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FOMC September Meeting Preview

The time has come for US cuts

Written by:

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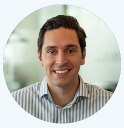
The time has come for US cuts.

The 'time has come' for the Fed to begin its long awaited easing cycle according to chair Powell, but will we see a 25 or 50 basis point rate cut on Wednesday?



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Highlights:

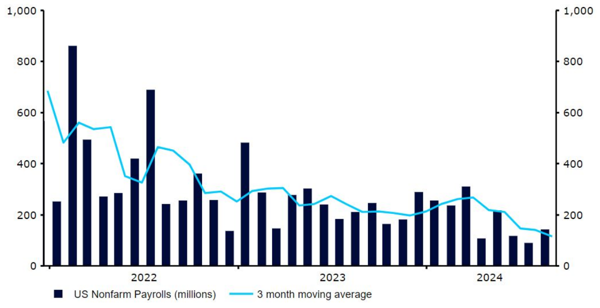
- Fed set to lower rates for first time since 2020.
- We are bracing for a 25bp cut to 5.00-5.25%.
- US labour market cooling, but recession not in sight.
- Downward revision to dot plot seemingly inevitable.
- We think Fed will hint at 3 cuts in 2024, 4 or 5 in 2025.
- Jumbo 50bp cut presents biggest risk to USD.

Federal Reserve officials made clear to markets that cuts were close at the July FOMC meeting. There were a number of dovish tweaks to the statement, with Powell indicating during his press conference that policymakers were taking a more balanced approach towards the dual mandate, and placing a greater emphasis on the state of the jobs market. Since then, we've continued to see signs of a cooling in US labour market conditions, and Powell effectively confirmed that a cut was on the way in September during his appearance at the annual Jackson Hole conference in August.

The big question in markets has not been whether or not the Fed would lower rates this month, but by how much. We have contested all along that calls for a jumbo cut were excessive. While labour market conditions have clearly softened, and inflation made continued progress towards the 2% target, we are not seeing evidence that would point to mass layoffs or a US recession. We also think that the Fed will be wary of triggering a broad market dislocation, as a larger cut would signal to investors that the Fed is not only behind the curve, but sees greater risks to the outlook than it has perhaps previously admitted.

At one stage following the release of the July nonfarm payrolls report, market participants were almost fully pricing in a 50bp cut from the Fed in September. Data released since then appears to have severely reduced this possibility. The August NFP data was a disappointment. The 142k net jobs added last month was less than the 160k consensus, dragging the 3-month moving average to its lowest level since June 2020 (116k). We did, however, see a dichotomy between the household and establishment surveys, as the jobless rate dropped as expected to 4.2%, while annual wage growth accelerated again to 3.8%.

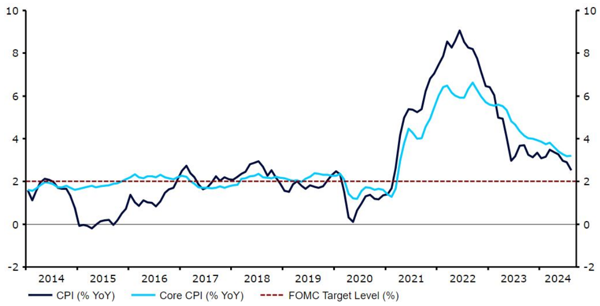
Figure 1: US Nonfarm Payrolls (2022 - 2024)



Source: LSEG Datastream Date: 13/09/2024

In our view, the August inflation figures, while consistent with the need for a loosening in monetary policy, were not sufficiently weak to force the Fed to deliver a larger cut. While the main inflation measure fell to its lowest level since February 2021 (2.5%), the core inflation rate remained stuck at July levels (3.2%) and posted a larger-than-expected 0.3% jump on a monthly basis - the fastest pace in four months. We think that this makes a larger cut far less likely, and we stand by our call that the FOMC will lower its fed funds rate by 25 basis points to a range between 5.00-5.25% this week.

Figure 2: US Inflation Rate (2014 - 2024)

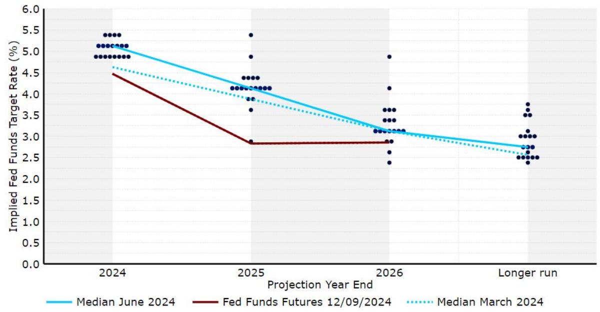


Source: LSEG Datastream Date: 13/09/2024

Market participants, however, still have doubts about the scale of the move and, at the time of writing, futures are pricing in around a 45% chance of a 50bp cut. With this in mind, the reaction of the dollar will likely be driven both by the decision itself and the Fed's communications, with the updated 'dot plot' of interest rate projections particularly closely watched.

At the June meeting, when the last quarterly Summary of Economic Projections (SEP) were released, Fed members saw, on average, just one 25bp rate cut by year-end, and an additional four in 2025. Given the extent of the slowdown in the US labour market, and the continued progress on inflation, a downward shift in the dots this week is not just likely, but seemingly inevitable.

Figure 3: FOMC Dot Plot [July 2024]



Source: LSEG Datastream Date: 13/09/2024

We expect there to be a rather wide disparity in the median dots for 2024 and, in particular, 2025. We think that the median dot for this year will be revised down to show a total of three 25bp cuts, i.e. two additional rate reductions after the September meeting. The path for rates in 2025 is less clear. We do envisage a convergence between the Fed's view and that of market participants, but we do not believe that the Fed will fully endorse market pricing, which is currently showing a fed funds rate below 3% by the end of next year. Indeed, we would not be surprised if the Fed stuck to its view for cuts on a roughly quarterly basis in 2025, i.e. a median dot that lands at either 3.375% or 3.625%.

Jerome Powell himself is unlikely to rock the boat too much in his accompanying press conference, and may largely repeat his communications from the Jackson Hole symposium. He will probably make clear to markets that additional cuts are coming, and he may hint that every meeting this year is a ‘live’ one. If anything, however, we think there is a much greater risk that Powell will disappoint market expectations. Futures are still pricing in around 115 basis points of cuts this year. This seems excessive, particularly given recent communications from Powell’s fellow FOMC members, including the likes of Bowman, Waller and Harker, who have all suggested that the Fed should proceed with a gradual pace of rate reductions.

While we think that the Fed is perhaps somewhat behind the curve in lowering rates, we do not think that conditions are bad enough to warrant panic stations. A 50 basis point cut does not appear to be in the offing, nor do we think that the FOMC will be prepared to fully endorse market pricing for rates. For now, we see a total of three 25 basis point cuts this year, in September, November and December, with another four or five to follow in 2025, depending on incoming data.

Any indication from the Fed that a gradual pace of cuts remains their base case could provide some near-term upside for the dollar, particularly given the dovish market pricing. On the other hand, a set of communications that flags heightened concerns over the labour market, while indicating that rates may need to be cut at every meeting deep into 2025, could trigger a fresh sell-off in the US currency. Clearly, however, the most bearish scenario for the dollar would be an immediate 50 basis point cut, which cannot be completely ruled out with the utmost of conviction.

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