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MACRO MORNING BRIEFING

April 15, 2024

Fed Call Change: First Rate Cut In September

Sticky Inflation, Resilient Growth Data

- We now expect the Fed's first rate cut in September
- Sticky inflation and resilient growth data responsible for change in view
- Fed will act on economic conditions regardless of election calendar
- This is a positive scenario for the US dollar

Changing The Call

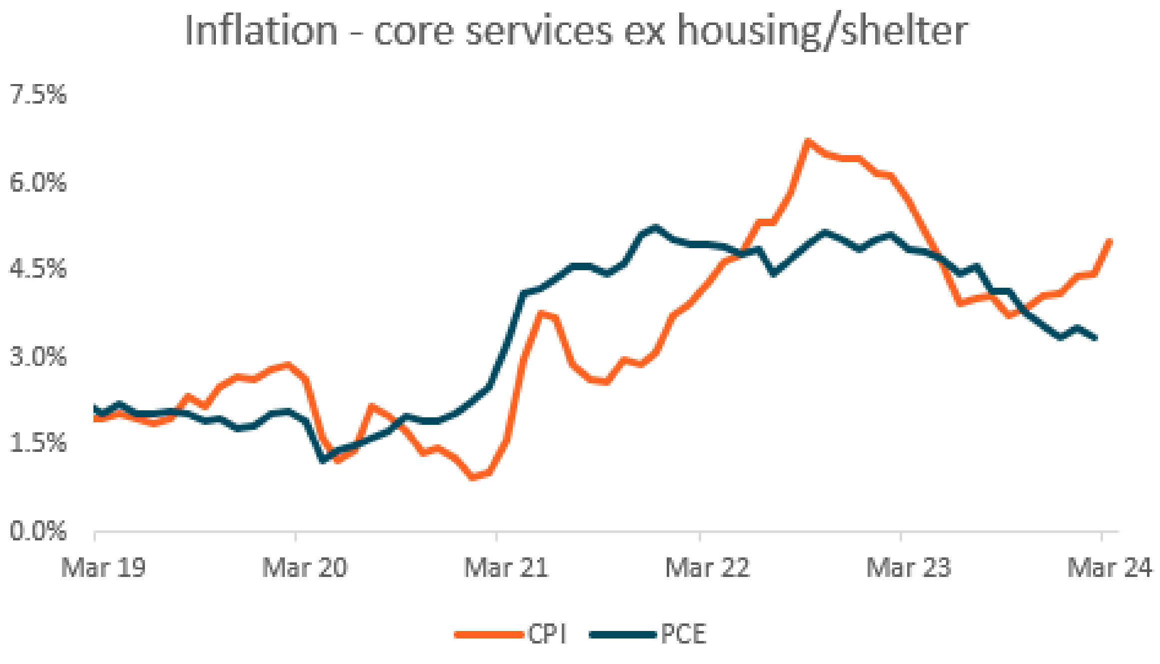
We now see the Federal Reserve waiting until September to cut the funds rate target, a shift from our previous call for June. Our new view is based on several months of disappointing inflation data since the beginning of the year, and the fact that the US economy is not slowing as quickly as we had expected. In this chart-heavy Morning Briefing, we lay our reasoning and include several diagrams which illustrate the key drivers behind our view.

Most importantly, inflation – especially services inflation – remains sticky. The disinflation progress we had seen in 2023 – and which we were expecting to continue in 2024 – has stalled. We are particularly focused on the core PCE deflator for services excluding housing, which fell from over 5% at the beginning of 2023 to 3.3% by December. After 11 consecutive declines last year, this index has remained in the 3.3%-3.5% range since December.

The message from the Fed this year has been that the next move in rates would most likely be a cut – but with continued insistence that it needs “greater confidence” that inflation is on its way to 2%. More recent Fedspeak has simultaneously assured that a cut is coming, but also that it’s too early to expect a move any time soon.

