50bp cut from the Fed as it looks to move rates to neutral quickly and avert recession

The US Federal Reserve wants to get to neutral quickly as it increasingly prioritises potential job weakness at a time when it is more comfortable with the inflation backdrop. We look for a further 150bp of cuts by next summer, but the risks are skewed towards the central bank doing more

Fed Chair Jerome Powell at the press conference following the 50bp rate cut, which marks the first rate cut in four years

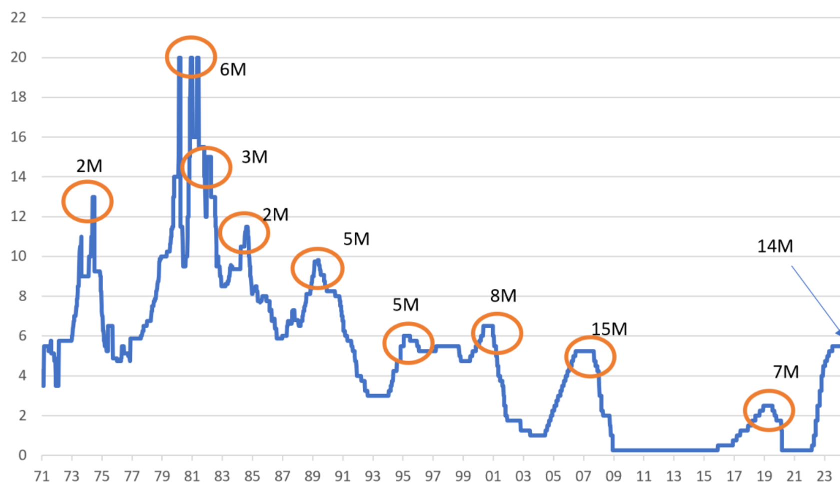
So we get the 50bp interest rate cut that the market had been gunning for despite the economy being described as expanding at a "solid pace" in the accompanying statement.

Expectations of a larger move had been building over the past week despite core inflation coming in at a relatively “hot” 0.3% month-on-month and the August jobs report painting a stronger picture than many thought likely.

The lack of pushback on market pricing from the Fed in sourced media articles suggested it was inclined to go boldly and in the end there was only one dissenter – Governor Michelle Bowman, who voted for a 25bp cut. Being "strongly committed" to supporting maximum employment and

returning inflation to target continues to be the theme, but it is clear where the priorities lie; get policy back to a more neutral setting to avert the risk of recession given growing comfort that inflation is on the path to 2%.

Fed funds ceiling with period between last hike and first cut indicated (%)



Source: ING, Macrobond

There was a sense in economist circles that the majority of Fed officials would be reluctant to take such bold action in an environment where the economy is growing at a 2.5-3% rate, equities are at an all-time high, inflation is above target and unemployment is low at just 4.2%. With no financial system stress apparent, unlike in 2007, this too argued for a more cautious 25bp cut.

A major catalyst for the move is likely to have been the narrative from the recent Federal Reserve Beige Book. This anecdotal survey on the state of the economy suggested that only three of the 12 Federal Reserve Bank districts reported growth over the previous eight weeks versus seven at the time of the previous report from July. With 75% of the Fed banks reporting flat or contracting activity, corroborated by weakness in ISM and NFIB business surveys, the Fed has taken the view that it needs to move policy from "restrictive" territory towards "neutral" quickly.

Fed forecasts

	2024	2025	2026	Longer run
Change in real GDP (4Q YoY%)	**2.0**	**2.0**	**2.0**	**1.8**
Previous Fed projection (Jun)	2.1	2.0	2.0	1.8
Unemployment rate (% year end)	**4.4**	**4.4**	**4.3**	**4.2**
Previous Fed projection (Jun)	4.0	4.2	4.1	4.2
Core PCE inflation (4Q YoY%)	**2.6**	**2.2**	**2.0**	**-**
Previous Fed projection (Jun)	2.8	2.3	2.0	-
Federal funds rate (year end)	**4.4**	**3.4**	**2.9**	**2.9**
Previous Fed projection (Jun)	5.1	4.1	3.1	2.8

