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By **Jason Thomas**
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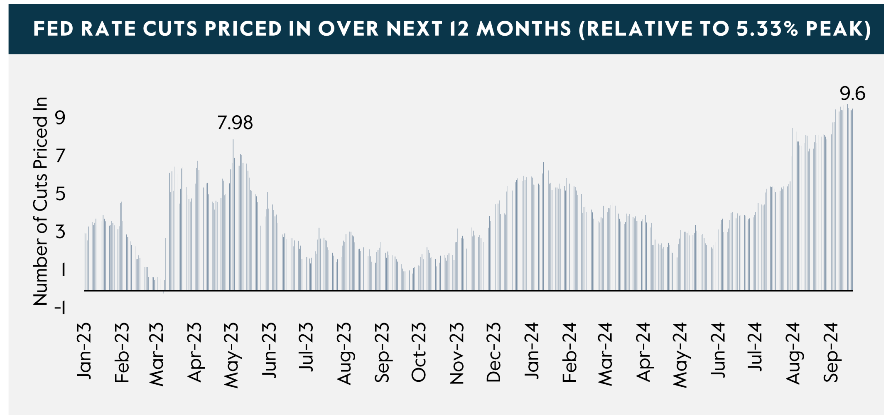
*Welcome back to **The Carlyle Compass**, your weekly newsletter that brings together the latest research and market insights from our global team.*

Overnight interest rates were too high when the Federal Open Market Committee (FOMC) met last Wednesday. And, after a 50-basis point cut, they're still too high today. The 50bps drop in expected inflation over the past six months means short-term real interest rates today are no lower than they were in April.

More cuts are coming. The debate in the lead up to the September meeting was about how to sequence them. Markets seemed to have gotten ahead of themselves, pricing 10 cuts over the next 12 months (Figure 1). The conservative path would have been to cut by 25bps and push back against such enthusiasm (an option preferred by Governor Bowman, who was the first fed governor to cast a dissenting vote at a policy meeting since 2005). Instead, the Fed chose to egg it on.

Figure 1: Leaning into Market Expectations

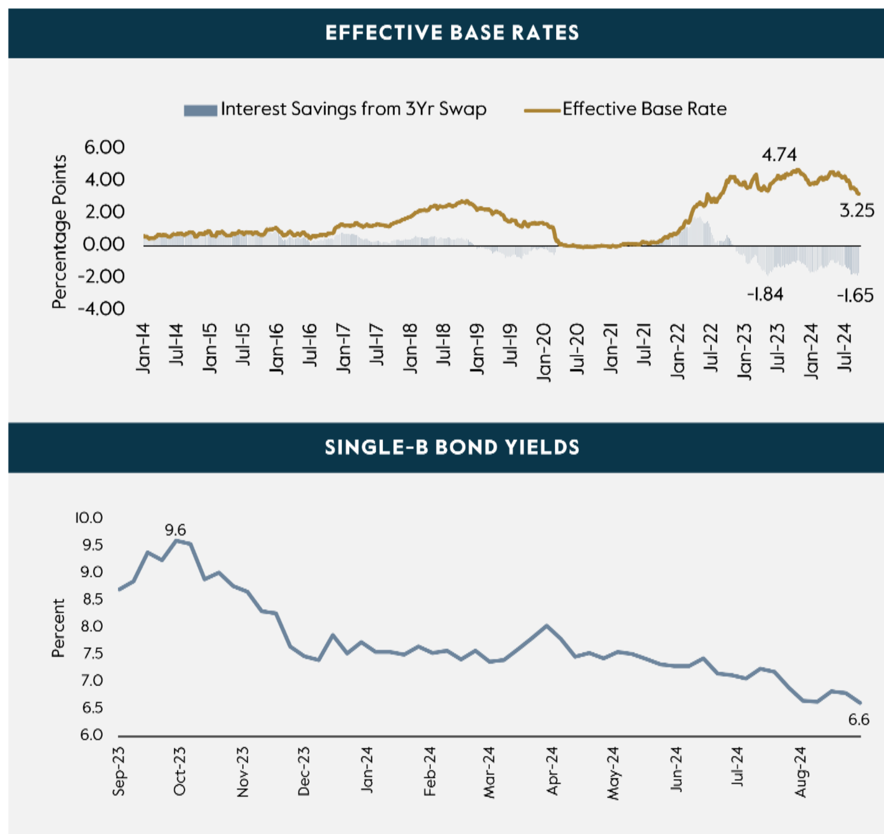


Source: Carlyle Analysis; Bloomberg, September 2024. There is no guarantee any trends will continue.

Outside of crisis, the short-term interest rates administered by central banks tend to adjust slowly. Rather than cut (or hike) all at once to reach the new target, central banks tend to prefer small but persistent changes in base rates over time. This approach allows the market to do most of the work; expectations for future policy changes get capitalized into asset prices today, while preserving the central bank's optionality at those future meetings.