Indeed, there has even been some mention, most notably from Minneapolis Fed President Kashkari, that rates could move higher again if inflation resumes accelerating. There are some upside risks to inflation, including rising core goods inflation – it has recently been hovering around 0% y/y – from supply chain disruptions. Services inflation in the CPI measure continues to rise, although as stated above, we observe core PCE service ex-housing holding steady – just too high for the Fed to be comfortable. Housing inflation, a favorite of Chicago Fed President Goolsbee, also remains stubbornly high.

"Supercore" Inflation Not Moving Lower



Source: BNY Mellon Markets, Bureau of Labor Statistics, Bureau of Economic Analysis

Even if inflation starts to cooperate and we were to see better numbers from the PCE data, there simply may not be enough time for enough good data to convince the Fed to go on June 12. That leaves July or September. We think September is an attractive option because it allows Chair Powell to use the Jackson Hole Symposium in late August to signal and explain the rationale for a rate move at the next FOMC meeting.

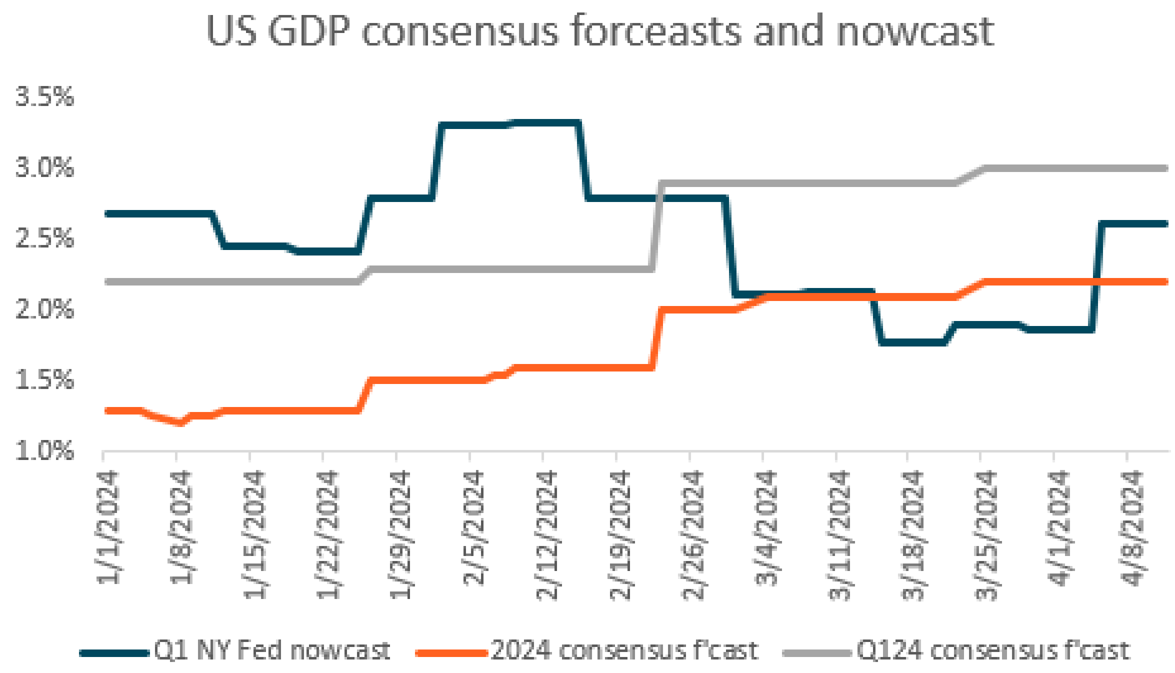
After raising the funds rate by 500bp and with a real funds rate now above 2.4%, the economy has barely cooled so far in 2024. The Fed's own "dot" for 2024 GDP growth moved up from just 1.4% in December last year to 2.1% in the March Summary of Economic projections. Bloomberg's consensus forecast for 2024 GDP has gone from 1.3% in early January to 2.2% now. The NY Fed's Nowcast sees Q1 GDP at 2.6%. See the chart below.

To be sure, it's not that we think strong growth and a robust labor market by themselves would deter the Fed from cutting if inflation were better behaved. We have heard on more than one occasion that the central bank's reaction function is focused on getting inflation down, and that it would tolerate a hot economy as long as inflation was slowing towards 2%.

