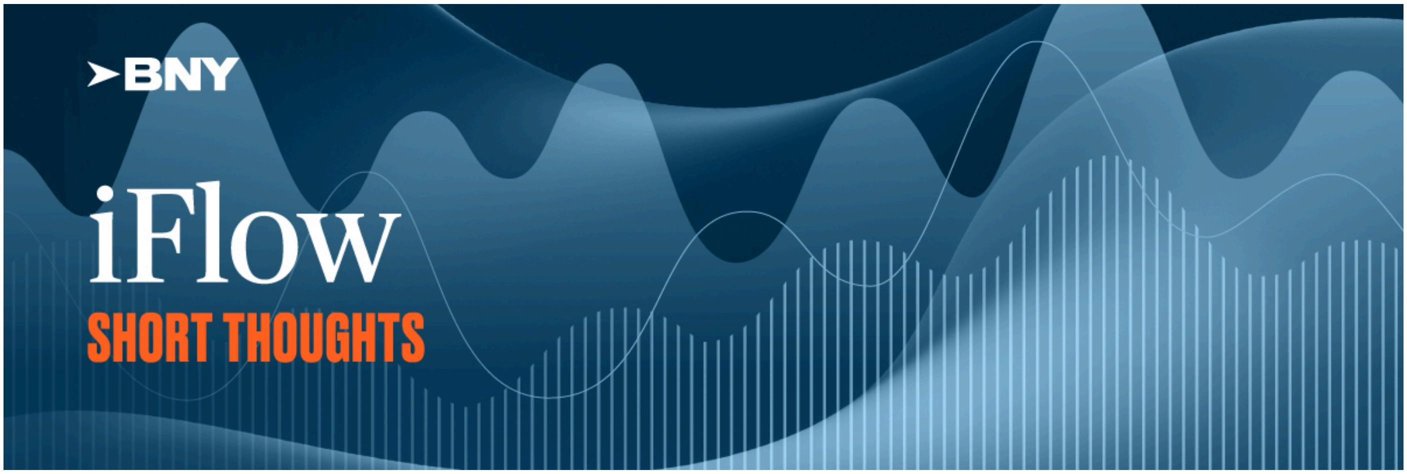


July 30, 2024

July FOMC Preview – Words Matter

- Watch the FOMC statement for indications that the Committee has moved dovish
- Economic growth is not in danger of collapsing and inflation is getting close to the 2% target
- Fed futures market pricing is too aggressive for 2025 in our view; we prefer the implications from forwards

Along with most of the Street, we don't expect the Federal Reserve to alter its policy setting this week, but we do – and have for a while now – think we're close to an inflection point, likely at the September 17-18 FOMC meeting, the next one on the calendar. Even with no rate move likely, there still could be a dovish tilt from the Committee this week.

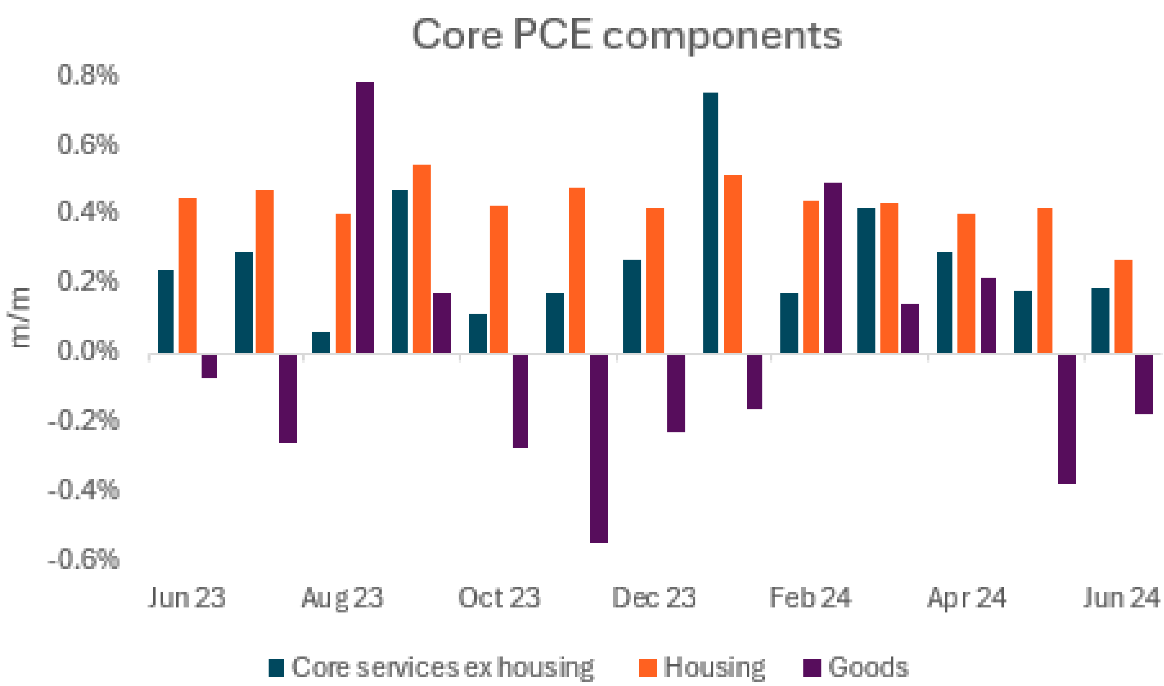
We'll be looking for any hints that the Fed is finally gaining the sufficient confidence it needs to consider a rate cut at the next meeting. Specifically, we'll be looking for key wording changes in the policy statement as well as some form of guidance from Chair Powell at his post-meeting press conference.

