Fed Watch

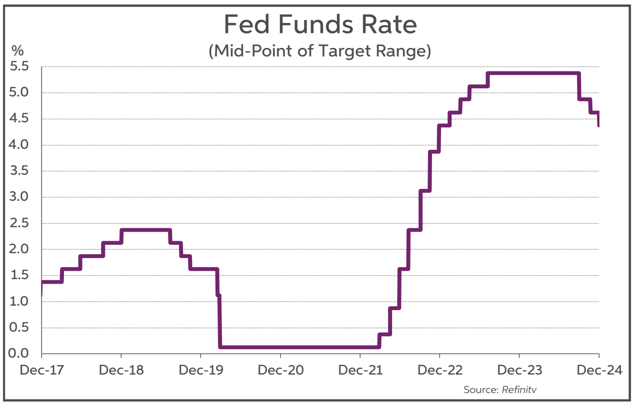
AIB Treasury Economic Research Unit

19th December 2024

Fed cuts by 25bps, hawkish on the outlook

The December meeting of the US Federal Reserve Open Market Committee (FOMC) saw the central bank cut interest rates for the third consecutive meeting. The target range for the Fed funds rate was reduced by 25bps to 4.25-4.50%, with one dissenting member voting for no cut. The decision by the FOMC to cut by 25bps brings the total rate cuts in 2024 to 100bps. Markets were teed up for a rate cut, but Chair Powell's comments were perceived as more hawkish than expected, leading to a sell-off in US equities, a hardening in rate futures, and a further rise in the dollar.

The FOMC statement in December contained a minimal, but material change from recent statements. In outlining the rationale for the further policy adjustments, the committee added the precursor phrase of "the extent and timing". This phrase in effect raises the bar for further rate cuts in 2025, and this was reflected in the interest rate dot plot also, with members pencilling in just two 25bps rate cuts next year.

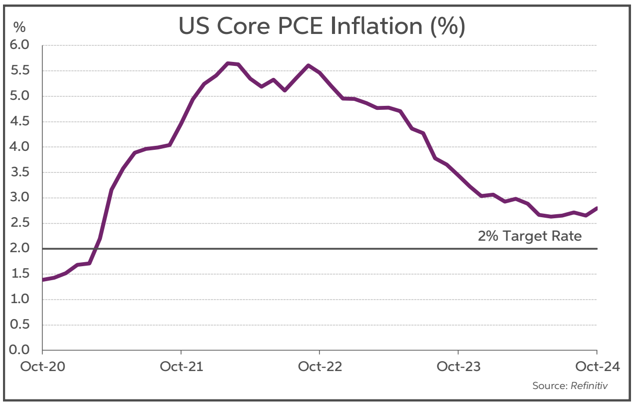


In the post-meeting press conference, Chair Powell elaborated further on the FOMC's decision. He stated that the decision "was a closer call" while also saying "it's a new phase, and we're going to be cautious about further rate cuts". The updated economic projections from the Fed were consistent with this view. The unemployment rate for end-2024 was revised lower to 4.2% (from 4.4% in Sept) and is seen at 4.3% through 2025 (from 4.3%), before remaining at that level in 2026 and 2027. Meanwhile, core-PCE, the Fed's preferred inflation gauge, is forecast to fall to 2.8% by end year (was 2.6%) and is projected at 2.5% in Q4'25 (was 2.2%). It now expects core inflation to be above target at 2.2% (was 2%) by end-2026. The Fed's GDP forecast for Q4'24 was revised higher to 2.5% y/y (from 2%), while it continues to expect the economy will grow at a c.2% rate over the remainder of its forecast horizon, easing to 1.8% in the long run.

On the impact of the incoming President on monetary policy, it appears some FOMC members may now be factoring in the potential for higher inflation in the near term, a fact eluded to by Powell in his remarks. Of the 19 voting members on the FOMC, 15 judged the risks to the inflation outlook to be tilted to the upside, compared to just three in September. This shift in outlook also likely reflects the succession of sticky core inflation points in recent months.

The updated interest rate projections (i.e. dot plot) from the Fed reinforces this view of a gradual pace of rate cuts, albeit there continues to be a relatively wide dispersion of views among FOMC members on the issue. The median projection is that rates will decline to a 3.75-4.0% range by end-2025. In other words, a further 50bps of rate cuts next year, compared to a previous projection of 100bps of rate cuts. Rates are seen as being cut by a further 50bps in 2026 and by c.25bps in 2027, falling to a 3.0-3.25% range. The FOMC is now projecting 150bps in cumulative easing to get to a 3% long-run rate, a similar end point to September, but with a much shallower trajectory to get there.

US futures contracts hardened markedly in the aftermath of the meeting. Current pricing is for just 35bps worth of rate cuts next year compared to c.50bps before the meeting. US Treasury yields rose sharply by 10-15bps along the curve, while equity markets nose-dived, with the S&P down by 2.9% on the day. The dollar was also higher on the day, although it has given back some of its initial gains.



