Fed Watch

AIB Treasury Economic Research Unit

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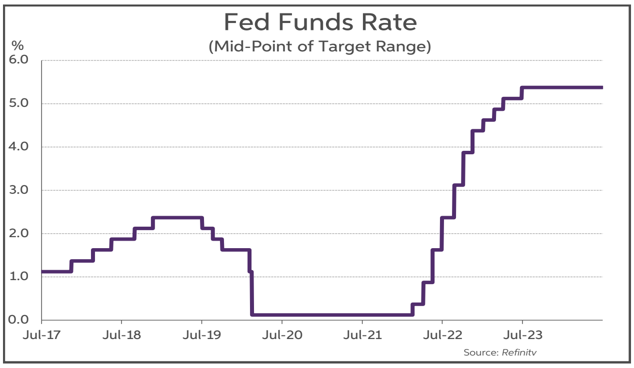
Powell's comments put September rate cut on the cards

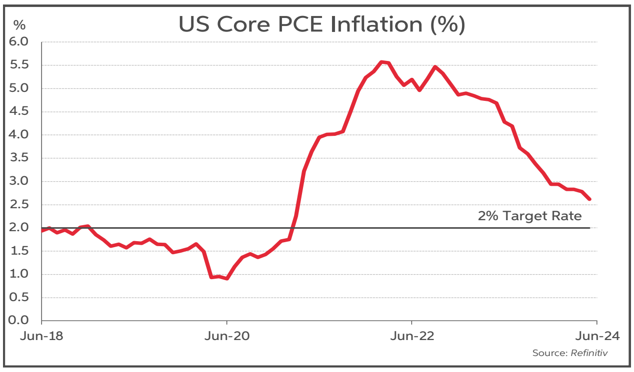
The US Federal Reserve Open Market Committee (FOMC) meeting for July saw the central bank leave its key interest rate policy unchanged. This decision was very much in line with expectations. The target range for the Fed funds rate remains at 5.25-5.50%, a 22-year high. It marks the eighth consecutive meeting that policy was left on hold. The decision by the FOMC to leave rates unchanged was once again unanimous.



The FOMC statement contained no significant changes in terms of its rate guidance compared to the June text. In its description of the economic backdrop though, it did acknowledge the easing in the labour market, commenting that job growth had "moderated" versus its June assessment that it "remained strong". On the inflation front, it now sees inflation as being "somewhat" elevated. Meanwhile, it continues to view the economic outlook as being uncertain. However, the FOMC is now "attentive to the risks to both sides of its dual mandate" whereas previously it was "highly attentive to inflation risks". This change suggests it is edging nearer to deciding that a rate cut may be warranted. Although, **it did not change its guidance that it does not expect a rate cut will be appropriate "until it has gained greater confidence that inflation is moving sustainably toward 2%".**

However, in the post-meeting press conference, Fed Chair Powell struck a more dovish tone. He noted that the economy had made considerable progress towards the Fed's employment and inflation goals and the risks to achieving its dual mandate "continue to move into better balance". He stated that there was a "real discussion" on rate cuts at the July FOMC. Meanwhile, more significantly, when asked about the timing of a rate cut, he stated that "**if we get the data that we hope we get, a reduction of the policy rate could be on the table at the September meeting".** Overall, he made several references during the course of the Q&A to the possibility of a rate cut in September. At the same time, he made sure to maintain flexibility around the timing of any rate cuts by reinforcing the Fed's data dependency in determining any policy changes.

Futures contracts were already fully pricing in a 25bps rate cut in September before the July FOMC. Powell's comments during the press conference validated this expectation. There was a further modest softening though in year-end rate expectations The market is now pricing in nearly 75bps of cuts in total for 2024, with futures contracts consistent with around 71-72bps of easing. Prior to the meeting, this pricing was nearer to 68bps and compares to around 45bps in the immediate aftermath of the June FOMC. **Interestingly, during the press conference, Fed Chair Powell made no attempt to push back against current market pricing/expectations.**



In summary, while the FOMC statement showed no significant changes, Fed Chair Powell used the post-meeting press conference to communicate the possibility that a September rate cut could be on the cards. Of course, not surprisingly, he caveated this by highlighting the data dependency of any such decision. Attention will now turn to the Jackson Hole Economic Symposium at the end of August as the market looks for more specific guidance in relation to the September 17th/18th FOMC meeting. Fed Chair Powell and a raft of other FOMC members will be speaking at this event, which will be of keen interest for market participants. The Fed has used the Jackson Hole to signal policy changes in the past under Chair Powell.

By this stage, the Fed will have further data on inflation and the labour market which should provide them with more confidence that a rate cut in September is appropriate. **Our view is that at least 50bps of rate cuts by year end is a reasonable expectation based on current trends in inflation and labour market metrics.** This would see the fed funds rate at 4.75-5.00% by year-end.

