## **Bond Blog**

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## **PGIM** FIXED INCOME

# The Fed's Drive Towards Neutral: Slowed, but not Stopped

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The Federal Reserve stayed the course with a 25 bp rate cut on Thursday and a firm reiteration of its intention to remain on a data-determined path towards a neutral rate. Given the recent stability in U.S. data, that path may be more gradual than initially presumed at the outset of the Fed's easing cycle, but Chair Powell clearly laid out the rationale for its continued drive towards neutral. Risk assets firmed on the additional easing in monetary policy, while a partial recovery in long-term rates gained momentum as Powell delivered his remarks.

Politics were clearly on the minds of those attending the Fed's press conference, but Chair Powell focused on the fact that the Fed funds rate remains restrictive and that committee members want to avoid further weakness in the labor market. While some participants continue pointing to the stronger-than-expected September payroll report, that report now appears to be the outlier in terms of labor market conditions (notwithstanding the hurricane-effected October reading). As such, we continue to see signs of further moderation across the Conference Board's Labor Differential, quit and hiring rates, the Fed's Beige Book, and small business hiring.

With Powell squarely focused on labor, the combination of an inflation rate now in the realm of the Fed's target means it can easily justify further cuts. Although uncertainty abounds, the Fed's year-end 2025 forecast for a Fed funds rate of 3.5% is still a useful starting point for where this cycle is going. Of course, as Powell suggested, neutral Fed funds is difficult to identify with any significant degree of precision, so patience is warranted when approaching that zone.

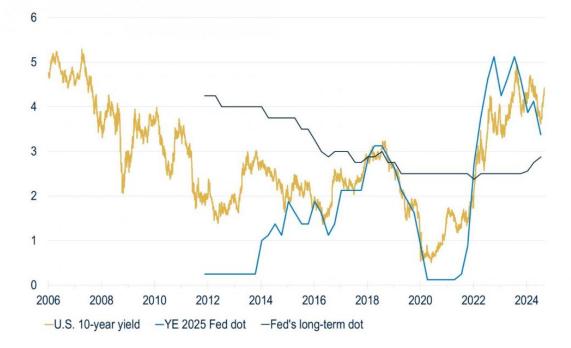
Indeed, the need for patience is another takeaway from today's meeting. On balance, recent data have been relatively solid, particularly the sizable upward revisions to incomes (when the saving rate was revised from 3% to 5%). We think the improved saving levels help establish a floor under economic activity. Hence, the Fed can continue driving towards neutral in order to preserve as much strength in the labor market as it can, but it may do so with reduced urgency. In general, it might be considered a comfortable policy position for the Fed.

As for the Presidential election results, Powell indicated that nothing changes as it relates to the immediate view on the economic backdrop or the Fed's monetary policy stance. He added that the new administration's policy initiatives could alter that backdrop over time, but that the Fed will address those as they become apparent.

#### Market Outlook: Uncertain? Sure, but not Bad...

With the Fed's course likely slowed, but by no means stopped, where does that leave the bond market outlook? As for the stronger economic data released since the September meeting, the markets appear to have adjusted accordingly (Figure). As a result, they may have priced in the firmer data and then some, leaving yields at what are likely to be attractive levels going forward.

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### FIGURE 1: U.S. 10-year yields are high and well above the Fed's year-end 2025 & long-term dots, suggesting Treasuries are well positioned for strong performance over the intermediate term. (%)

Source: Bloomberg.

As for credit spreads, they extended their bull market rally subsequent to the U.S. election results, leaving spreads at levels that can best be described as fully valued from a historical perspective. Although this leaves spreads vulnerable to short-term setbacks, fundamentals remain firm, as does net demand for fixed income. This combination of factors suggests that spreads may remain range bound near historic tights for some time to come.

So, while the environment is undoubtedly uncertain, yields are nonetheless back up at levels that (prior to COVID) hadn't been seen since before the GFC. In addition, central banks are in all likelihood past their respective cycle peaks, setting the market up—intermittent volatility notwithstanding—for a continuation of the bull market that began in late 2022.

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