Interestingly to us, Fedspeakers of late been putting more emphasis on the Fed's dual mandate, implying that the balance of risks to the outlook was close to equal and that undue weakening in the labor market could add to the impetus to cut rates, so long as inflation was evolving favorably. This indicates to us more focus on any downside risks to jobs.

We had believed the labor market was beginning to show some slowing, although not at a pace that would threaten any kind of jobs recession or real deterioration in the employment picture. However, the March employment situation data, released on April 5, upended that view – indicated widespread strength instead. Given the Fed's view of the balance of risks between inflation and jobs moving close to equal, we think a sudden deterioration in the jobs outlook could induce a rate cut sooner. But we don't see evidence of a downturn coming.

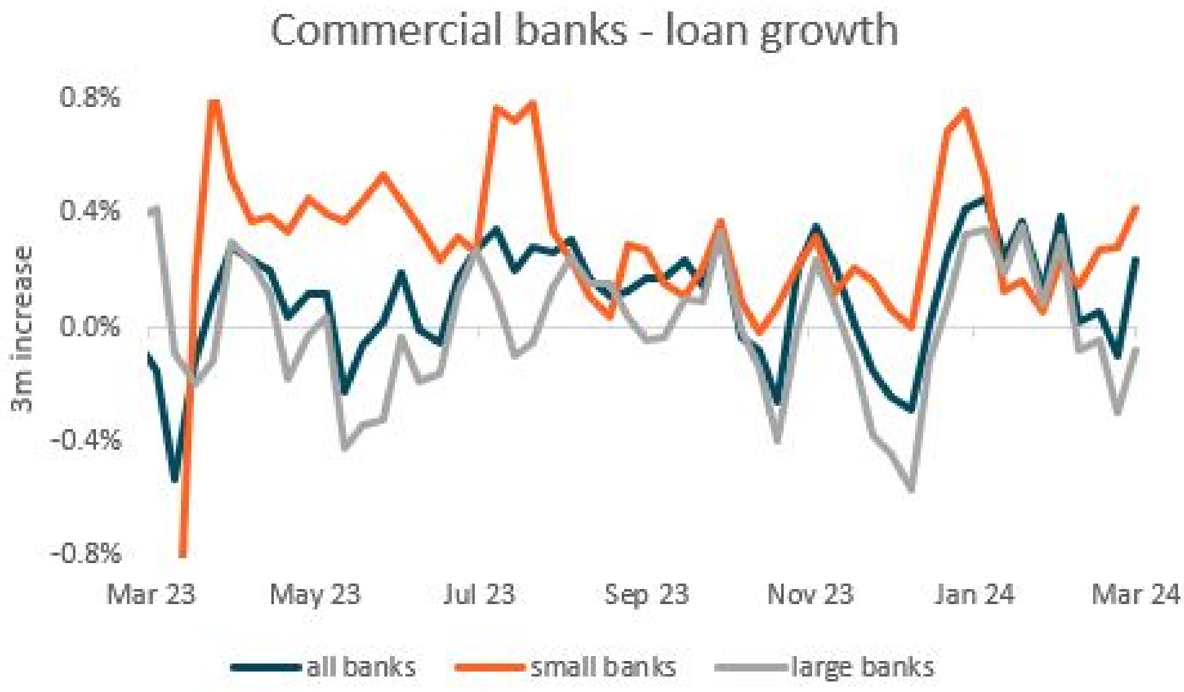
Forecasts Heating Up



Source: BNY Mellon Markets, Bloomberg, Federal Reserve Bank of New York

The Chicago Fed's Adjusted Financial Conditions Index (click NFCI tab) is lower now than it was in early 2022. While this past week – with higher bond yields, a stronger dollar, and soft equity markets – likely made for a slight tightening, we can't agree with Chair Powell when he says financial conditions have tightened over the past few quarters. We had observed that credit conditions were tightening, with the three-month pace of loan growth approaching zero or lower. But even that has turned around and loan growth has picked back up in recent weeks (see chart below). So even if Powell was speaking about credit conditions rather than traditional financial conditions indices, this is no longer the case.

