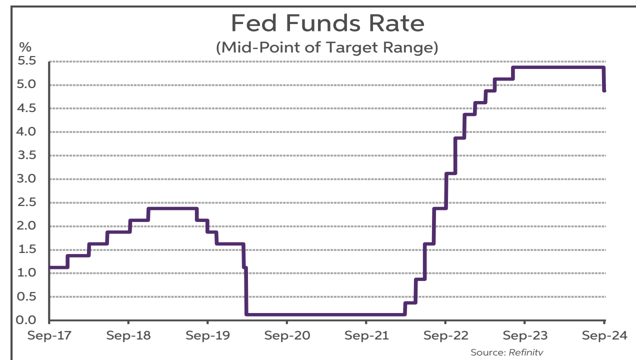
Fed Watch

AIB Treasury Economic Research Unit

19th September 2024

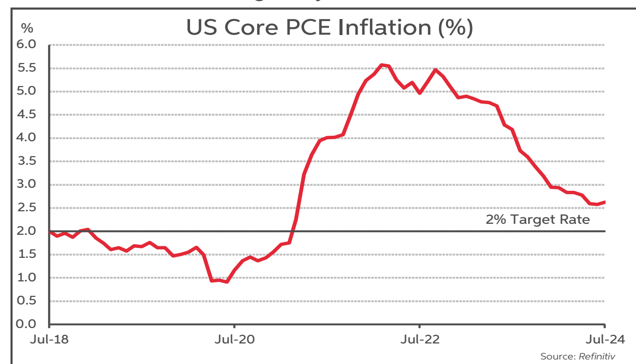
Fed cuts by 50bps but emphasises this is not a "preset course"

The September meeting of the US Federal Reserve Open Market Committee (FOMC) saw the central bank cut interest rates for the first time since 2020. The target range for the Fed funds rate was reduced by 50bps to 4.75-5.00%. It marks the first rate change from the Fed in nine meetings. The decision by the FOMC to cut rates by 50bps was not unanimous, with one member (Bowman) preferring a 25bps reduction. Markets were fully teed up for a rate cut. However, the 50bps was somewhat of a surprise, with uncertainty in the lead up to the meeting as whether it would be 25bps or 50bps. Prior to the meeting the market had assigned around a 60% probability to a 50bps reduction.



The FOMC statement outlined the rationale for the decision to cut rates in the context of its dual mandate (i.e. maximum employment and stable prices). It noted that job growth has "slowed" and the "unemployment rate has moved up", while at the same time, "inflation has made further progress" towards its 2% target. It was satisfied to cut rates at this point, as the FOMC has "gained greater confidence that inflation is moving sustainably" to its target and the risks to each of its two mandates are "roughly in balance". The FOMC now states that it is "strongly committed to supporting maximum employment and returning inflation to its 2% objective". In its previous statement from July, the FOMC only referenced inflation in this context.

In the post-meeting press conference, Fed Chair Powell elaborated further on the FOMC's decision. He stated that the "upside risks to inflation have diminished" while the "downside risks to employment have increased" and that the FOMC concluded "this was the right thing for the economy". The updated economic projections from the Fed were consistent with this view. The unemployment rate for the end of 2024 was revised higher to 4.4% (from 4.0%) and is seen remaining at this level through 2025, before edging down to 4.3% by Q4'26 and to 4.2% by end 2027. Meanwhile, core-PCE, the Fed's preferred inflation gauge, is now forecast to fall to 2.6% by end year (was 2.8%) and is projected at 2.2% in Q4'25 (was 2.3%). It continues to expect core inflation to be at its 2% target by end 2026. The Fed's GDP forecast for Q4'24 was revised down marginally to +2.0% y/y (from 2.1%), while it continues to anticipate the economy to grow at a 2% rate over the remainder of its forecast horizon.



However, Chair Powell was keen to downplay the prospects that the Fed would continue to cut rates at a 50bps clip. He emphasised that policy is not on a "preset course", commenting that "I do not think that anyone should look at that (50bps) and say this is the new pace". Instead he reiterated that the Fed would make its policy decisions "meeting-by-meeting, based on the incoming data, the evolving outlook" and "the balance of risks".

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 4.25-4.50% range by year end. In other words, a further 50bps of rate cuts over its remaining two meetings of 2024 (Nov 7th and Dec 18th). Rates are seen being cut by a further 100bps in 2025 and by 50bps in 2026, falling to a 2.75-3.00% range. The Fed is now projecting 250bps in cumulative easing, which compares to 225bps in the June 'dots'.