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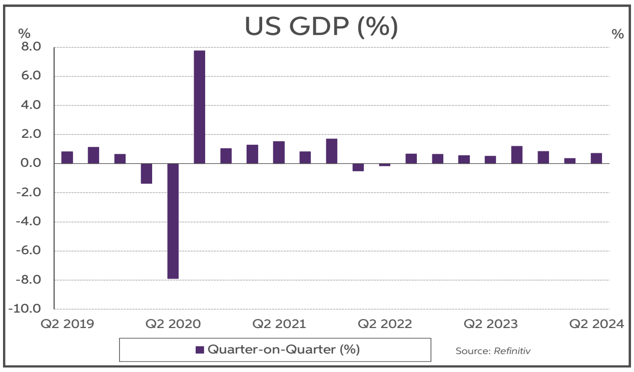
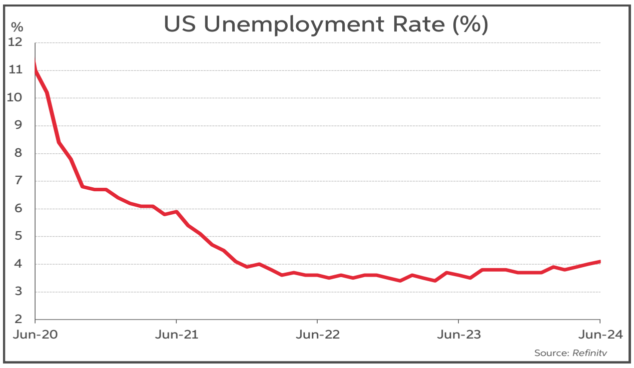
US growth gathers steam in Q2, while disinflation resumes

Having expanded by 1.4% annualised in Q1, GDP growth accelerated sharply to +2.8% in the second quarter. Meantime, real final sales of domestic product rose by 2.0% annualised in Q2, up from 1.8% in Q1. Regarding the underlying breakdown of GDP for Q2, consumption, non-residential investment and Government expenditure were the main drivers of growth. Consumption rose by 2.3% annualised in the quarter, adding 1.6 percentage points p.p. to GDP. Similarly, investment rose by 8.4%, led by the aforementioned non-residential category (residential investment declined by 1.4%), contributing 0.6 p.p. to the total. Government expenditure increased by 3.1%, with both defence and non-defence spending rising. This boosted output by 0.5 p.p.. Meantime, imports continued to grow at a rate over three-times faster than exports, meaning net trade knocked 0.7 p.p. from growth. However, this was offset by a 0.8 p.p. contribution from inventories.



Meanwhile, the very limited available survey data for July have been mixed. As has been the case now for a number of months, the services sector is outperforming manufacturing. Indeed, the services PMI improved to 56.0 in July, its highest level since March 2022. In contrast, the manufacturing PMI dipped below the key 50 level, falling to 49.5 in July, indicating that activity in the sector contracted, albeit marginally, for the first time since December 2023. At the same time, consumer confidence has also been somewhat varied at the start of Q3. The Conference Board measure rose for only the second time in seven months in July. Meantime, the University of Michigan indicator - which places a greater emphasis on household finances - declined for a fourth consecutive month in July, registering its lowest reading since last November.

Regarding the labour market, there are signs that conditions are softening, although they remain tight overall. 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 4.1% in June, its highest level since November 2021. Meanwhile, the pace of payroll expansion slowed to an average of +177k per month in Q2, down from an average of 267k per month in the first quarter of the year, and below the average of +251k per month in 2023. Furthermore, the number of job openings has declined to circa 8.1m, 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 +3.9% y/y in June, down from +4.4% y/y in January.



In terms of inflation, a shallow disinflationary trend has reasserted itself in Q2. In the first quarter of the year, price pressures were somewhat sticky, with headline CPI inflation rising to 3.5% in March. However, it fell throughout Q2, printing back at 3% in June, its lowest level in a year. Meantime core-CPI inflation has continued to slowly dissipate, edging lower in 17 of the last 21 months, and declining to 3.3% in June, its lowest reading since April 2021. Similarly, core-PCE has been falling slowly, inching down to 2.6% in May and staying at that level in June, its lowest level since March 2021. Indeed, at the post-meeting press conference, Chair Powell acknowledged the recent progress on the inflation front.

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. Meanwhile, there were signs of softening in the labour market in Q2. **However, the US economy continues to confound expectations, with GDP accelerating in the second quarter.** A resumption of the disinflationary trend has also taken place over the summer months. Looking ahead, the US economy may well lose some momentum in the second half of the year, as the labour market continues to cool. However, the Fed is expected to start cutting rates between now and year end and inflation is set to fall further, which should support real incomes. Against this backdrop, the US is expected to register solid growth this year. Both the IMF and the OECD are projecting the US economy will expand by 2.6% in 2024.

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