Our US Macro Perspectives report covers our views on the US economy and the Fed. It features probability forecasts for key macro drivers, and a rigorous assessment of how shifts in macro regimes shape the Fed policy and Treasury yield outlook.

January 9, 2025

Out of consensus: The case for lower rates

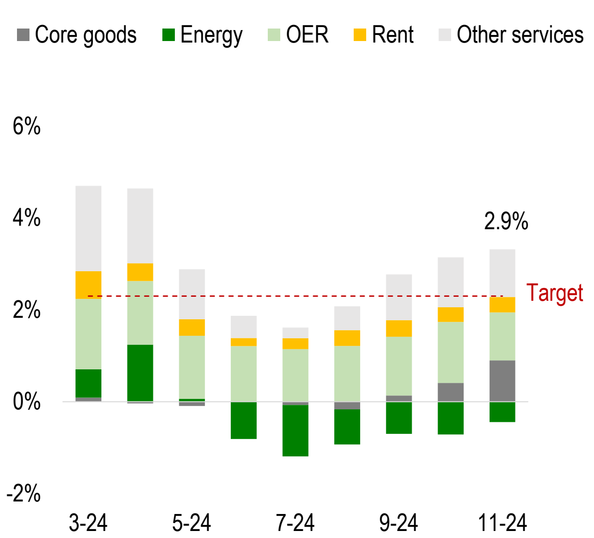
The dot plot revenge – The FOMC's last meeting of the year sent shockwaves across markets as the Fed adopted a decisively more hawkish stance. As was widely expected, the Fed cut rates by an additional 25 bps. But what rocked sentiment was a change in guidance, with the Board now anticipating two less cuts in 2025 in their 'dot plot' outlook.

Underlying this change in view are expectations of higher inflation and stronger activity. The most noticeable change was a 40 bps revision to the PCE inflation outlook to 2.5% (T1). This, in turn, reflects both a pick-up in pricing pressures in recent months (F1), and uncertainty over the impact of Trump's policies on the inflation outlook.

This hawkish shift led to an immediate market sell-off, and a further repricing of rate expectations. Following Fed guidance, markets are pricing six cuts over a 2-year span, well below the average of past easing cycles (F2). In fact, the only times the Fed cut by less since the 80s was in 1995 and 1998, the classic examples of a 'soft landing'.

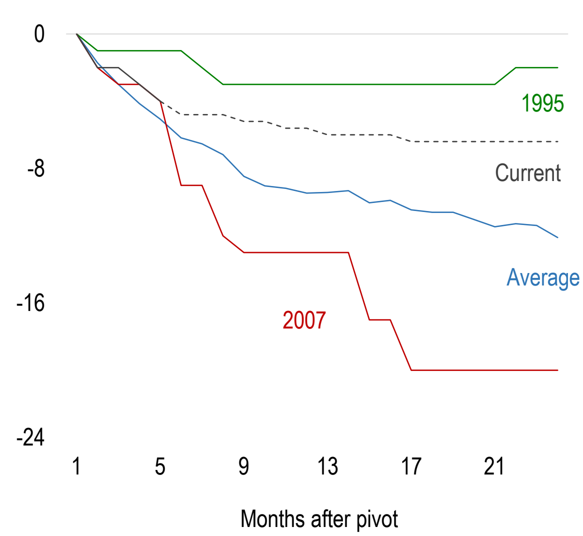
Table of Contents

F1: Pricing pressures resurfaced in Q4
CPI inflation by component (3-month run rate)



Note: Bars break contribution of selected goods and services to the 3-month average on annualized CPI inflation. Source: BLS; Numera calculations.

F2: Markets expect limited policy support
Rate cuts during Fed easing cycles (1984+)



Note: Chart tracks number of cuts in the two years following a pivot since 1984. Dotted grey line shows current market expectations. Source: Numera Analytics.

