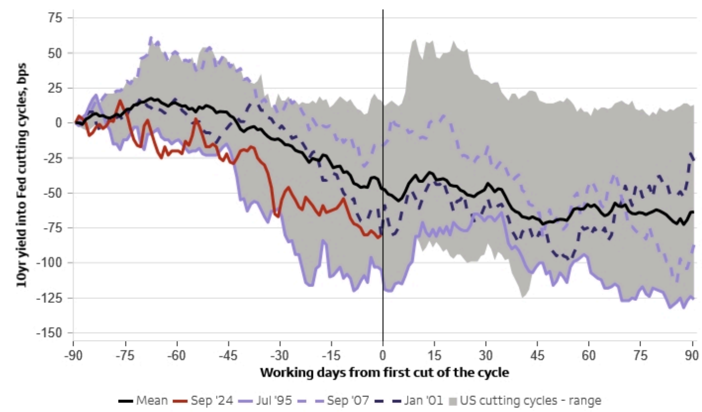
Figure 8 - 2yr Yield Into US Cutting Cycles



Source: Macrobond, Wells Fargo Macro Strategy

1989 to present

Figure 9 - 10yr Yield Into US Cutting Cycles



Source: Macrobond, Wells Fargo Macro Strategy

1989 to present

Forwards price a significant amount of SOFR curve steepening over the next year.

- The USD 2yr/5yr swap curve is priced to steepen 15bps over the next three months, 23bps in six months and 30bps of steepening over the next year. Despite the seeming high hurdle, we expect this area of Treasury and U.S. swaps curves to steepen more than implied by forwards for the next six to 12 months. In six months, forwards price the 2y/5yr swap curve to be flat (1bps), we think the spread should be +10-15bps. In our opinion, a sizable chunk of the $6+ trillion in U.S. money market funds is likely to be redeployed. We consider shortish (e.g. 2yr) Treasuries to be the most likely destination.
- The USD 5yr/10yr swap rate curve is priced for 5bps of steepening over the next 3 months, 8bps of steepening over the next six months and 10bps of steepening over the next year. This is a smaller hurdle than 5s/10s but we are a bit less convinced about this part of the curve.
- Swap 10yr/30yr is priced to steepen about 2bps over three months, then it gets interesting. The 6m forward is less than 0.5bp steeper than the 3 month forward, while the 1yr forward is flatter than the spot level today. We expect swaps and cash Treasuries to steepen more than implied by these very low hurdles. Fiscal and election concerns have taken a backseat to monetary policy recently, but are likely to resurface around the time of the November election. We expect the long end of the curve to steepen significantly, probably more than 10bps, if either party sweeps.

Figure 10 - SOFR Swaps and Forwards

Tenor	Spot swaps	3m fwd	6m fwd	12m fwd	3m fwd vs spot	6m fwd vs spot	12m fwd vs spot
2	3.41	3.18	3.04	2.96	-23.3	-37.0	-45.1
5	3.19	3.10	3.05	3.04	-8.8	-13.5	-14.7
10	3.25	3.21	3.19	3.20	-4.0	-5.8	-5.1
30	3.22	3.19	3.18	3.17	-2.5	-4.0	-5.2
2s/5s	-22.4	-7.9	1.1	8.0	14.5	23.5	30.4
5s/10s	6.0	10.8	13.7	15.6	4.8	7.7	9.6
10s/30s	-3.2	-1.7	-1.3	-3.3	1.5	1.8	-0.1

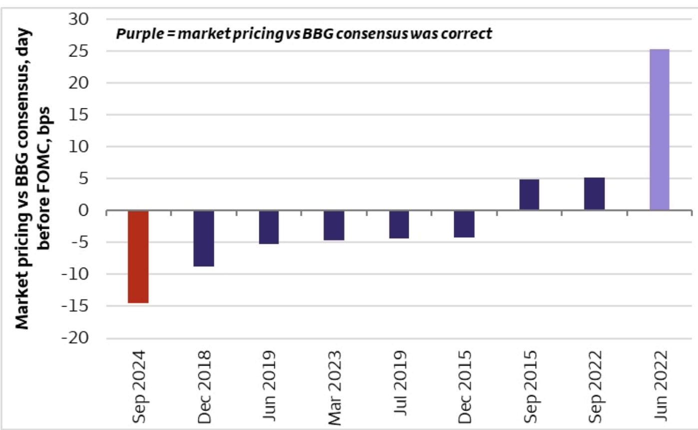
Source: Bloomberg, RiskVal Financial Solutions, Wells Fargo Macro Strategy

An unusual cycle

The 2024 easing cycle starts with historic levels of market uncertainty. Market pricing was split almost perfectly evenly between expecting a 25-bp and a 50-bp Fed rate cut today. With the vast majority of economists expecting a 25-bp cut, the gap between market pricing and consensus expectations ahead of today's meeting reached a level rarely seen since 2009 (Figure 11). The deviation between market pricing and consensus was "correct" today, i.e. the Fed move confirmed market pricing. The market had been proven right in only similar case — June 2022. In that instance, a WSJ story heavily tipped market pricing toward a 75-bp hike.