By leaning into the market repricing, the Fed delivered far more easing than could be inferred from money markets. Over the past year, "effective" base rates—the lowest rate at which floating rate borrowers could swap their liabilities over the next three years—have dropped by 150bps—3x the actual easing to date. And when accounting for the tightening of credit spreads over the same period, the yield on single-B corporate bonds has dropped by 300bps—6x the decline in base rates (Figure 2).

Figure 2: Effective Easing

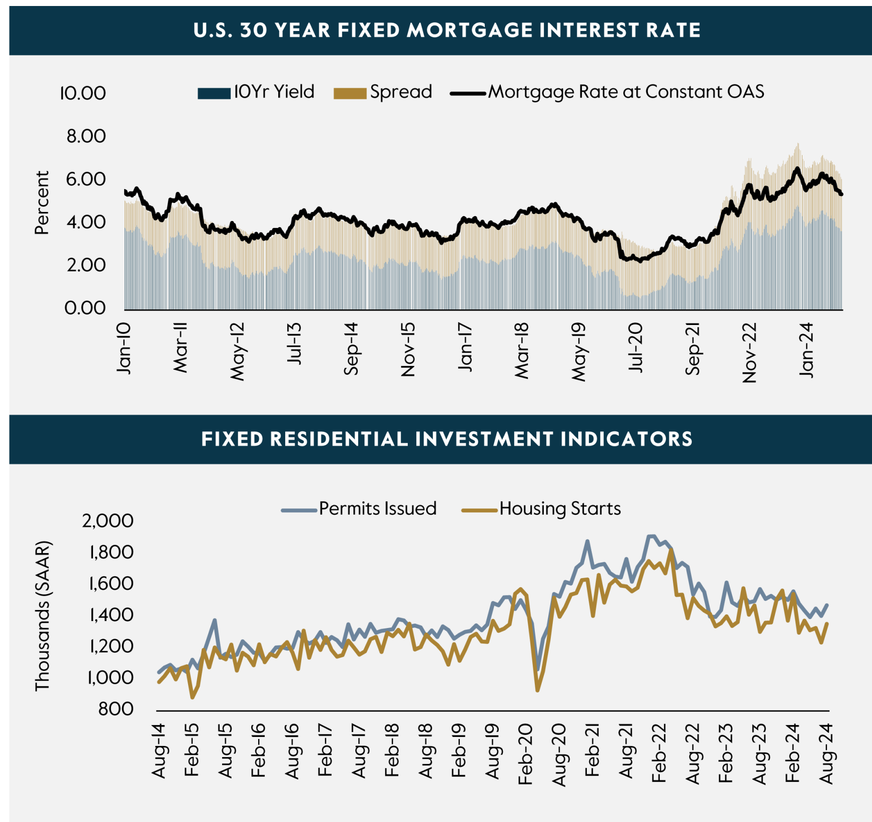


Source: Carlyle Analysis; Federal Reserve, September 2024. There is no guarantee any trends will continue.

Perhaps the most economically consequential easing has been observed in U.S. mortgage

markets. 30-year fixed rates have already declined by 170bps over the past year and could be 225bps lower than October 2023 levels as spreads relative to Treasuries normalize. Mortgage rates of 5.5% to 5.75% could spur a significant pick-up in transaction volumes, fomenting demand for new single and multifamily units. Even after the August rebound, housing starts remain 25% below levels when the Fed started hiking rates (Figure 3).

Figure 3: A Rebounding Residential Real Estate Market



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Schrödinger's Fed

Does the U.S. economy really require easing on this scale? This was a question posed on multiple occasions by investors arriving in the U.S. from Europe and Asia for our annual Global Investor Conference. To their eyes, the U.S. economy seemed to be doing just fine without it.

In the years following the Global Financial Crisis (GFC), the Fed garnered a reputation among some foreign observers as inclined towards exotic experiments and unduly focused on the fortunes of major equity indexes. Staff at other central banks scoffed at the Fed's willingness in 2010 to risk long-term monetary stability by "printing money" to add, under the most favorable assumptions, 0.5% to real GDP growth over the next two years.

The "supersized" cut seemed to rekindle this characterization. After two years of wearing green eye shades, meticulously documenting its progress on inflation, the Fed has once again donned the buccaneer hat. Its message to market participants, entrepreneurs, and management teams seems unambiguous: the worst is over; do your thing.

But before thinking this means the Fed has reverted to dovish form, consider the optionality this creates. By inciting the market to deliver this much effective easing up-front, the Fed may have altered the trajectory of employment and output in ways that make multiple cuts in 2025 unnecessary. And if price pressures should reemerge thanks to a rebound in interest-sensitive sectors like housing, the Fed just demonstrated its willingness to course-correct, delivering tightening on a scale that as of late-2021 would have seemed less probable than alien contact.

This is an institution that defies "dovish" or "hawkish" labels by exhibiting both tendencies simultaneously.

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