BNY MELLON

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SHORT THOUGHTS

June 11, 2024

June FOMC Preview – On The Dot(s)

How Many Cuts This Year?

- We expect the updated SEP to indicate 1.5 to 2 rate cuts this year
- We will also focus on the projections for growth and unemployment
- Longer-run FF projections could rise, but remain below our terminal rate view

The Fed Will Probably Come Into Line With Market Pricing

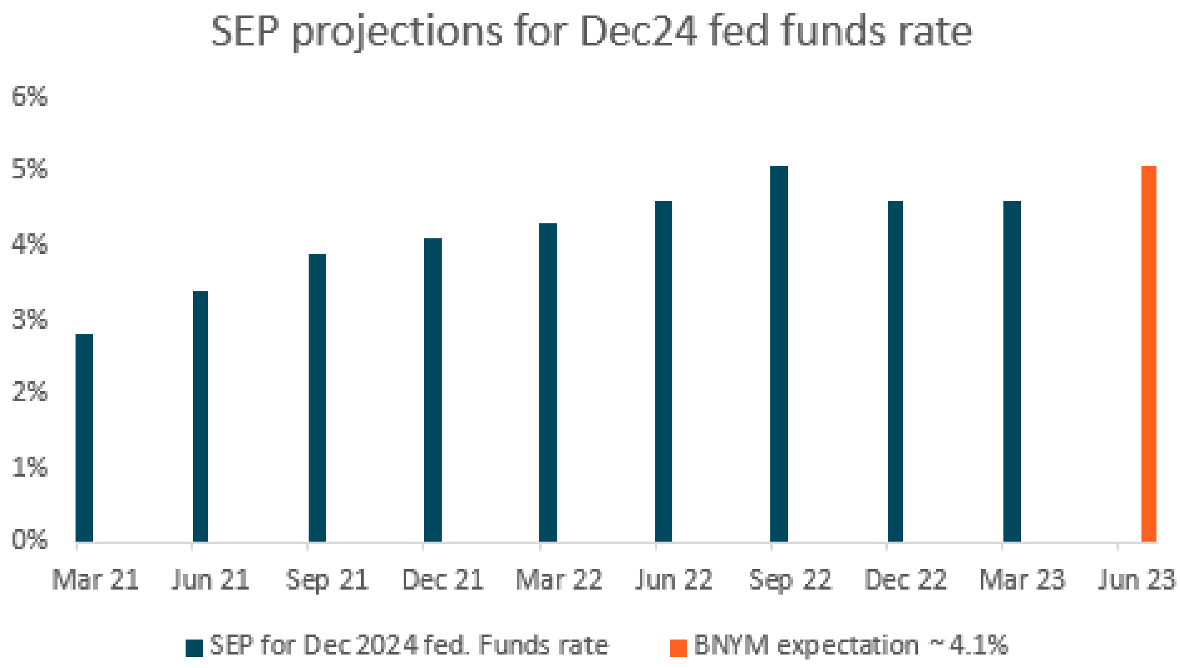
There is little to no expectation of a rate move to come from the Federal Open Market Committee's meeting on Wednesday. We do, however, get a new set of “dots” via the quarterly Summary of Economic Projections (SEP). This will be markets' focus. We are anticipating that the median projection for the end-2024 federal funds rate will indicate just two cuts – or even one-and-a-half – for the period.

Current futures market pricing for the December 2024 FOMC meeting has a fed funds rate of 4.96%, essentially matching what we think the Fed will put forward in the dots. The chart below shows the evolution of the central bank’s end-2024 projections since March 2021. As rates have stayed higher for longer and inflation has persisted, this median projection has steadily increased from below 3% back in March 2021 (when 2024 dots first appeared in the SEP) to as high as 5.1% in September of last year. It settled down to 4.6% in the two most recent SEPs, December 2023 and March 2024.

It almost goes without saying that the various FOMC participants who provide projections will propose fewer than three rate cuts remaining for the year. Indeed, some dots could indicate no cut at all, while others could propose two, or just one. There will be four FOMC meetings remaining in the year, and we are ruling out a rate move in July, so assuming – as we do – an initial cut in September, there simply won't be enough time for more than three cuts, and we don't believe the FOMC will move at every remaining meeting (unless of course the economy deteriorates sharply, which is not our base case). We don't think the majority of the Committee will anticipate each meeting to feature a rate move either, so we're going with two (or slightly fewer) as the median projection.

We're not sure that the median of all the 2024 dots submitted indicating 1.5 to 2 cuts would shock markets given current pricing. That means the potential to move markets on the day will – not unusually – fall on the Fed Chair Powell's post-meeting press conference.