Source: Macrobond, ING

The Fed's new forecasts show it still expects the economy to continue growing at 2%, and that unemployment will rise to 4.4% from 4.2% by year-end and stay there for 18 months, but it has trimmed their inflation numbers. The central bank suggests a further 50bp of cuts this year with 100bp more in 2025 and 50bp in 2026, taking the policy rate down to the 2.75-3% range. The market, though, thinks it will end up going harder and faster with a 2.9% Fed funds rate priced a full 12M ahead of when the Fed thinks it will happen. Note yet another incremental increase in where it thinks the long-run "neutral" policy rate is.

Our forecasts are broadly in line with what the Fed is indicating – get rates down to 3.5% or a bit below by next summer on the basis that prompt action from the Fed allows the US economy to avoid recession just as it did in the mid-1990s under Alan Greenspan. That view still holds, but we certainly acknowledge that the jobs market outlook is more concerning and the risks are indeed skewed to the Fed having to do more, more quickly. Remember 3% is not stimulative territory so if the growth story weakens more markedly then we know the Fed will go lower.

For market rates, a steeper curve is the most meaningful follow-on move

Market reaction to the 50bp has been a steeper curve, from the front end. Inflation expectations are up a tad as measured through the 10yr inflation breakeven rate. Reaction in risk space is positive as spreads tighten. Impact reaction had market rates net lower right along the curve. Ahead of the cut, there had been a drift higher in market rates. The 50bp move facilitated the reverse reaction lower.

It's still too early to conclude that longer tenor market rates will continue to move lower. We've noted before that they have made quite some headway in recent weeks, and there is always a risk for a pullback, especially as yields are already quite low relative to the likely terminal rate. The Fed pitches that at 3.4% for 2025, versus 10yr SOFR now at 3.2%.

The steepener makes the most sense here, potentially from both ends, as the 10yr can still decide to baulk at a material move lower from here, and indeed the risk for a reversal higher in rates cannot be ruled out. Perverse yes, on a 50bp move, but not so perverse from a relative value perspective.

Remember, the 10yr Treasury yield is constrained by the spread to 10yr SOFR, currently around 45bp (and for good reason given the supply pressure in Treasuries). Hence, 3.65% on Treasuries coincides with 3.2% on SOFR, and the latter is already through the Fed's end game dot for 2025 (albeit slightly above the 2.9% dot for 2026).

FX: Dollar shorts build-up to accelerate

The dollar fell after the surprise 50bp cut but rebounded following Powell's comments that seemed to push back against multiple 50bp cuts. That said, if we had thought a dovish 25bp cut wouldn't have turned the tide for the underperforming USD, a 50bp move unlocks more downside potential.

Our calculations on CFTC data show that aggregate USD positioning against reported G10 currencies (i.e. G9 minus SEK and NOK) moved into net-short territory at the end of August. Still, those net USD shorts amounted to around 6% of open interest, a rather small figure compared to the 24% net-long peak reached last April. If unwinding dollar longs has been the story of the past few months, a steady build-up in dollar shorts may be the narrative into the US election.

Looking at EUR/USD, even if the pair is back to the pre-meeting levels, it has equally shown good resilience to swings in sentiment lately, and we remain confident about our 1.12 short-term target for the pair. That said, the yen should remain a preferred channel of USD weakness, due to its high sensitivity to UST yields, while also being less at risk from potential Trump protectionism measures. A move below 140.0 remains all but possible in USD/JPY over the next few days.

Unless jobs figures come in much stronger than expected, and force the Fed to a more cautious easing path, the dollar appears bound to stay soft into the US election. In November, a Trump win could see a sharp dollar rebound, especially if markets have built large USD short positions. Should Harris secure the presidency, we'd probably be looking at a further gradual USD weakening into 2025.

Authors

James Knightley
Chief International Economist, US
james.knightley@ing.com

Francesco Pesole
FX Strategist
francesco.pesole@ing.com

Padhraic Garvey, CFA
Regional Head of Research, Americas
padhraic.garvey@ing.com

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