Over the four meetings since January this year, the FOMC statements have all included the following sentence: "The Committee does not expect it will be appropriate to reduce the target range until it has gained greater confidence that inflation is moving sustainably toward 2 percent." The first place to look for a shift heralding any upcoming easing is in this key phrase about the policy setting. If there is indeed an expectation within the Committee that rate cuts will soon be appropriate, we would expect to see language suggesting that either it is gaining greater confidence, and/or if inflation developments evolve as they have recently, it will soon be appropriate to reduce the target range.

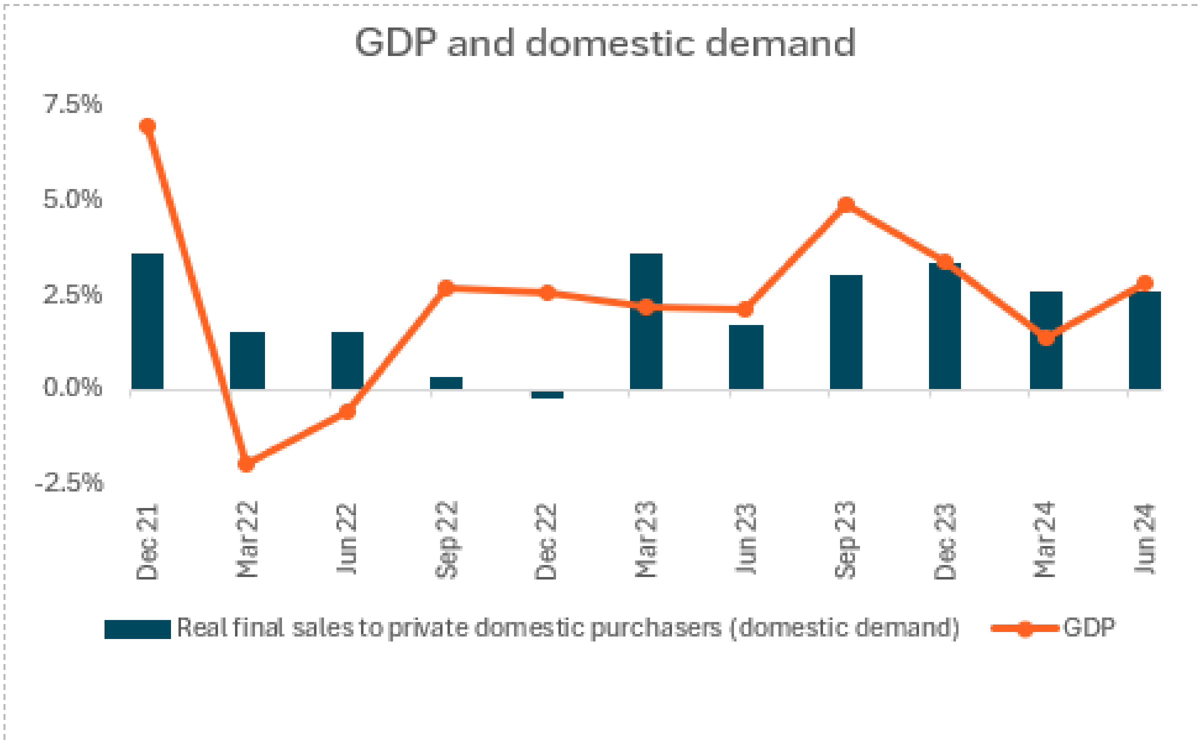
The US economy grew at a real rate of 2.8% in the second quarter, according to the advance estimate of GDP, published last week. Moreover, aggregate private domestic demand, as measured by real final sales to private domestic purchasers (which strips out inventory accumulation, government spending and net exports), has been steady at around 3% for the last six quarters. This suggests domestic demand is fairly stable and healthy.

