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The Neutral Rate
The Fed's Goldilocks Interest Rate

MANAGED FIXED INCOME

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What does a low neutral rate[1] mean for investors?

- As inflation nears the US Federal Reserve's target level of 2%, rate cuts remain on the horizon.
- The neutral interest rate is where monetary policy is neither restrictive nor accommodative. Despite being a short-term rate, it influences interest rates across all fixed income maturities.
- Current market expectations indicate the neutral rate to be around 4%. We estimate the rate to be closer to the Fed's projected level of around 2.5% due to factors such as low trend productivity growth and an aging workforce.
- **A neutral rate which is closer to the Fed's estimate would imply a sustained cycle of the Fed lowering interest rates and material bond price returns.**

Tamping Down Inflation is the Priority, For Now

The timing of when the US Federal Reserve will start lowering its target interest rate has been at the forefront of monetary policy discussions. While the Fed has a dual mandate for monetary policy - full employment and price stability (i.e. low inflation) - inflation has been its primary focus over the past two years. It will likely continue to be the most important variable influencing the timing of a rate reduction. The Personal Consumption Expenditure (PCE) price index, which the Fed views as the best measure of inflation, has fallen from a peak of 7.1% to around 2.7%. However, it may take an extended period of time to achieve 2% - the Fed's target level.

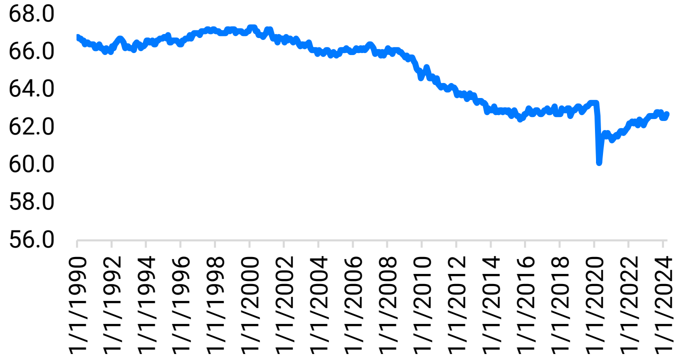
Understanding where the neutral rate will likely be, especially vis-a-vis the market's estimate, can unlock opportunity for fixed income investors.

Going Forward, An Increased Focus on the Neutral Rate

One important aspect of future Fed policy which has not been prominently discussed is its projection of the neutral interest rate.

The neutral interest rate is simply the equilibrium interest rate where monetary policy is neither restrictive nor accommodative – a rate that maintains an economy at full employment alongside stable inflation. Estimating the neutral rate helps the Fed formulate and administer monetary policy with the goal of achieving its dual mandate.

Chart 1. Labor Force Participation



Source: U.S. Bureau of Labor Statistics

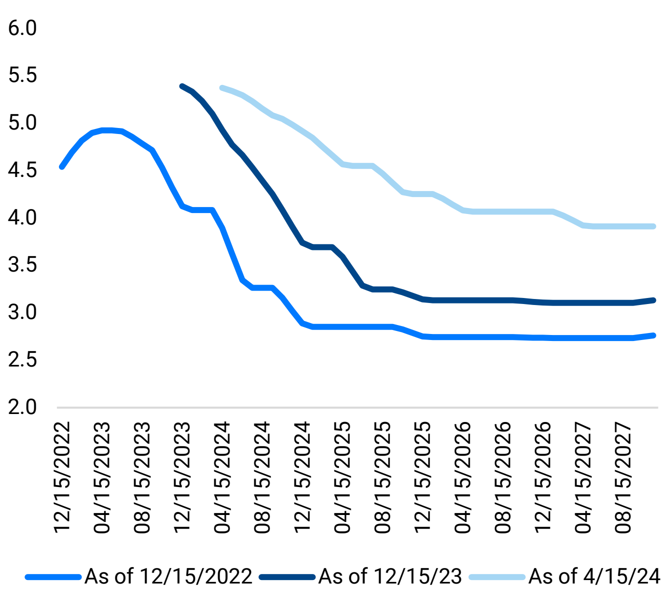
1 "Neutral Rate" refers specifically to the nominal neutral rate which includes inflation

The neutral rate is influenced by multiple factors -- productivity growth and worker demographics being the most relevant today. Productivity has been on a downward trend[2], and while future technologies such as Artificial Intelligence and self-driving cars have the potential to foster a new productivity boom, those effects are more likely to be realized over a longer time horizon. Regarding worker demographics, although an additional one million recent immigrants are estimated to have joined the labor force in 2023[3], the effects of lower labor force participation (Chart 1) due to population aging will continue to weigh on economic growth over the coming years, as growth in hours worked declines. The overriding factors of declining productivity and an aging workforce underpin our belief that the neutral rate level is likely to be lower than the current market expectation of around 4%, and nearer to the Fed's expectation of around 2.5%.

Impact of a Lower Neutral Rate

Market expectations of the ending interest rate level, looking out one to three years from now (Chart 2), are around 4% and have increased over the past year. **A shift of market expectations towards our estimate of 3% would more closely align with the Fed's expectation and likely lead to compelling bond price returns as lower interest rates resonate across the yield curve.** All else being equal, a lower Fed target policy rate would affect the entire yield curve as long-term interest rates reflect the average of expected short-term interest rates plus a risk premium over a specific time horizon.

Chart 2. Market Expectations of Fed Interest Rate Policy



Source: Bloomberg 3-month Forward Overnight Indexed Swap Rate

Our View | Strategy Update

We continue to view the current fixed income environment as closely associated with the rate of inflation and its subsequent effects on interest rates. The declining trajectory of inflation stalled in the first quarter compared to the end of 2023 when it appeared inflation may return to the Fed's 2% target later this year. The acceleration of inflation over the past several months has caused the Fed and the market to re-evaluate the number of interest rate cuts expected in 2024. The market was pricing six cuts while we expected only three given the uncertainty surrounding inflation and a resilient labor market. We have since moved our expectation down further to only two Fed cuts this year. Economic and labor market indicators have remained relatively strong, and the likelihood of recession remains low in the near term.

As a result, now remains an opportune time to consider bonds as investors have an opportunity to capture yield and price returns due to the prospect of lower rates. As such, we view the year-to-date increase in yields as a buying opportunity and remain constructive on corporate credit despite historically low spread levels.

2 U.S. Bureau of Labor Statistics, Nonfarm Business Sector: Labor Productivity (Output per Hour) for All Workers – 3y annualized rate
3 "New immigration estimates help make sense of the pace of employment" by Wendy Edelberg and Tara Watson; https://www.hamiltonproject.org/wp-content/uploads/2024/03/20240307_ImmigrationEmployment_Paper.pdf

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