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BREAKING NEWS
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Powell pivots policy: moving closer to rate cuts

The U.S. Federal Reserve left interest rates unchanged at its December meeting, as expected, and updated projections signal even more rate cuts in 2024 than previously expected.

Tony Rodriguez
Head of Fixed Income Strategy

WHAT HAPPENED?

The U.S. Federal Reserve kept interest rates at 5.25% - 5.50%, remaining at their 22-year high. However, the policy statement and accompanying economic projections were unequivocally dovish, signaling higher odds of sizeable rate cuts in 2024.

The policy statement continued to characterize inflation as "elevated," but also said that "economic activity has slowed." In discussing the policy outlook, the statement used more hedged language than previously, referencing "any additional policy firming that may be appropriate," signaling that rate hikes are likely finished.

The summary of economic projections showed a lower inflation forecast for 2024, with core PCE inflation now expected to run at 2.4% next year, down -0.2 percentage points from the September forecasts. The unemployment rate is still forecast to rise to 4.1%. That combination – substantial disinflationary progress and a softer labor market – supports the Fed's updated projections for -75 bps of rate cuts in 2024, from -50bps of cuts in the September forecasts.

In his press conference, Chair Jerome Powell also struck a dovish tone. Though he explicitly said that additional rate hikes are not off the table, he stated that "we are likely at or near the peak rate for this cycle." He also argued that it makes sense to cut rates even before inflation returns to 2%, to avoid overshooting to the downside and to properly calibrate the real policy rate in the face of lower inflation.

RECENT DATA HAVE BEEN MIXED

Economic data were mixed during the intermeeting period. On the positive side, the labor market remains strong. The unemployment rate fell -0.2 percentage points to 3.7% in November, erasing around half of the recent uptick. Job growth continues to average around 200,000 net new jobs per month. This total is down from earlier this year, but still strong and likely more than required to keep unemployment flat.

Other growth data appear weaker. Surveys of manufacturing sentiment continue to signal contraction in the U.S., Europe and China. Third quarter GDP surprised to the upside in the U.S., expanding at a 5.2% quarter-over-quarter annualized rate, but it contracted in Europe.

On the inflation front, the picture also looks mixed. Overall, U.S. price pressures have continued to decelerate, with CPI inflation down to 3.1% year-over-year in November. However, most of the improvement has come from energy prices and durable goods, neither of which is likely to improve much further from current levels. Shelter inflation picked up again in November, and the three-month annualized rate has returned to a six-month high of 5.9%. Other core services also re-accelerated, to a 12-month high of 5.2%.

The economic outlook remains healthy, with growth slowing but not collapsing. This is what the Fed wants, and it should be sufficient to continue bringing down inflation next year. We continue to forecast a material growth slowdown over coming quarters.

WHAT DOES THIS MEAN FOR INVESTORS?

With increased confidence that the Fed is finished with the hiking cycle, attention should pivot more fully toward the potential timing and magnitude of rate cuts next year. We continue to expect U.S. Treasury yields to broadly fall next year and the curve to become less inverted.

In fixed income, we favor taking selective risk in credit sectors, including investment grade and high yield corporates, emerging markets and senior loans. We still think it makes sense to add duration risk at the margin, even after the recent rally in long-end rates. Credit spreads have tightened materially over recent months, to 18-month lows in corporate credit markets, boosting returns. Though that slightly reduces the scope for outperformance moving forward, overall starting yields remain very attractive at 5.5% and 8.3% in investment grade and high yield, respectively.

In the equity space, we continue to favor dividend growers. These companies are supported by positive fundamentals, sustainable growth potential and ample free cash flow, all of which makes them well positioned to enter 2024 on a cautiously optimistic note. Their capital flexibility allows them to return more cash to shareholders via increasing dividend payments. Additionally, these companies have historically proven resilient amid heightened volatility following Fed rate hiking cycles, as the economy adjusts to the lagging effects of the hikes, causing activity to slow and monetary policy changes to remain on hold.

We also see opportunities in publicly listed infrastructure. Surprisingly strong economic growth – led by stalwart consumers – contributed to listed infrastructure’s underperformance relative to broad global equity markets for much of this year, but we expect the asset class to find favor again in 2024. Demand for the services and operations of infrastructure companies tends to hold up relatively well in an economic downturn, creating a potential buffer. What’s more, infrastructure is generally well insulated from higher debt costs (i.e., interest rates) and persistent inflation, thanks to inflation escalators built into contracts.

For more information, please visit us at nuveen.com.

Endnotes

Sources

Federal Reserve Statement, December 2023.

Bloomberg, L.P.

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