In the near term, the Fed has now signalled a pause until at least its March 2025 meeting, given the greater uncertainty on the medium term path of monetary policy and the potential for significant changes in US trade and fiscal policy next year. In the information vacuum left by the dropping of forward guidance, a data-dependent Fed is likely to yield further event risk and market volatility in 2025.

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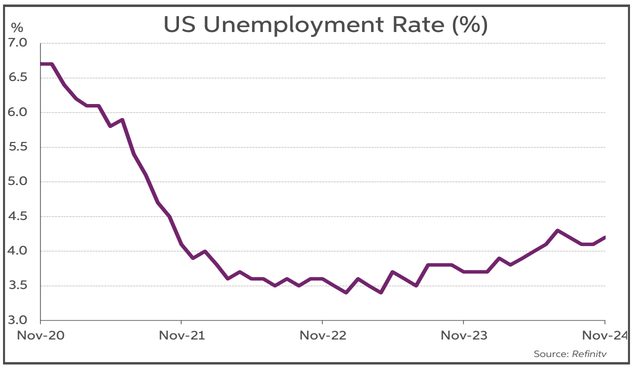
US economy maintains strong growth in 2024

The US economy has continued to perform very strongly in 2024. GDP expanded by 1.6% annualised in Q1, with growth accelerating to 3.0% and 2.8% annualised, respectively, in Q2 and Q3. Regarding the underlying breakdown of GDP in Q3, consumption and a sharp increase in government spending were the main drivers of growth. The former added a hefty 2.4 percentage points (p.p.) to GDP, while the latter contributed 0.8 p.p. to the total. Elsewhere, a solid increase in the non-residential category was once again undercut by a decline in residential activity, meaning investment added a meagre 0.3 p.p. to output. Imports continued to grow at a faster pace than exports, resulting in net trade knocking 0.6 p.p. from growth. Changes in inventories clipped 0.1 p.p. from GDP.

Meanwhile, the data so far in Q4 indicate the economy maintains good momentum, although pockets of weakness are also apparent. In terms of the available hard data, headline retail sales rose by 0.5% m/m and 0.7% m/m in October and November, respectively, although the control group measure has been somewhat softer. It contracted by 0.1% m/m before rebounding by 0.4% m/m over the same period. However, industrial production has performed relatively poorly in the quarter. Output continued to fall, declining by a cumulative 0.6% in the opening two months of Q4. **Elsewhere, survey data indicate that the services sector continues to outperform, with both the PMI and the non-manufacturing ISM firmly in expansion mode.** In contrast, manufacturing remains weak, with the sector PMI and ISM both staying in contraction mode in October and November. The flash manufacturing PMI deteriorated further in December also. At the same time, consumer sentiment has improved in the final quarter of the year, with both the Michigan and the Conference Board indices trending higher.

In terms of the labour market, conditions have softened, albeit the data have been somewhat volatile. The unemployment rate was at 4.2% in November, having oscillated between 4.1-4.3% since June. This compares to a range of 3.7-3.9% in Q1. Meanwhile, the pace of payroll expansion has slowed, averaging 148k and 159k per month, in Q2 and Q3, compared to 267k per month in Q1. Furthermore, payrolls have risen by just 132k per month so far in Q4, amid disruptions from storms and industrial action. At the same time, there are signs that labour demand is waning. The number of job openings stood at 7.7m in October, down from 8.7m at the start of the year. Amid the softening in labour demand, average earnings growth has slowed but remains elevated. It printed at +4.0% y/y in October and November, up from +3.9% in September, but below the +4.4% rate registered in January.

Like-wise, the inflation data have been somewhat noisy in recent months. Headline CPI inflation had been trending lower, before it rose to 2.6% in October and to 2.7% in November. Meantime, having slowly dissipated in the first seven months of the year, to a low of 3.2% in July and August, core-CPI rose to 3.3% in September and stayed at this rate in October and November. Similarly, core-PCE had been falling slowly, inching down to 2.6% in June, its lowest level since March 2021. However, it rose to 2.7% in July and remained at that level in Q3, before rising to 2.8% in October.



To summarise, the US economy came into 2024 in rude health, on the back of strong growth, a tight labour market and falling inflation last year. Furthermore, the economy has maintained strong growth momentum in the first three quarters of the year. However, amid a clear softening in the labour market (notwithstanding the volatility in the data), and slowly waning inflation, the Fed has cut rates by 100bps in 2024. **Against this backdrop, the IMF expects US GDP to expand by 2.8% this year and by 2.2% in 2025.** It should be noted though, that the unemployment rate remains low, disinflation has lost steam in recent months, and monetary policy is still tight. This suggests the Fed will have to proceed cautiously in setting rates in 2025. Longer-term there remains a level of uncertainty surrounding the US economic outlook. President-elect Trump has proposed a number of policies (tax cuts, restricted immigration, trade tariffs) which are likely to add significantly to an already yawning fiscal deficit, and to inflation. The policies may also restrict the level of rate cuts from the Fed.

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