T1: FOMC guidance	Summary of economic projections (SEP):				
2025 projections by release	Q4/23	Q1/24	Q2/24	Q3/24	Q4/24
PCE inflation	*2.1%*	*2.2%*	*2.3%*	*2.1%*	*2.5%*
Fed funds rate	*3.6%*	*3.9%*	*4.1%*	*3.4%*	*3.9%*
Neutral rate	*2.5%*	*2.6%*	*2.8%*	*2.9%*	*3.0%*

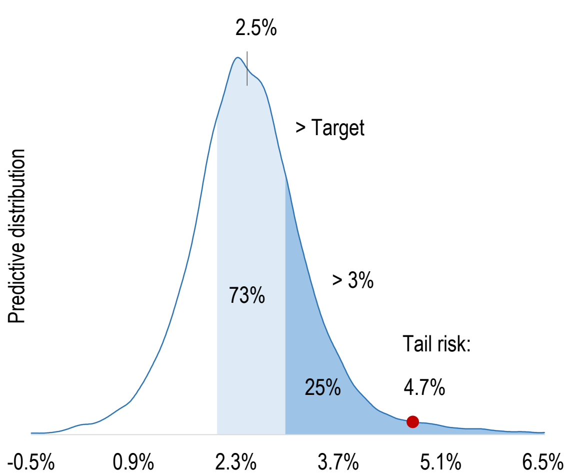
Note: Chart tracks the FOMC's inflation outlook and policy rate guidance for 2025, and its neutral rate estimate by release date. The Fed funds outlook is the consensus for 'appropriate' monetary policy by year-end. Source: Federal Reserve.

Of course, the fact that the Fed is signaling limited easing next year does not mean these predictions will materialize. This is particularly evident when macro conditions diverge from expectations. For example, in late 2021 the Board signaled three 25 bps hikes in 2022, expecting inflation to ease. However, overheating resulted in 17 (!) hikes.

In understanding the interest rate outlook, it is therefore crucial to assess whether the Fed and the market are properly assessing macro risks. Like the FOMC, investors and Wall Street economists expect inflation to remain contained. The Philadelphia Fed's SPF survey provides additional insight, by offering probability ranges. In their Q4 Survey, forecasters reported an 80% chance that inflation would exceed 2% in 2025, but only a 16% of 3%+ inflation.

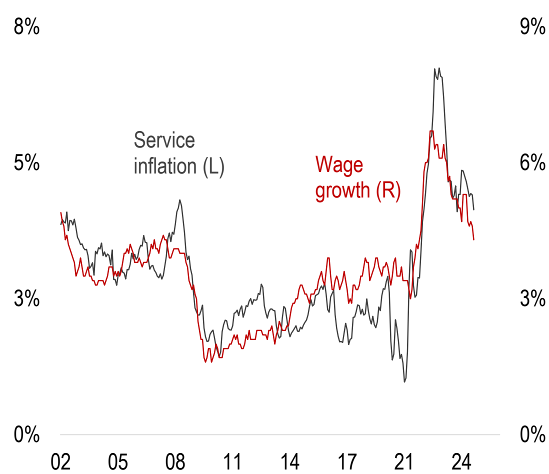
F5 shows our own inflation outlook. The results stem from our extensively back-tested model, with significant accuracy gains over competing frameworks over the past six decades. The most likely outcome is very close to market expectations at 2.5%, with a 73% probability of 2%+ inflation and a 22% chance of a 3%+ jump in CPI. As long as our framework has no major blind spots, this would suggest the market today is properly assessing inflation risks.

F3: Inflation should slightly exceed target
CPI inflation - 2025 probability forecast



Note: There is a 58% probability that inflation exceeds 2% for the year, and a 22% chance that inflation averages mor than 3%. The worst potential outcome would be an inflation rate of 4.7%. Source: Numera Analytics.

F4: Cooling job market limits inflation risk
Service ex. shelter inflation vs. wage growth

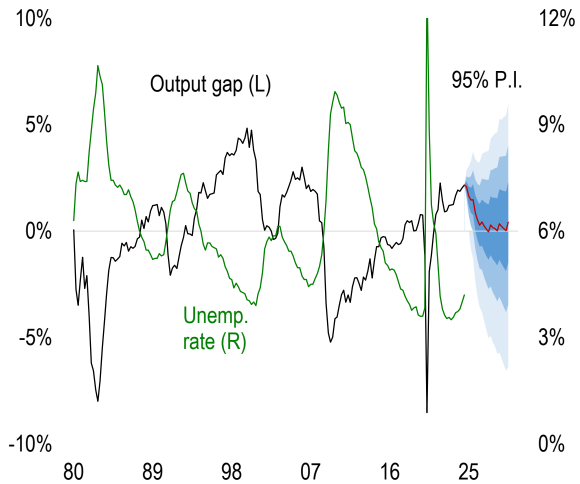


Note: Chart compares YoY inflation in CPI services (ex. shelter) against median wage growth. Source: BLS, Atlanta Fed; Numera calculations.