Futures contracts softened by around 10bps in the aftermath of the Fed meeting. The market expects a more aggressive pace of rate cuts over the next 15 months compared to the Fed. However, the market and Fed are more aligned on where rates will fall to. The market envisages rates falling to 4-4.25% by end year and to reach their trough around 2.75-3.00% by end 2025. **In the near term, a further 50bps of rate cuts by year end seems a reasonable expectation, assuming a gradual softening in US labour market conditions, rather than a significant downturn.**

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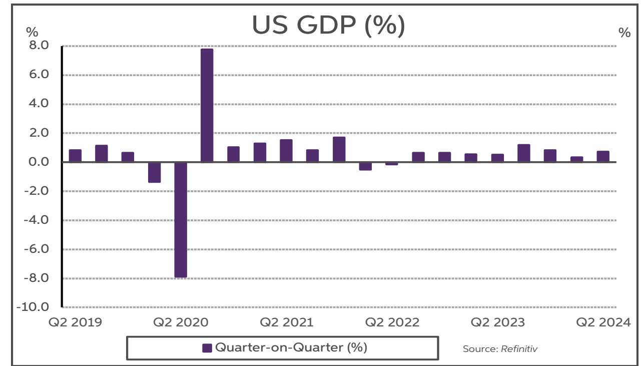
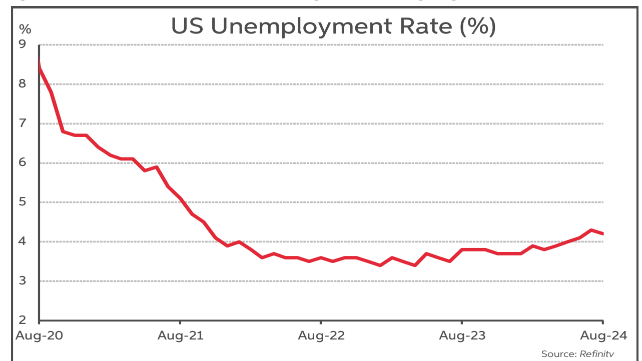
US labour market softens and inflation continues to slow

Having expanded by 1.4% annualised in Q1, US GDP growth accelerated sharply to +3.0% in Q2. Regarding the underlying breakdown of GDP, consumption, non-residential investment and favourable movements in inventories were the main drivers of growth. Consumption rose by a 2.9% annualised pace, adding 2.0 percentage points (p.p.) to GDP. Similarly, investment rose by 3.0%, led by the aforementioned non-residential category (residential investment declined by 2.0%), contributing 0.5 p.p. to the total. Government expenditure increased by 2.7%, boosting output by 0.5 p.p.. Meantime, imports grew at a rate over four-times faster than exports, meaning net trade knocked 0.8 p.p. from growth. However, this was offset by a 0.8 p.p. contribution from inventories.



The available hard data have been mixed so far in Q3. Retail sales expanded sharply by 1.1% in July, before rising by 0.1% in August. At the same time, the control group measure - a key underlying sales metric - rose by 0.4% in July and by 0.4% in August. Meanwhile, industrial production fell by 0.9% in July but rebounded by 0.8% in August. Overall, industrial output was flat in year-on-year terms. **Survey data have also been signalling differing messages on the health of the US economy.** As has been the case for a number of months, the services sector is outperforming manufacturing. The services PMI has printed well in expansion mode so far in Q3, at 55.0 and 55.7 in July and August, respectively. In contrast, the manufacturing PMI dipped below the key 50 level, falling to 49.6 in July, and deteriorating to 47.9 in August. In terms of some other survey indicators, the University of Michigan measure has steadily improved throughout Q3. Likewise, the Conference Board metric rose in July and August.

Meantime, labour market conditions have softened. The unemployment rate has been trending higher since January, albeit this is partly due to an increase in the size of the labour force. Nevertheless, it rose to 4.3% in July, before edging back to 4.2% in August. Meanwhile, the pace of payroll expansion has slowed, averaging +116k per month in the 3 months to August, down from an average of 225k per month in the first five months of the year. Furthermore, the number of job openings has declined to below 7.7m, down from 8.8m at the end of 2023 and well below the 11m total at the end of 2022. Amid the softening in labour demand, average earnings growth slowed to +3.8% y/y in June, down from +4.4% y/y in January.



In terms of inflation, a disinflationary trend has reasserted itself in recent months. In the first quarter of the year, price pressures were somewhat sticky, with headline CPI inflation rising to 3.5% in March. However, it has fallen since then, printing below 3% in July, before nosediving to 2.5% in August. Meantime core-CPI inflation has continued to slowly dissipate, edging lower in 18 of the last 23 months, and declining to 3.2% in July and August. Similarly, core-PCE has been falling slowly, inching down to 2.6% in May, its lowest level since March 2021, and staying at that level in June and July. In its updated projections released at this meeting, the Fed sees core-PCE staying at 2.6% in Q4 of this year, before falling to 2.2% by Q4 2025, and back to 2% in 2026.

To summarise, the economy came into 2024 in rude health, on the back of strong growth, a tight labour market and falling inflation last year. However, there was some loss of momentum in the economy at the start of 2024, reflected in weaker GDP growth and survey data. Furthermore, little progress on the inflation front was made in the early months of the year. **The US economy performed better than anticipated in the second quarter though, with GDP accelerating markedly.** A resumption of the disinflationary trend has also taken place over the summer months. However, the economy may have lost some steam in the third quarter, and there are clear signs that the labour market has softened. The recent downtrend in inflation and the weakening in the labour market has seen the Fed cut rates for the first time in four years, but monetary policy is still tight. Thus, despite markets expecting an aggressive cutting cycle from the Fed, it will be awhile yet before monetary policy is no longer acting as a headwind to growth. Against the backdrop of still tight monetary policy, and a softer jobs market, the Fed sees GDP rising by 2.0% y/y in Q4 2024 and by 2.0% y/y in Q4 2025.

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