Evolution Of The End-2024 Dot



Source: BNY Mellon Markets, Federal Reserve Board of Governors

Growth And Unemployment Projections

To us, the more interesting set of projections, beyond that for the funds rate, will be those for growth and unemployment. The March SEP indicated a 2024 value for real GDP growth of 2.1% (up from just 1.4% in the December 2023 projection) and an unemployment rate of 4.0% (down from 4.1%). Regarding the latter, last Friday's jobs data reported an unemployment rate of 4.0%, and we believe the labor market is slowing and coming into better balance (see here). We'll be interested to see if that projection moves up on Wednesday. The so-called "longer run" unemployment projection is currently 4.1% (unchanged from December last year), so if it rises to something above that rate, this would indicate that the Fed sees the economy weakening between now and December this year.

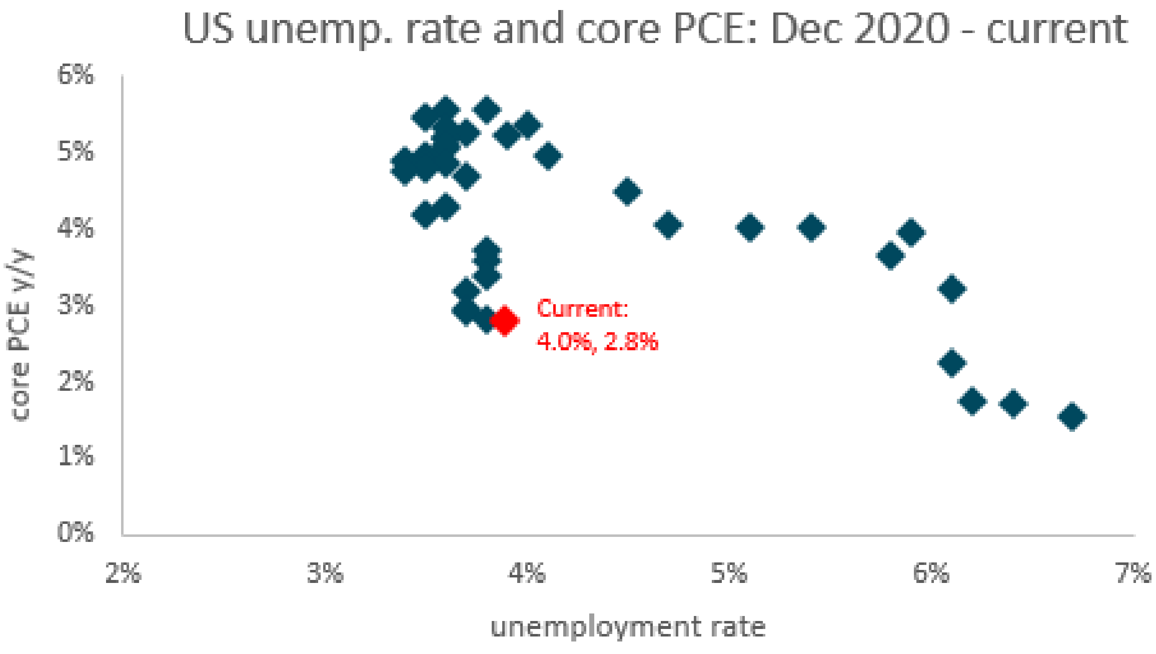
The same interest regarding GDP growth exists. Given the SEP's longer run projection of 1.8%, we would presume this is what the FOMC regards as potential – or trend – growth for the economy. Does the Committee think that the real economy, in addition to the labor market, will slow below trend this year? Considering GDP for Q1 2024 was just 1.6%, we might wonder – does the FOMC see growth meaningfully below trend for the rest of the year? Our own thinking is that 2% growth (plus or minus a bit) over this year is achievable.

Complicating matters is the release of May CPI data on Wednesday morning. Consensus sees the m/m core CPI print at 0.3%, or an annual rise of 3.5%. We think, given the recent decline in new car prices as well as stabilization of used car prices, there is a chance of a monthly change of just 0.2%, which would of course be Fed-friendly. Although they are excluded from the core reading, lower fuel costs and reports of slowing food inflation should also help keep the headline rate of inflation down. These lower costs could also feed indirectly into the core measure. Nevertheless, the SEP submissions will likely have already been collected and collated before the CPI release. We don't think that data will affect the Fed's decision-making at this meeting.