Focusing only on FOMC meetings when market pricing versus Bloomberg consensus was correct, we plot the performance of the 2yr UST following these meetings (Figure 12). June 2022 is a clear example of when market expectations were validated, yet in the month following the Fed's surprisingly big hike the 2yr UST yield actually fell 7bps.

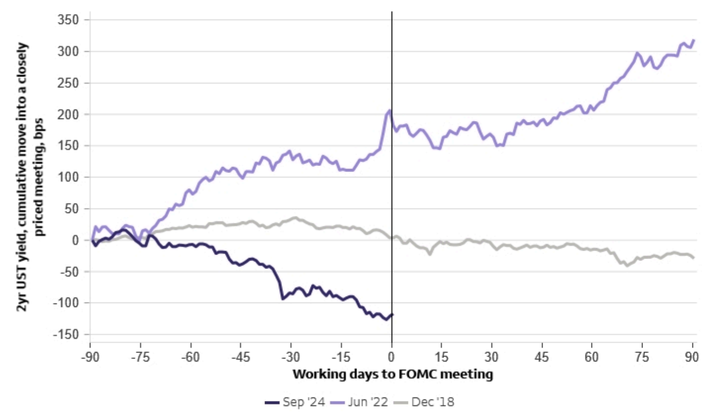
Figure 11 - Sep '24 FOMC Pricing Spread vs BBG Consensus Is a Standout



Source: Bloomberg LP, Wells Fargo Macro Strategy

Post 2015

Figure 12 - 2yr UST Yield, Cumulative Move Into Closely Priced FOMC Meetings



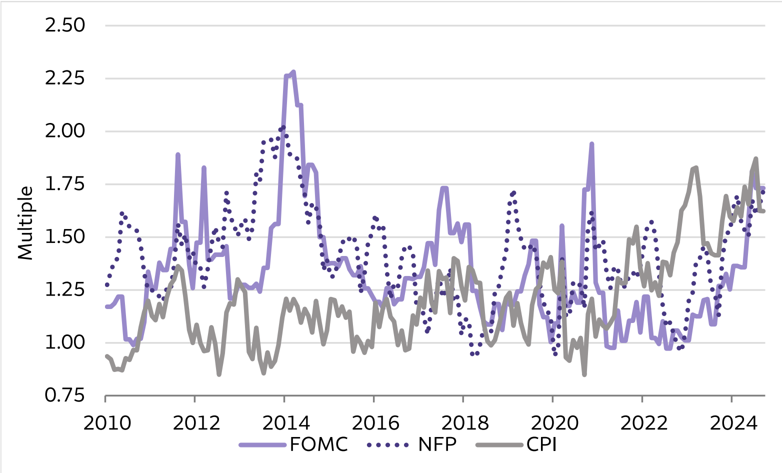
Source: Macrobond, Bloomberg LP, Wells Fargo Macro Strategy

What should clients watch to assess the Fed's path?

Labor market data are critical. The typical non-linear deterioration in labor markets makes the employment situation report the key data release to watch in coming months. Meanwhile, the Federal Reserve's focus has shifted to the employment mandate. We highlight two key points from Chairman Powell's Jackson Hole speech on August 23: "My confidence has grown that inflation is on a sustainable path back to 2 percent." and "we do not seek or welcome further cooling in labor market conditions." Furthermore, in the press conference today Chair Powell indicated the Fed might have eased at the July 31 meeting had it known that the July jobs report would be quite weak.

Clients have focused increasingly on risks to growth since the Sahm rule, a benchmark measure of the rise in unemployment, breached 0.5% in July. The Sahm indictor compares the three-month moving average of the unemployment rate to the 12-month low of the three-month moving average, a breach of 0.5% has coincided with recessions. Since 1970, in the eight instances when the Sahm calculation breached 0.5% unemployment continued to climb and the indicator rose to at least 1.5% every single time. The average of the indicator's peaks is 2.5% excluding the COVID period.

Figure 13 - NFP has Become More Market Moving Than CPI



Source: Bloomberg LP, Wells Fargo Macro Strategy

Average 10yr Treasury yield range on meeting or economic release days over past six months divided by average range over all days in the past six months, 2010-24

Wells Fargo Macro Strategy

Michael Schumacher, CFA	Managing Director, Head of Macro Strategy	+1-212-214-5043
Aroop Chatterjee	Managing Director, Macro Strategist	+1-212-214-8819
Chidu Narayanan	Head of Macro Strategy, APAC	+65-6961-6516
Erik Nelson	Executive Director, Macro Strategist	+44-20-3942-8410
Angelo Manolatos	Vice President, Macro Strategist	+1-704-410-1797
Jack Boswell	Analyst	+44-20-3942-9701
William Gibbons	Analyst	+1-212-214-5656

