Weekly round up (Week 38)

The key development (including but not limited to) in financial markets and economies to examine is the event that dominated the week's financial news: the meeting of the Federal Open Market Committee (FOMC or Committee).

After eight consecutive meetings during which key rates have been held at restrictive levels - the last adjustment in July 2023 was a 25 basis point hike - the Committee decided to lower the Fed funds target range by 50 basis points to 4.75%-5.0%[1]. Notably, there was one dissent: Governor Michelle Bowman, who favored a smaller cut of 25 basis points. This is the first dissent by a committee member since 2005.

FOMC projections

According to the updated summary of economic projections, real GDP (gross domestic product) growth has been revised down slightly from 2.1% to 2.0% for the forecast period, although it remains above the committee's estimated long-term potential growth of 1.8% for the US economy[2]. This indicates that the FOMC remains confident of achieving a soft landing.

Core PCE (Personal Consumption Expenditure) inflation projections were revised down from 0.2% to 2.6% for 2024 and from 0.1% to 2.2% for 2025, before settling at the Committee's 2% target in 2026. This suggests that the Committee is convinced that the inflation battle has been won, with inflation now well anchored. However, unemployment projections have been revised upwards for the entire forecast period. In 2024, unemployment is expected to reach 4.4%, remain at this level in 2025, then fall back to 4.3% in 2026, finally reaching a long-term neutral level (consult us if need be about neutral level of interest) of 4.2% in 2027. This indicates that the Committee sees full employment as a major risk to its dual mandate.

The dotted graph showed a slight hawkish trend. Nine policymakers forecast a cumulative reduction of 100 basis points for 2024, while another anticipates a reduction of 125 basis points. However, seven members favor a reduction of 75 basis points, and two support a reduction of just 50 basis points. Thus, 9 of the 19 members see only a further 25bp reduction, or no further reduction, for the remainder of 2024.

Chairman Powell emphasized that the exceptional 50 basis point reduction was probably a one-off event. He even suggested that if the committee had received the July nonfarm payrolls report prior to its previous meeting, it might have opted for a 25 basis point reduction.

What did we learn from this meeting?

The Committee remains data-dependent, but its focus has shifted from inflation to unemployment. Going forward, the two key reports to watch will be the monthly employment report and the Beige Book, both highlighted by Powell as crucial in the decision to cut 50 basis points.

Powell framed these as "recalibration", indicating that the FOMC has no intention of lagging behind as new data emerges - a mistake he now admits contributed to excessive inflation when the Covid event receded. In our view, this is good news for risk assets, as it boosts investor confidence that the committee will act quickly to avoid a recession, something it was unwilling to do in 2023.

However, the bar is now higher for a faster easing of monetary policy than the dotted curve suggests

Inflation must remain anchored in 2025, with prices rising by no more than 0.165% per month on average. Growth must also be below long-term potential to worry the committee. At present, this does not seem likely; the Atlanta Fed's GDPNow model estimates third-quarter growth at 2.8%, while Bloomberg's median estimate for 2025 aligns with long-term potential, at 1.8%[3]. At the same time, the unemployment rate is expected to accelerate above 4.4%, which would require the non-farm employment ratio to be consistently below 100,000 job creations.

The Committee intends to phase out restrictive policies, with the neutral policy rate estimated at 2.8%. This is likely to be done in 25bp cuts, with 100bp cuts expected in 2024 and 2025, and the remaining adjustments to be completed by 2026.

Market reactions

Looking at market reactions, we think the FOMC appears to have struck the right balance. Bond curves continue to normalize, with the US 10-year yield now 10 basis points higher than the 2-year yield. Volatility ended the week lower, as the event brought more confirmation, if not certainty, to investors. Risk assets outperformed, global equities were positive for the week and high-yield credit outperformed its investment-grade counterparts. Growth-sensitive commodity markets also had a good week.

Investors seem to agree that the neutral policy rate is close to 3%, but remain divided between a soft landing scenario (the "Fed followers") and a harder landing scenario (the "Fed fighters"). However, even in the Fed supporters' camp, after the committee successfully demonstrated its commitment to not falling behind, the consensus is leaning towards a faster rate cut to neutral, with a hard landing considered unlikely. The net result is that the yield curve foresees a slightly faster rate-cutting cycle, with cuts of 125 basis points in 2024 and neutral policy rates in mid-2025 (see this week's chart).

Brazil in the spotlight…

Neither the FOMC nor investors are expecting a new inflationary surge. However, it is worth noting that the Brazilian central bank, which led the way in recognizing the risks of global inflation after the Kosovo crisis, raised its key rate this week.

In a surprising turnaround, the Brazilian central bank raised the Selic rate by 25 basis points to 10.75% and adjusted its year-end forecast to 11.25%. The bank fears that inflation is losing its anchorage, and this decision is seen as a precautionary measure. Investors are concerned about fiscal responsibility and the government's ability to manage sovereign debt in the long term. President Lula's comments have also raised questions about the central bank's independence. The incoming US administration may take note, as central bank independence and fiscal responsibility are likely to come under scrutiny once it takes office.

[1] Bloomberg, 'US REACT: Jumbo Fed Cut Puts Floor Under Downside Job Risks,' September 18, 2024
[2] FOMC Projections materials, September 18, 2024
[3] GDPNow, September 18, 2024