

25 July 2024

Research US

Fed preview: Opening the door but not pre-committing

- We expect the Federal Reserve to maintain its monetary policy unchanged next week. Focus will be on upcoming rate cuts, which we expect to begin in September.
- The two latest CPI prints have built significant confidence in inflation remaining en route to target, but with the economy still on a stable footing, we doubt Powell feels the need to pre-commit to rate cuts quite yet.
- We expect the Fed to cut rates twice by 25bp this year, while markets price in a cumulative 64bp of cuts by year-end. We see risks skewed towards modestly higher short-end rates and lower EUR/USD during the press conference.

After Powell and Waller confirmed the Fed feels no urgency to cut rates just ahead of the blackout, markets have mostly priced out any speculation of a rate cut next week. With no new economic and rate projections on the agenda, the meeting's focus will be fully on any communication around the start of rate cuts later in the fall.

We still like our call for quarterly rate cuts starting from September, while markets have swung from pricing only one 25bp cut this year to now pricing a cumulative 64bp by year-end and 142bp over the next year. The Fed could deliver a faster series of cuts if it believes the economy is on a brink of an abrupt slowdown, but we do not believe this is the case today. We list three arguments for why the Fed is likely to opt for a more gradual pace:

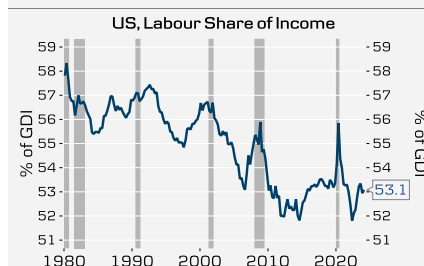
1). **Labour markets are cooling, but not collapsing:** The unemployment rate has risen to 4.1% from the low of 3.4% reached in April 2023, but largely as a result of rebounding labour supply. Number of layoffs remains historically low, because labour costs are not yet pressuring firms' margins, given that that labour share of income remains modest (Chart 1). Labour demand has normalized to pre-pandemic levels, but as long as firms hold on to their existing workforce, this is not a signal of recession to come.

2). **Fiscal policy continues to counteract tight monetary policy:** Bank lending and broader credit growth remain muted, but rapid expansion in public debt continues to counteract the restrictive effect of higher rates (Chart 2). November election outlook will not materially impact the Fed's decision making over the 1-year horizon.

3). **Fixed interest rates limit pressure on firms' margins:** Non-financial corporates' net interest costs remain at post-GFC lows due to fixed-rate financing (Chart 3). High interest rates mean that expanding business is costly, but companies are not struggling with their existing loans for now. When firms are not pressured to cut costs, labour markets remain steady, in turn supporting consumer confidence.

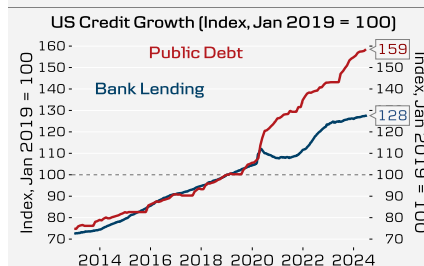
The Fed will have access to the results of Q3 Senior Loan Officer Opinion Survey (SLOOS, due for public release on 5 Aug), which we expect to signal still weak credit demand as real interest rates remain at restrictive levels. We pencil in gradual cooling in both economic activity and inflation towards year-end but do not foresee a recession. As such, we doubt Powell feels the need to pre-commit to rate cuts at this point, which could spark a modestly hawkish reaction in the markets. Any more explicit guidance towards cuts either in the press release or during the press conference would have the opposite effect.

Chart 1: Firms are not under pressure to cut labour costs



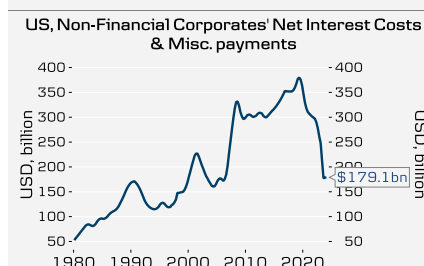
Sources: Macrobond Financial, U. S. BEA

Chart 2: Lending growth has slowed, but public debt pile continues to grow



Sources: The Fed, U. S. Department of Treasury

Chart 3: Firms' interest costs remain at the lowest levels since 2006



Sources: Macrobond Financial, U. S. BEA

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Markets: We continue to favour lower EUR/USD

We think that the dovish repricing of Fed cuts over the summer is overdone, and therefore, we lean towards a slightly hawkish market reaction based on Powell's communication, which could lead to a lower EUR/USD during the press conference. While signs of disinflation are bolstering the Fed's confidence that rate cuts are imminent, there are still two months of data to consider before the September meeting. We expect rate cuts to begin in September, which also seems very likely as a 25bp cut is more than fully priced. However, any setbacks, particularly concerning inflation, pose risks that the 'higher for longer' scenario may continue longer than what the markets have recently priced in. We expect the EUR/USD to move towards 1.03 on a 12M horizon, driven by our expectation of stronger US growth dynamics.

Several key indicators due for release right before and after the meeting

- **Tue 30 July:** June JOLTs Report
- **Wed 31 July:** ADP July Private Sector Employment, Q2 Employment Cost Index, **FOMC Meeting**
- **Thu 1 Aug:** Q2 Prelim. Productivity & Unit Labour Costs, July ISM Manufacturing
- **Fri 2 Aug:** July Jobs Report

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Ad hoc

Date of first publication

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