Inflation has behaved well over the last several months, and the main elements of the PCE price deflator – also published last week – are all moving down, as the chart below (lower panel) shows. Goods inflation (purple bars) is actually slightly negative. The two heretofore “sticky” inflation measures, core services ex housing (blue) and housing (orange) are also moving lower. This is no doubt cause for celebration for the Fed, and one of the main reasons we see a rate cut in September. Remember, Powell has said that the Fed doesn’t need to see 2% inflation to cut, it needs to have “greater confidence” that inflation is moving in that direction.

Growth Stable, Inflation Cooling



Source: BNY Markets, Bureau of Economic Analysis

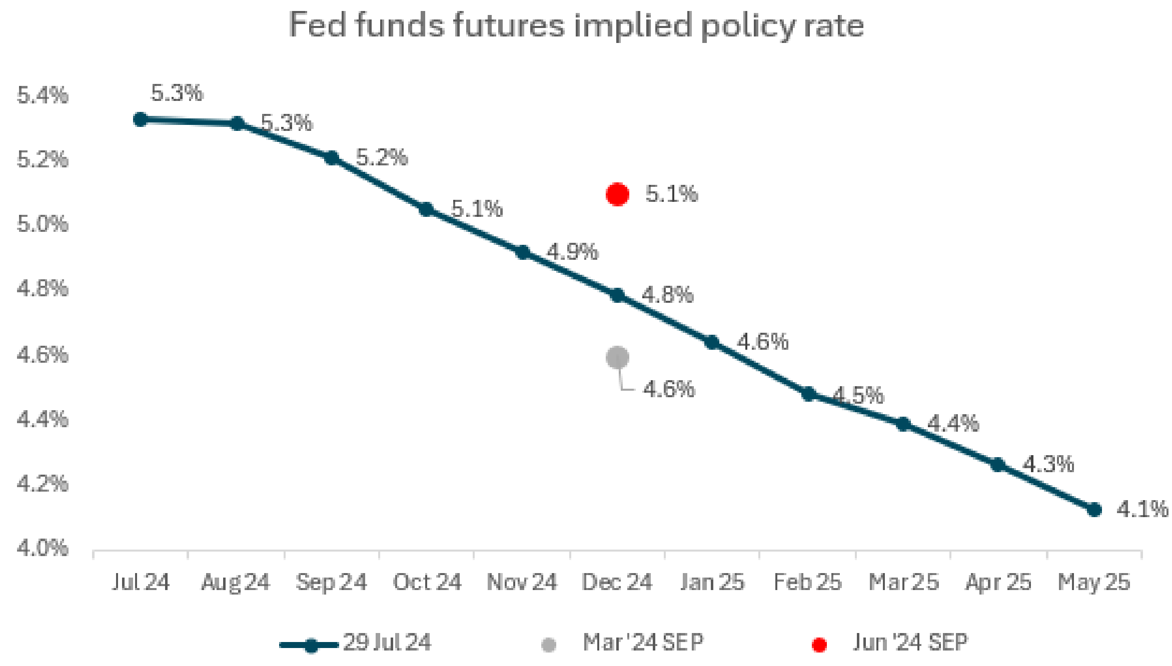


Source: BNY Markets, Bureau of Economic Analysis

Given that the market-implied rate cut probabilities for the September meeting have been at or very close to 100%, we're not sure if a dovish turn like the one we suggest above would really be market moving. We do think, however, leaving that key sentence unchanged could be a hawkish surprise that markets would scoff at. In some ways, we think changing that statement would be the first move in a cutting cycle and leaving it as is would be an indication that the Fed's policy bias hasn't changed – something would be contrary to both the data and recent Fedspeak, hence a negative market reaction. The balance of risks is probably asymmetric.