One important factor limiting the likelihood of a surge in inflation is the normalization of job market conditions. While layoffs remain low, there is no longer excess demand for workers, which has eased wage pressures. Leading indicators like a falling quit rate point to even weaker wages next year, which should lower core service inflation (F4).

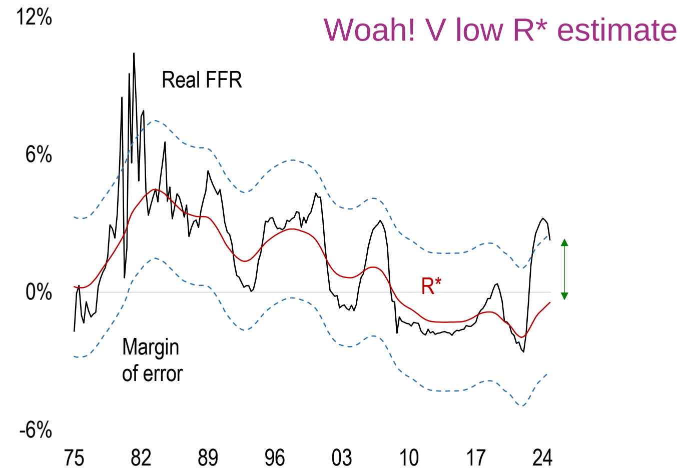
Another crucial aspect is the evolution of shelter inflation. As we described in our year-end report, owners' equivalent rent (OER) alone accounted for half of the increase in CPI last year. OER indirectly reflects homeowner costs, so falling real mortgage and principal interest payments points to weaker shelter inflation next year.

F5: Unemployment should continue to rise
Output gap vs. unemployment rate



Note: Chart compares the historical and projected output gap to the headline unemployment rate. Source: Numera Analytics, BLS.

F6: Fed policy is still highly contractionary
Real Fed funds rate vs. neutral (R*) estimate



Note: The real Fed funds rate is the difference between policy rates and 1-year inflation expectations. The neutral rate is the real interest rate that is consistent with full employment and stable inflation. Source: Numera Analytics.

What about unemployment? In a late cycle, the Fed stance depends mainly on macro conditions. The Fed's hawkish signal reflects bullish growth perceptions, leading them to expect no change in the unemployment rate in 2025 – a view shared by the market. This is where our view deviates significantly from consensus. As we can see in F5, we expect cyclical conditions to weaken in 2025-26, as consumers and businesses run out of sources of support.

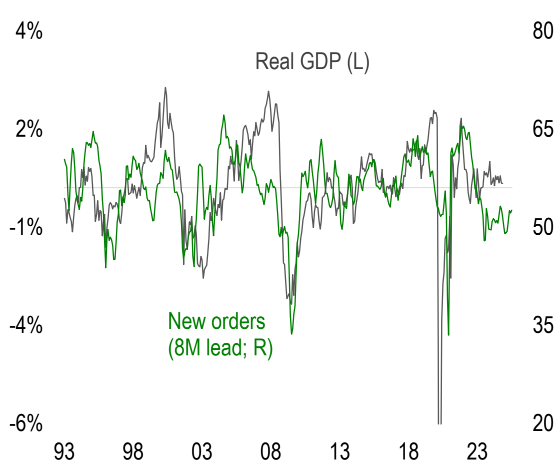
If growth disappoints and layoffs rise, this increases the incentive to cut. This is particularly true considering Fed policy remains highly contractionary. We can see this in F6, which plots real policy rates to our estimate of the US 'neutral' rate of interest (i.e. the rate consistent with full employment and trend inflation). While the neutral rate rose in 2023 and 2024 in response to higher productivity, the interest gap is very high by historical standards.

To be sure, the neutral estimate carries significant uncertainty, but it does suggests that the Fed has plenty of room to maneuver before it fuels inflation. This has key implications for the interest rate outlook. If inflation stays contained and unemployment rises, this translates into a very high probability of further Fed easing. In particular, our models point to 4+ cuts this year, with an 81% chance that the FOMC cuts rates by more than they and markets anticipate.

