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Federal Reserve Chair Jerome Powell at a news conference on Wednesday. The Fed lowered rates this past week for the first time since December. HU YOUSONG/ XINHUA/ ZUMA PRESS

Investors Bet Rates Will Fall Rapidly

BY SAM GOLDFARB

Wall Street thinks interest rates are poised to come down faster than the Federal Reserve does—a wager that's already boosting the economy and markets by making it cheaper for Americans to borrow.

Bets in the futures market show investors expect that the Fed's benchmark short-term rate will fall just below 3% by the end of next year, from slightly above 4% now, according to LSEG data. That marks a sizable shift from May, when investors thought that rates would fall only to around 3.5% at the end of 2026. *Note*

It is also below what most Fed officials are forecasting. Their latest "dot plot" showed a median expectation that rates end next year at 3.4%—the equivalent of two fewer quarter-point rate cuts than investors are anticipating.

With stocks at record highs, investors are hoping that they can have it all: substantially lower rates without that much risk of a recession. Some warn that they could end up disappointed.

Investors' expectations for short-term interest rates matter because—even more than the current level of rates set by ~~Please turn to page A2~~

the Fed—they dictate borrowing costs across the economy. Bets on rates directly affect U.S. Treasury yields, the recent decline of which has lowered mortgage rates and payments on new corporate debt.

The risk now is that investors have become overly optimistic about rate cuts and that borrowing costs will rebound if the Fed, which just lowered rates this past week for the first time since December, proceeds cautiously from here, pushing traders to a rapid shift in positioning.

"I think the market is getting a little bit excited," Ed Al-Hussainy, a fixed income portfolio manager at Columbia Threadneedle Investments, Fed officials, he added, "are very conservative"—they don't want to overtorque the economy with inflation still lurking in the system."

Investors and Fed officials alike have a decidedly checkered history when it comes to forecasting the path of rates.

Treasury yields also declined before the Fed started lowering rates in September of last year. Investors were more acutely worried about a recession then and expected officials to cut rates aggressively.

Soon after, however, strong jobs data eased recession fears and investors started anticipating fewer cuts. President Trump's election win in November then sparked bets that his policies could lead to higher budget deficits and inflation.

The yield on the 10-year note climbed as high as 4.8% in January from 3.6% in September, even as the fed-funds rate was cumulatively lowered by a full percentage point. *Note*

This time around, the 10-year yield has already come off its recent lows, settling Friday at 4.14%—up from 4.01% earlier in the month.

Still, many investors think that a dramatic divergence between short-term rates and Treasury yields is unlikely. Rates are already lower now, and investors are starting out expecting fewer cuts than last year.

There is also no presidential election coming up, meaning government policy is more settled.

“It is possible that we get maybe a bit of a reversal in the rate market. However, I think the potential magnitude for that type of a move is much smaller than what it was last year,” said Brian Quigley, a senior portfolio manager at Vanguard.

One other factor investors are watching: the unusual circumstances surrounding this cut. *Note*

Trump has been lobbying aggressively for lower rates and doing his best to alter the makeup of the central bank's rate-setting committee.

Trump recently appointed one of his top economic advisers, Stephen Miran, to a 4½-month term on the Fed's board of governors.

He is also trying to remove Fed governor Lisa Cook, a Biden- appointee whom the current administration has accused of mortgage fraud, an allegation Cook denies.

Still, various market gauges suggest that investors don't think that the Fed is cutting rates now for political reasons.

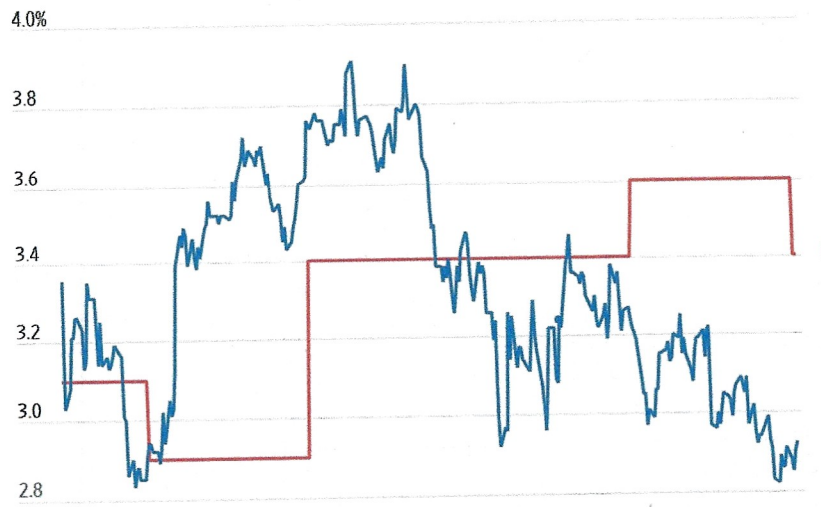
For example, market-based measures of inflation expectations remain in check, indicating that investors don't think that the Fed will cut rates more than is necessary, risking a jump in consumer prices. *Note*

Many investors say that there are good reasons for the Fed to keep cutting rates. Even if the economy avoids a recession, economic growth has already slowed and monthly job gains have fallen sharply, sparking concerns that the unemployment rate could start climbing.

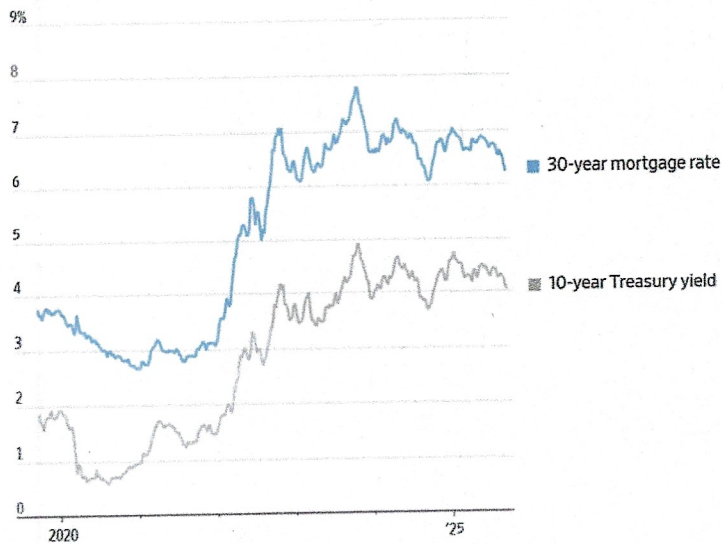
Meanwhile, Trump's tariffs have yet to push up inflation as much as many had feared, and there are signs that underlying inflation pressures are moderating, as prices of services rise more slowly.

“There's clearly risks to the downside in the labor market here,” said Quigly, “and so the likelihood is that the market continues to price in a lower trough rate than what the [Fed] dots are indicating.”

Fed-funds forecast for year-end 2026



Interest rates



Sources: Freddie Mac (mortgage rate); Federal Reserve Bank of St. Louis (10-year yield)