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Even if your financing includes a reference rate floor, such as a floor set at 0%, express wording in swap transactions is required to place a floor on the floating benchmark rate of a swap transaction. No such 0% floor or other floor is included in an interest rate swap or other swap transaction unless mutually agreed between the parties as reflected in the swap confirmation. Absent such floor in an interest rate swap, if a Floating Amount is negative under the swap, the Floating Rate Payer does not make such payment. Instead, the Fixed Rate Payer pays the absolute value of the negative Floating Amount in addition to the Fixed Amount. See §6.8 of the 2021 ISDA Interest Rate Definitions, as amended. If you wish to acquire a swap with a 0% floor or other floor, this may increase the price of your swap as reflected in a higher Fixed Rate. For further information on negative interest rates, including their effect on swaps and the loans they are hedging, see the Negative Interest Rates Disclosure (including disclosures regarding benchmark rate floors) at: Swap Disclosures.

Risks to Consider

While transactions described in the Materials may be used for hedging purposes to reduce certain risks associated with your assets or liabilities, the effectiveness of hedging may depend upon holding these transactions to maturity and not reducing or disposing of all or any portion of the asset or liability during the term of the hedge. If a transaction is terminated early, or if you reduce or dispose of all or a portion of the underlying asset or liability before the transaction matures (such as prepaying a floating rate loan you hedge with a swap or disposing an FX or commodity liability or asset you have hedged), depending on the nature of the transaction, you may incur a substantial loss or you may receive little or no hedging benefit from any upfront premium payment or any other costs incurred in purchasing the transaction. You may also incur a substantial loss if you enter into a transaction in anticipation of hedging an asset or liability that does not materialize. You should understand that significant potential amounts could become payable by you for modifying a transaction, terminating it early or transferring your position in the transaction to another person or entity, depending upon then existing market conditions and the terms of your transaction. You should also consider that prepaying your loan or disposing of an asset or other liability, including a foreign currency denominated or commodity liability or asset, does not relieve you of your obligations under a hedge transaction, which may be terminated early only in accordance with the terms of the swap or SBS trading relationship documentation, other transaction documents, or otherwise by mutual agreement. Such termination may require payment by you of an early termination amount, which may be substantial. Whether you use a transaction for hedging or another purpose, you should satisfy yourself that you understand these and other risks discussed in greater detail in disclosures provided to you at: Swap Disclosures.

Independent Obligation

To the extent any transaction described in the Materials may be used to hedge against FX risks, commodity risks, or interest rate risks, the transaction would be a separate and independent obligation and would not be contingent on whether or not any financing closes, is outstanding or is repaid, in whole or in part, at any time, subject to any contractual requirement to terminate and settle the transaction early upon prepayment of any financing or for other financing-related events. In addition, if you provide any existing or future collateral or other credit support to secure the transaction and any financing, then you would be entitled to the release of such collateral or credit support only if certain conditions contained in the related collateral agreement or credit support document are completely satisfied for both the transaction and any such financing, or we otherwise reach agreement with you on alternative collateral, credit support or other arrangements.

Unmatched Terms & Conventions

If the principal amount or duration of a financing, FX, or commodity asset or liability differs from that of a transaction used to hedge such financing, asset or liability (e.g., a different notional amount), you may be exposed to risk of loss from such over-hedging or under-hedging. If any other economic terms or characteristics of a financing, asset or liability differ from those of the related hedge, then in addition to any losses that you could incur from such differences, the hedge may create unanticipated accounting exposure or tax liability for you. To the extent fair value accounting applies to the hedge, you may have to reflect unrealized gains and losses (i.e., the so-called "mark-to-market" value of the hedge) over the life of the hedge on your balance sheet and/or income statement. If hedge accounting applies, any ineffectiveness in the hedge resulting from such differences may likewise need to be taken into account and reflected in your financial results. These hedge valuation considerations may also be important to you for tax purposes, including any tax laws that may require unrealized gains or losses on hedges to be taken into account in determining your income tax liability. Conventions used in the underlying market for the financing, assets or liabilities and the conventions used in the derivatives and FX markets may differ, and we are under no obligation to ensure that any transaction we offer is a perfect hedge even if we provide you with the underlying financing, asset or liability. For example, if the method for determining a loan's floating rate differs from that for a hedge's floating rate, the loan floating rate payments could diverge from those of the hedge. As another example, if the method for determining the applicable exchange rate for a foreign currency denominated liability differs from that for the exchange rate of the hedge, the payments associated with the underlying liability could diverge from the hedge. Such divergence may occur by convention or as the result of contractual differences, such as in the definition of or the reset timing of the exchange rate or for a referenced floating rate benchmark, the dates or times at which the benchmark is set, the number of days in the payment periods, divergent fallback rates upon the temporary or permanent discontinuation of the benchmark (e.g., SOFR) or the benchmark rate's rounding convention.

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