T2: US macro drivers Growth rates (%)	Baseline 2023	2024	2025	2026	2025 probabilities > Trend[1]	> 2024	Tail risk[2]
Real GDP	2.9%	2.8%	1.6%	0.8%	15%	7%	-0.9%
Consumer spending	2.5%	2.7%	1.8%	0.9%	10%	13%	-0.6%
Private investment	2.4%	3.6%	0.6%	-1.1%	17%	7%	-4.8%
Non-farm payrolls	2.3%	1.6%	0.8%	0.0%	40%	14%	-1.4%
Unemployment rate	3.6%	4.0%	4.4%	4.6%	32%	66%	6.6%
Housing starts	-8.4%	-5.4%	-3.3%	0.4%	18%	63%	-18.7%
New home sales	4.5%	2.3%	-1.3%	3.5%	38%	39%	-28.7%
Manufacturing	-0.4%	-0.4%	1.3%	1.0%	85%	88%	-2.3%
Durables	0.2%	-0.9%	1.6%	1.4%	79%	85%	-4.5%
Non-durables	-0.9%	0.1%	0.9%	0.6%	80%	75%	-1.7%
CPI inflation	4.1%	2.9%	2.5%	2.3%	4%	25%	4.7%
Hourly wages	5.0%	4.1%	3.4%	2.5%	1%	10%	2.2%
Housing prices	2.5%	5.1%	4.2%	5.5%	0%	18%	1.9%
US dollar (DXY)	-2.0%	7.0%	-1.0%	-0.8%	32%	5%	-11.2%

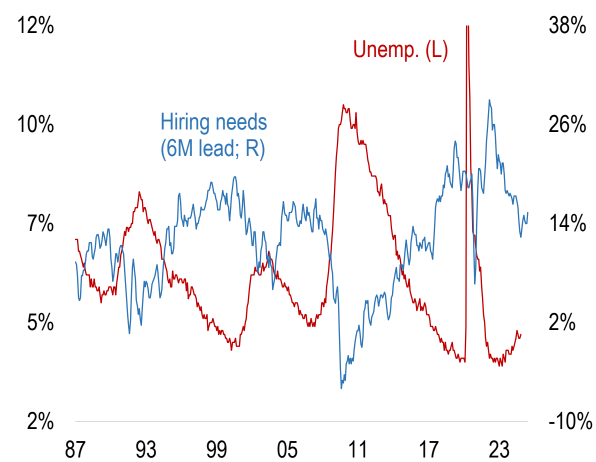
1. Probability that next year's growth exceeds its 5-year average. 2. Tail risk measures potential drawdown, calculated as the expected loss at the 5% quantile. For unemployment and CPI inflation, tail risk is set to the 95% quantile. All forecasts and probabilities, except for the US dollar, are based on full-year averages.

F7: Economic cycle vs. ISM new orders
Deviations from trend and diffusion index



Note: Chart compares cyclical fluctuations in real GDP against 8-month prior changes in the combined ISM manufacturing and service new orders indices. Source: Numera Analytics on BEA, ISM data.

F8: Unemployment rate vs. hiring needs
Share of workforce and of SMEs (%)



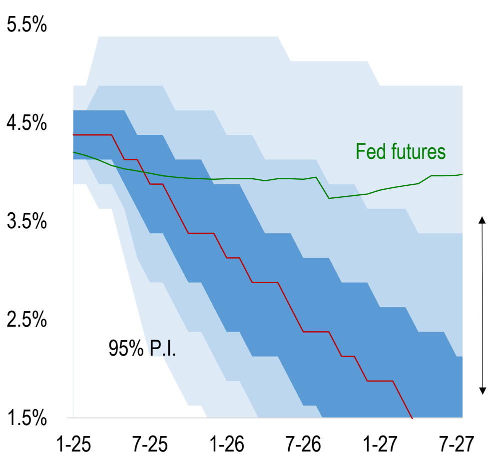
Note: Chart compares the headline unemployment rate against 6-month prior changes in SME hiring needs. Source: BLS, NFIB.