As mentioned, markets are just about 100% convinced that an initial cut is coming in September, and we agree. However thereafter, it appears that things are getting ahead of themselves. The chart below shows the current market-implied expected policy rate through May 2025. Nearly 125bps in cuts are expected in the space of about six FOMC meetings.

Fed Funds Futures Very Aggressive for 2025



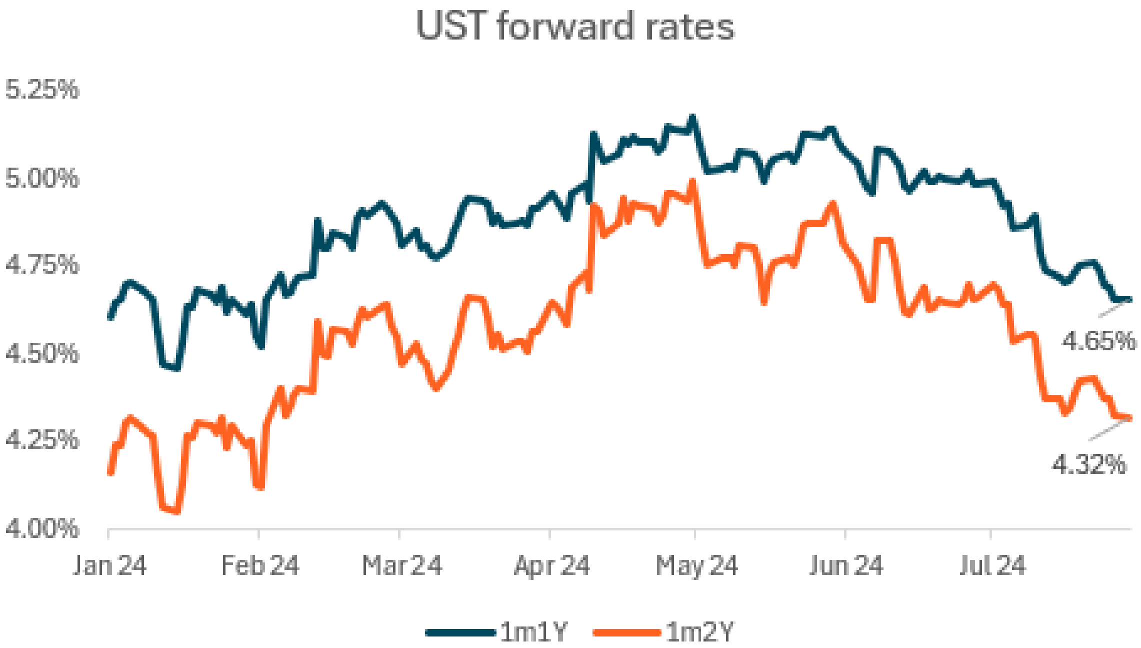
Source: BNY Markets, Bloomberg

From where we stand now, we think this is overly aggressive. After September we see a cut in December, with the Fed choosing to wait and see the effects of the first move. After all, inflation, while on the retreat, is still above target, financial conditions still relatively loose, and the economy – in our opinion – slowing, but not such that it would enter a recession this year.

To be honest, we see the 2025 policy path as murky, depending on where inflation and economic growth are at the end of this year, and given the uncertainty surrounding the US election. It would appear that the federal funds futures market is taking out insurance against the possibility of recession and the ensuing need for deeper and faster cuts.

On the other hand, and more aligned with our view, the Treasury forwards market sees the 1m1y forward at 4.65%, indicating a little over three cuts by this time next year, while the 1m2y forward only sees a total of four cuts, or around 100bp. We think this caution implied by forward pricing is appropriate currently – indicating a rather high terminal rate for this cycle, and a view that the economy and inflation will settle down to trend over the next few years.

We Prefer Implications from the Forward Market



Source: BNY Markets, Bloomberg

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

John Velis
AMERICAS MACRO STRATEGIST

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