Loan Growth Picks Up Again

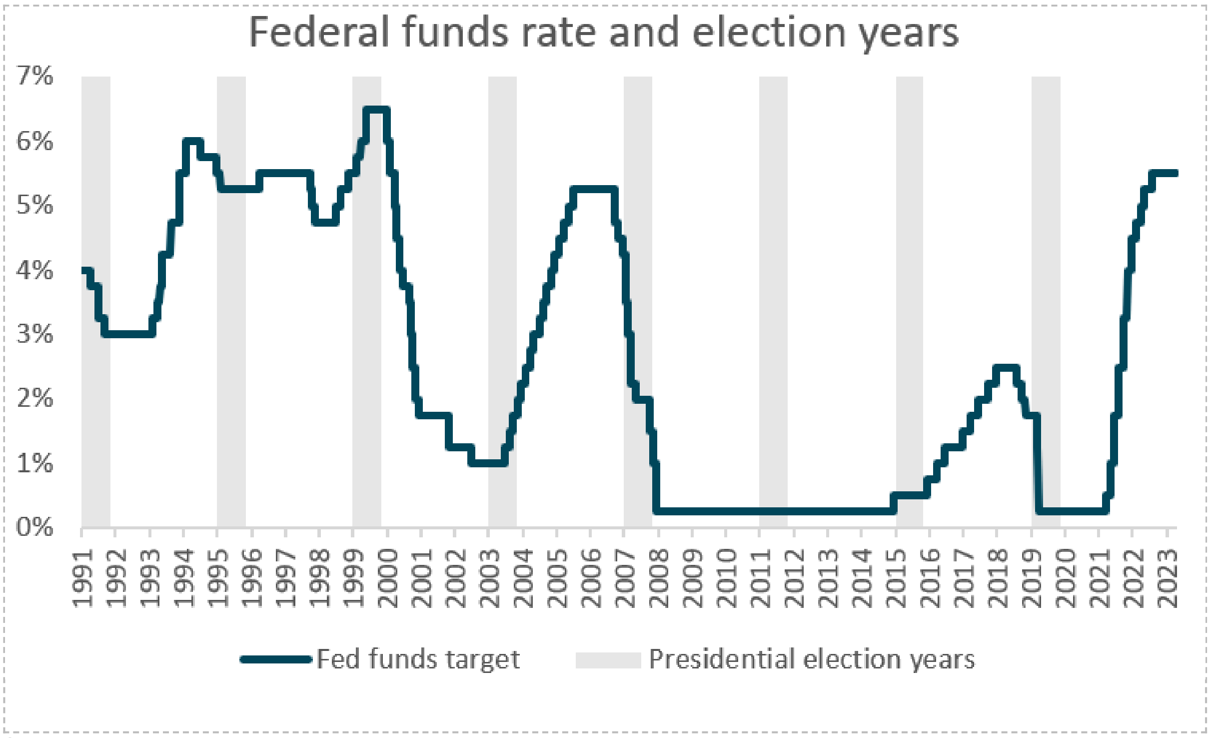


Source: BNY Mellon Markets, Federal Reserve Board of Governors

September might prove tricky for a cut given the political calendar. It would be difficult for the Fed to avoid criticism that it was acting politically, even if we don't think that would remotely be the case. If the data and circumstances preclude a cut in June but argue for one in September, we think the Fed would act regardless of the political fallout. Recent Fedspeak has brought an increase in comments affirming an apolitical approach when it comes to making decisions. Chair Powell, in his latest public appearance, spent a significant portion of his speech extolling the virtues of apolitical monetary policy and an independent central bank. This may be the beginning of a preemptive defense against being seen as politicized.

It's not as if the Fed has never changed policy rates during an election year. The chart below shows the evolution of the federal-funds rate from 1990 – there have been a number of policy changes during election years. In some cases, like 1992 at the backend of a recession, it's easy to understand why rates were coming down. Another obvious example is 2008. But in 2000 and 2004, for example, rates were rising. Eight observations don't settle the debate, but our point is that economic considerations don't preclude election-year moves.

