

December 18, 2024

Fed's monetary policy: We expect three 25 bps cuts in 2025

- The FOMC cut rates by 25 bps, as it was widely expected
- Our model suggests that the terminal rate of the Fed's easing cycle (upper range) could stand at 2%
- We expect three 25 bps cuts on the federal funds rate during 2025

Fed's topics classification using NLP and ML techniques. In July 2022 we published a research note where we described a model using natural language processing (NLP) techniques that classify and interpret FOMC statements. In addition, it also **provides a methodology to confirm whether the communication made by the Central Bank is consistent with the monetary policy implemented** (refer to: [Welcome to the Machine \(Learning\): An NLP framework for analyzing the Fed's monetary policy statements](#)).

The relationship between the Fed funds rate and the semantic classification obtained was also analyzed. In this regard, the most important finding in our research note was the degree of strength in the correlation between the Fed funds rate and the semantic classification obtained, given that the latter can explain 9 out of 10 rate movements. The model also defines the range of variation of the terminal reference rate (refer to Chart 1).

The Fed's semantics allude to a terminal rate of 2% for the easing cycle. The Committee decided to lower the target range for the federal funds rate by 1/4 percentage point to 4.50% (upper bound). Powell showed a significantly more hawkish bias in his speech following the monetary policy announcement. Nevertheless, the model continues to rank the semantics of the statement with the central topic alluding to the tightening monetary cycle of 2023 (Topic 8 in Chart 2). We highlight that this topic has been the dominant one since the Fed began implementing its current tightening monetary cycle in March 2022.

In this regard, the same topic can give us an estimate of the terminal rate for Fed's easing cycle. Taking the 1st quartile for the monetary policy rates included within this topic, we forecast that the upper bound for the terminal rate will stand at 2% (refer to Chart 2).

We expect three 25 bps cuts on the federal funds rate during 2025. We highlight that in today's press conference, Powell was significantly more hawkish than in November's meeting. Nevertheless, he mentioned that economic indicators provided support for the decision to cut the target range. Powell confirmed that the following Committee's decisions will depend on incoming data, the evolving outlook, and the balance of risks. The FOMC will be cautious in recalibrating its monetary policy. However, the economic projections reveal that officials expect inflation to be more persistent next year, as they revised core inflation estimates from 2.1% to 2.5%. In this regard, and considering Powell's more hawkish rhetoric, we expect a slower pace of rate cuts in 2025, and we estimate only three 25 bps cuts on the target range for the federal funds rate.



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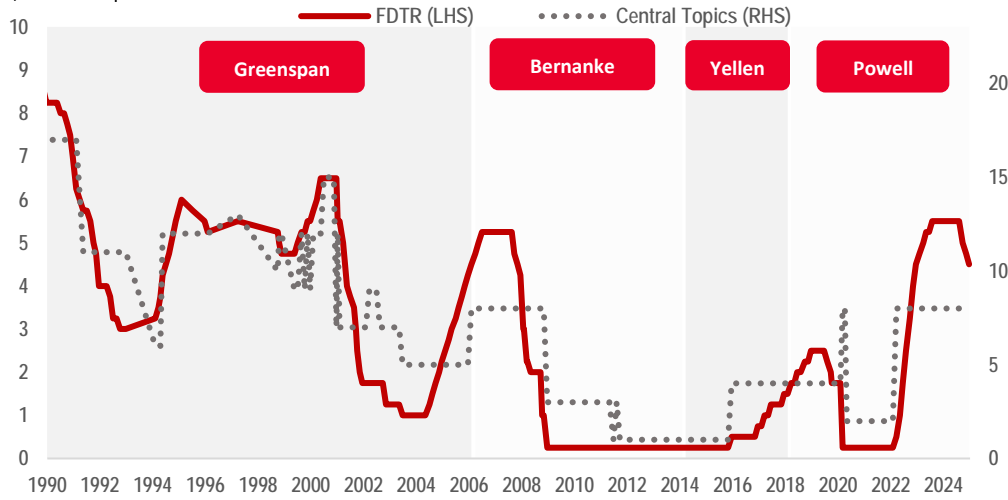
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Winners of the award as the best economic forecasters in Mexico by LSEG in 2023



Chart 1: Banorte's Fed Topic Index vs Fed Funds (upper range)

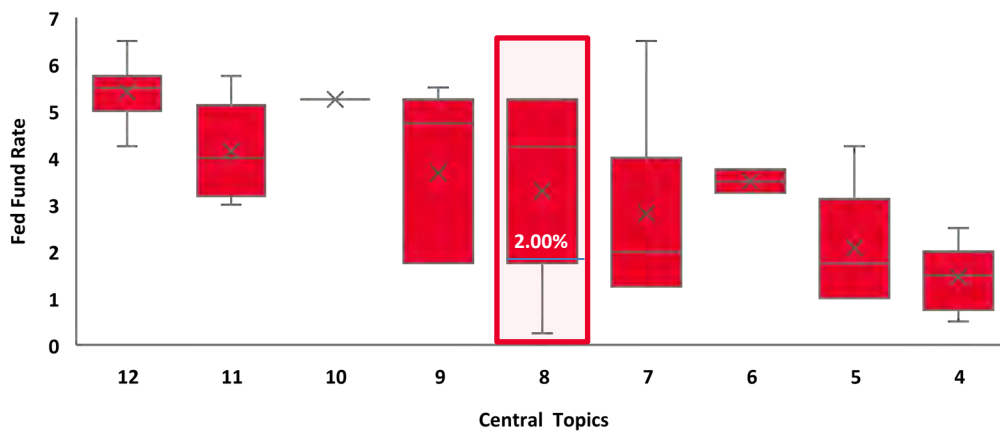
%; Central Topics



Source: Banorte, Federal Reserve

Chart 2: Range of Fed Funds Rate by Topic

Central Topics



Source: Banorte

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