T3: Fed funds rate	Baseline scenario		Probabilities			
bps and probabilities	Numera	Futures	> Futures	-50 bps	-100 bps	-200bps
6M ahead	3.9%	4.0%	39%	61%	30%	4%
12M ahead	3.1%	3.9%	19%	81%	63%	24%
24M ahead	1.9%	3.8%	9%	93%	87%	68%
Dec. 2024	3.4%	3.9%	19%	77%	56%	18%
Dec. 2025	1.9%	3.7%	9%	92%	86%	64%

T4: Treasury market	10-year yields[1]			Yield curve[2]		
Percent and probabilities	Baseline	> Current	Tail risk	Baseline	Steepening	Inversion
6M ahead	4.0%	24%	5.8%	0.7%	77%	8.3%
12M ahead	3.7%	18%	5.9%	0.9%	83%	7.8%
24M ahead	2.9%	10%	5.8%	1.2%	86%	7.8%
Dec. 2024	3.7%	19%	5.9%	0.9%	82%	7.9%
Dec. 2025	3.0%	10%	5.8%	1.2%	86%	7.7%

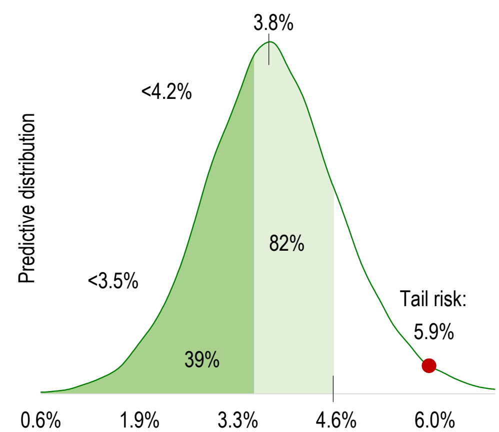
1. The 10Y yield columns show the probability that yields are higher than their current level (4.6%), and the maximum expected yield at the 95% quantile. 2. The yield curve projections show likelihood that the 10Y-2Y term spread steepens and inverts over a given holding period.

F9: Fed funds rate target vs. FFR futures
Baseline and probability forecast, 2025-27



Note: Probability forecast for Fed funds rate target against the January 3th CME Fed funds futures curve. Fan chart denotes 50 / 80 / 95% prediction intervals. Source: Numera Analytics, CME.

F10: 10-year Treasury yield outlook
Probability forecast - 12M ahead (%)



Note: There is a 82% chance that 10Y yields trade below current levels (4.6%) one year from now, and a 39% probability they fall below 3.5%. The most likely outcome is for 10Y yields to fall to 3.8%. Source: Numera Analytics.

Data release calendar:

Economic indicators	Date	2023	YTD	Sep-24	Oct-24	Nov-24	Dec-24
ISM manufacturing *Diffusion index*	3-Jan-25	47.1	48.3	47.2	46.5	48.4	49.3
New orders *Diffusion index*	3-Jan-25	46.0	48.8	46.1	47.1	50.4	52.5
Non-farm payrolls *Δ in 000s workers, SA*	6-Dec-24	251	180	255	36	227	-
Unemployment rate *% workforce, SA*	6-Dec-24	3.6%	4.0%	4.1%	4.1%	4.2%	-
CPI inflation *YoY (%)*	11-Dec-24	4.1%	3.0%	2.4%	2.6%	2.7%	-
Core inflation *YoY (%)*	11-Dec-24	4.8%	3.5%	3.3%	3.3%	3.3%	-
Retail sales *MoM SA (%)*	17-Dec-24	2.4%	2.2%	0.9%	0.4%	0.9%	-
Industrial production *MoM SA (%)*	17-Dec-24	0.2%	-0.4%	-0.5%	-0.4%	-0.1%	-
Housing starts *MoM SA (%)*	18-Dec-24	-8.4%	-3.5%	-1.7%	-3.2%	-1.8%	-
New home sales *MoM SA (%)*	23-Dec-24	4.5%	1.4%	6.5%	-14.8%	5.9%	-
Consumer spending *MoM SA (%)*	20-Dec-24	2.5%	2.8%	0.5%	0.1%	0.3%	-

Sources: ISM, Bureau of Labor Statistics, US Census Bureau, Federal Reserve, Bureau of Economic Analysis.

Data sources:

- **Growth**: Spending: BEA, Labour: BLS; Housing: US Census Bureau; Industry: Federal Reserve
- **Prices**: Inflation and wages: BLS; Housing: S&P Case-Shiller; US dollar: ICE
- **Rates**: Fed funds: Federal Reserve; Yield curve: Department of Treasury

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