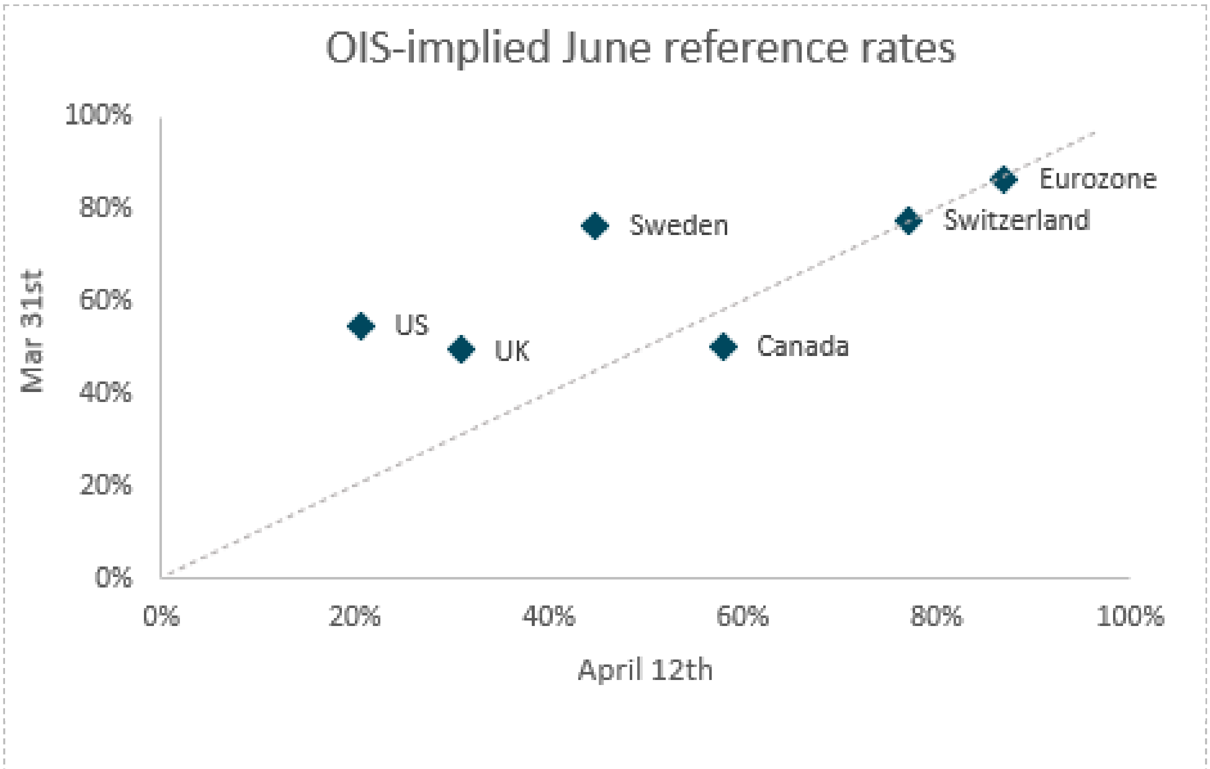
Federal Funds Can Move During Election Years



Source: BNY Mellon Markets, Bloomberg

What would a later start to Fed rate cuts mean for other central banks? Just as it's not infrequently said that the Fed won't cut rates during an election year, it is also popular to argue that other central banks poised to reduce policy rates will not act until the Fed does. We reject this, as well. We expect the European Central Bank to cut rates in June. The Bank of Canada, too. The chart below shows that the market – judging by OIS spreads – sees several other major central banks cutting rates before the Fed does. We obviously see this as dollar-positive, especially if US real economic fundamentals stay so resilient.

More Likely To Cut Than The Fed



Source: BNY Mellon Markets, Federal Reserve Board of Governors

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Please direct questions or comments to: iFlow@BNYMellon.com

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