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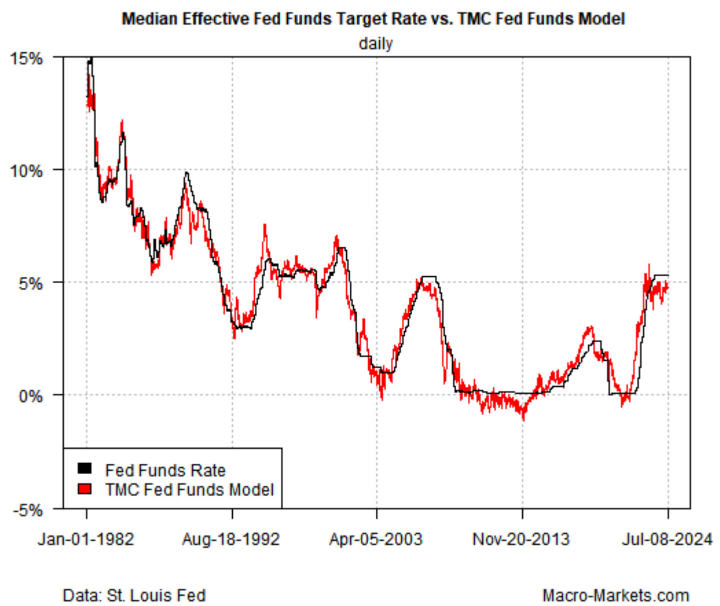
TMC Research's Fed Model Indicates The Federal Reserve Is Overdue For Rate Cuts

Key Points:

- *TMC Research's Fed Funds Models suggests the target rate should be 50-75 basis points lower*
- *The Fed should have cut interest rates more than a year ago, our model advises*
- *Fed funds futures are pricing in the first rate cuts at the September 18 FOMC meeting*



Markets are expecting that the Federal Reserve will soon cut interest rates. Using TMC Research's Fed model as a guide, a lower target rate appears to be long overdue.

The model's current estimate for the optimal Fed funds rate is roughly 4.75%, which is well below the current 5.25%-to-5.50% target range.

TMC's model is based on five factors that are crucial inputs for monetary policy: 1) inflation; 2) trend in unemployment; 3) real (inflation-adjusted) 10-year U.S. Treasury yield; 4) year-over-year change in U.S. economic output (real Gross Domestic Product); and 5) 10-year/2-year yield curve.

The model is designed to estimate the optimal Fed funds rate given the current state of the five factors. On that basis, policy is overly tight, which suggests the central bank is raising the risk of slowing growth, perhaps to the point of tipping the economy into recession.

As the chart above reminds, our Fed model tends to hug the actual Fed funds rate, but with a degree of variation. At various points in time, the model implies that the central bank should be tightening or loosening policy, although recent history points to the latter.

For example, the model advised that the Fed should have started raising interest rates in the third quarter of 2021 (red line above black line in chart above). The first rate hike, in fact, arrived roughly six months later, in March 2022 – a lapse that arguably allowed inflation to accelerate to extreme levels.

Disinflation increasingly looks entrenched and the Fed appears to be late once again for easing policy – a delay that could needlessly increase economic headwinds and possibly tip the U.S. into a premature recession. Fed funds futures are currently pricing in moderate odds that policy will remain unchanged at the July 31 FOMC meeting, followed by a rate cut at the September 18 meeting. Using TMC Research's Fed model as a guide, the delay looks increasingly ill-advised.