The chart below plots inflation (expressed as annual rate of growth in core PCE prices) and unemployment. Think of it as a very simple Phillips curve graph, which in theory should be downward slopping, i.e., lower unemployment rates should correspond to higher inflation rates. This characterization was accurate between the end of 2020 and the beginning of 2022, but since then the slope of this curve has been close to vertical. There is some movement to the right, indicating that the labor market has slowly weakened (probably from much too tight a level) as inflation has come down.

Nevertheless, we expect Powell to describe the economy as in a good place, and therefore not interfering with the rates outlook. However, Powell – and other Fedspeakers – have indicated that an "unexpected" deterioration in the labor market could prompt cuts sooner and more so than anticipated. In the absence of such a weakening, we still think the Fed – especially given the ambiguity in the jobs data we highlighted on Monday – will concentrate on the inflation data released over the summer. This is where we think the "will they cut rates, or won't they cut rates this year" question will be resolved.

Steep Phillips Curve



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

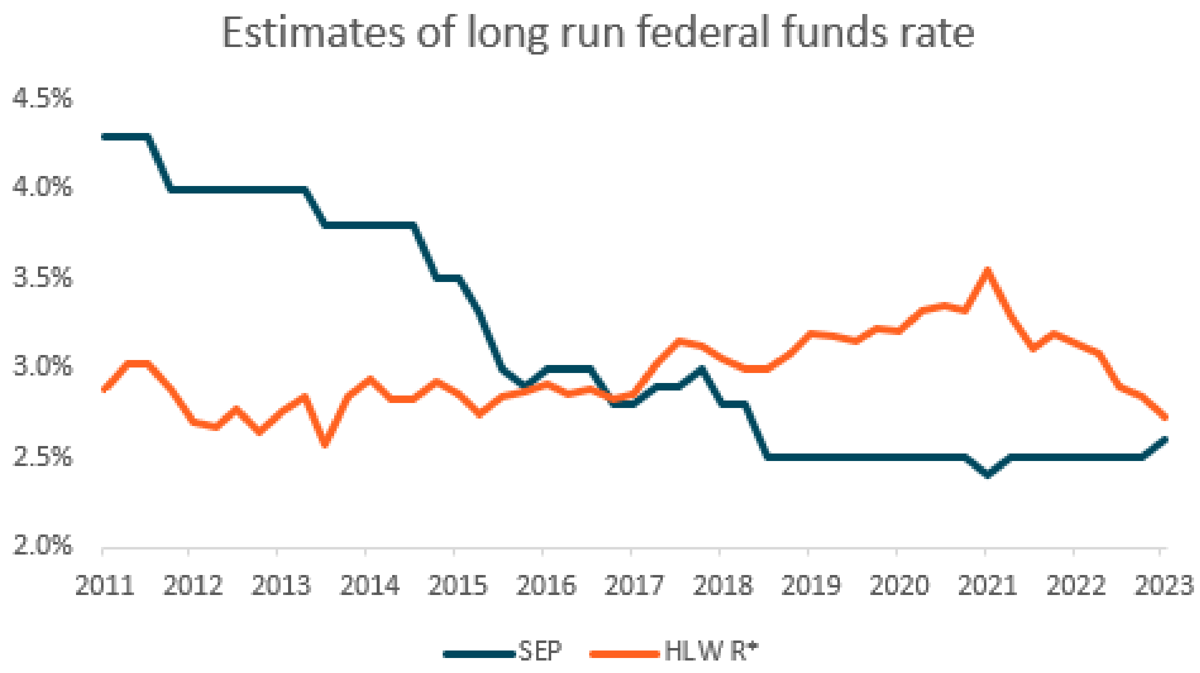
Longer Run Rate Expectations

Also potentially of interest will be the SEP's view of the longer run, or neutral rate, of interest. Last time around, in March, there was slight increase in this value, to 2.6% from the 2.5% that persisted in the SEP since the end of 2018. We still reckon that the neutral rate interest, or r*, is closer to 4% than 2.5%, and have discussed this in detail recently (see here).

The chart below shows the longer run level of the SEP projections since 2011 (when the dots first were featured) through this past March. It fell steadily during the first half of the 2010s, reaching 2.5% in 2018. Also plotted (orange line), is the Holsten-Laubach-Williams estimate of r* through the years. The dots and the HLW model are close to equal currently.

An increase in the longer run federal funds rate dot would probably cause a reaction in the long end of the US curve, although any movement in the median projection will likely be small. Nevertheless, we know that the Fed is thinking about this topic, and we won't be surprised to hear a question in the press conference along those lines. However, we also think Chair Powell will stick to his oft-repeated retort that (paraphrasing) "we don't know its value a priori, it's a theoretical construct, and we'll know it when we see it."

Longer Run Rate Expectations Converge - Are they Right?



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

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