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September 16, 2024
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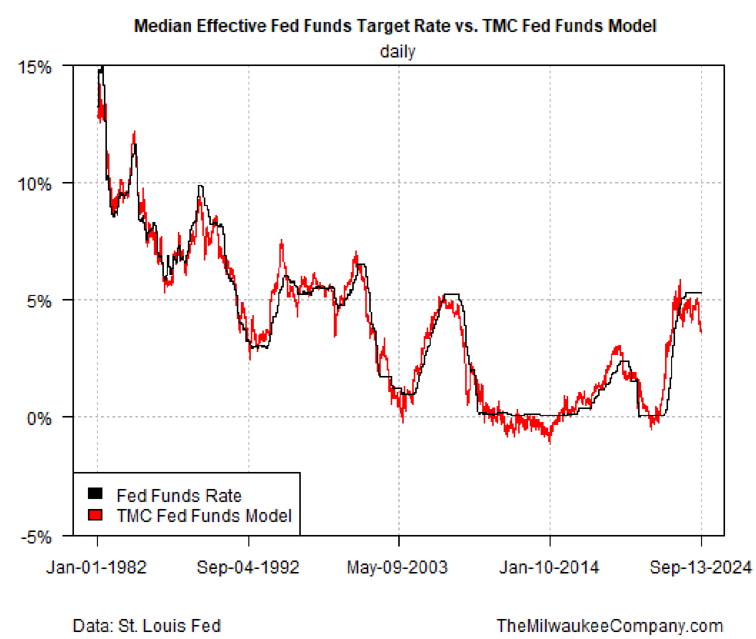
Market Expectations Now Favor A ½-Point Rate Cut At Wednesday's Fed Meeting

Key Points:

- *Fed funds futures are pricing in a roughly 59% probability for a ½-point cut in the target rate at the Federal Reserve's policy meeting on Wednesday, September 18.*
- *TMC Research's Fed funds model continues to show that the current Fed funds target rate exceeds TMC's model estimate by the largest degree since 2008.*
- *The recent shift in market expectations in favor of a ½-point rate cut brings the crowd's view closer in line with the optimal rate indicated by TMC's Fed funds model.*

TMC Research's Fed funds model has been indicating for several months that a larger-than-expected rate cut is reasonable if not likely. Market expectations via Fed funds futures are now embracing the idea, based on changing estimates in recent days.



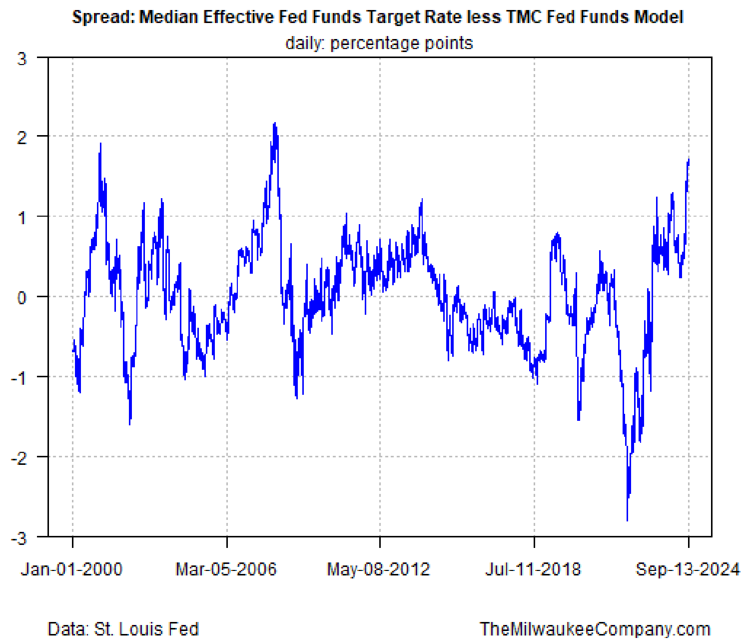
As of mid-afternoon on Monday, Sep. 16, futures are pricing in 59% probability for a 50-basis-points cut vs. a 41% probability for a 25-basis-points cut, based on CME FedWatch data. By contrast, in our Aug. 29 note we noted that futures favored a 25-basis-points reduction.

It's uncertain what the Federal Reserve will decide on Wednesday, but our model has been consistently indicating that the current target rate range (5.25%-5.50%) is excessive relative to current economic and financial conditions (for details on the model, see our July 9 update).

As previously reported, the spread for the current Fed funds target rate less the TMC model estimate has surged to 171 basis points -- the widest level since 2008. As we write, the gap continues to expand. In the days since our Aug. 29 note, the spread has increased 21 basis points.

Taken at face value, our model estimates that the optimal Fed funds rate is currently in the 3.50%-3.75% range – dramatically lower than the current 5.25%-to-5.50% range. Although the model's estimate is extreme compared with current policy conditions, the estimate highlights the potential for a larger rate cut than the market has recently been anticipating.

Although it would be surprising if the Fed cuts more than 50 basis points, a ½-point reduction appears to be the revised consensus view. Why? The primary reason: The data lends support to such a policy change – a view that's been highlighted since July in updates of TMC's Fed funds model.



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