

FOMC preview: Growing confidence of a Fed rate cut in September

US data should give officials more confidence that inflation is heading to 2% and we suspect attention will start focusing on achieving a 'soft landing' for the economy. Next week's FOMC meeting should lay the groundwork for a September rate cut as policy starts shifting from restrictive territory to something more neutral



Just one US rate cut this year? We don't think so. The Fed's Jerome Powell

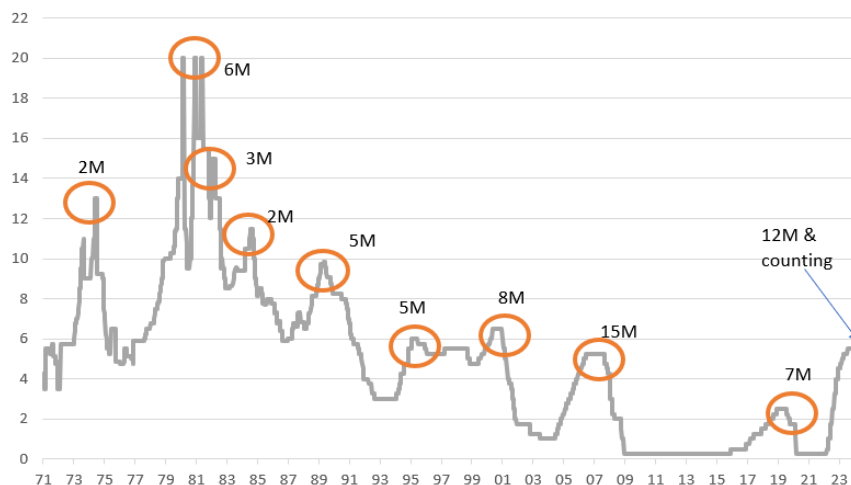
Back on track for rate cuts

We have to ask the question: have events already overtaken the Fed? At June's FOMC meeting, the most interesting aspect was the Fed moving away from a view of three possible rate cuts this year suggesting just one was the most likely path ahead. But given the recent data flows and financial market moves, this may already seem out of date.

The Federal Reserve will still leave monetary policy unchanged at next week's FOMC meeting, but we believe they will use it to offer the clearest hint yet that they're starting to seriously consider an interest rate cut, most probably at the subsequent September FOMC meeting. Inflation is looking better behaved, the unemployment rate is on the rise and there is growing evidence that consumer spending is cooling. The Fed has been striving for a "soft landing" and if the data allows them to cut, and it is certainly moving in that direction, then we think they will seize the

opportunity.

Fed funds rate and duration between last hike and first interest rate cut



Source: Macrobond, ING

Inflation is in a better place

Regarding inflation, both core CPI and the core PCE deflator were running far too hot for comfort in the first quarter, but May and June numbers are looking more encouraging. Most notably, the so-called “super-core services” that exclude housing, food and energy, on which the Fed have been putting heavy emphasis, have slowed markedly, and we are finally seeing the key housing components reflecting the moderation witnessed in third-party private rent series.

Fed Governor Christopher Waller stated last week that *“I do believe we are getting closer to the time when a cut in the policy rate is warranted”*, and Fed Chair Jerome Powell, at his recent appearance before Congress, added that *“more good data would strengthen our confidence”* that inflation is on the path to 2%. We think they will get it for the July and August inflation reports. This is a necessary requirement - but not sufficient on its own - for a September interest rate cut.

A “soft landing” is possible if the Fed is able to cuts rates

The second area in which we need to see moderation is the labour market. The unemployment rate has risen from a low of 3.4% in April of last year to 4.1% in June, above the 4% level the Fed predicted for the end of the year at their most recent forecast round. Governor Waller has warned that *“there is more upside risk to unemployment than we have seen for a long time.”* San Francisco Fed President Mary Daly suggested, *“We don’t want to be to a point where we start to see the labour market weaken substantially - to falter - because by then, it is actually often too late to bring it back”*.

For now, the rise in unemployment is being caused by labour supply growth outstripping demand; we aren’t seeing net job losses. Nonetheless, the ISM and NFIB employment indicators suggest risks on this front are growing. Even if we don’t see net job losses, the growing slack in the jobs market is boosting confidence that wage growth will continue to slow to rates that have long been consistent with an inflation target of 2%.

The third area the Fed wants to see cooling is the consumer sector, which saw annualised spending growth of 3.2% in the second half of 2023. This has dropped below 2% through the first half of this year, and with income growth slowing, pandemic-era accrued savings being run down, and consumer credit growth under pressure from high borrowing costs and rising loan delinquencies, this third leg of the stool is also starting to argue for the Fed making a policy change.

Growth to become the greater concern for the Fed with risks skewed toward more cuts

Our position is that the Federal Reserve doesn't want to cause a recession if they can avoid it, and if the data allows, we expect officials to start moving monetary policy from "restrictive" territory to "slightly less" restrictive policy from September. We are getting very close, and assuming things pan out as we expect, the Fed will use the Jackson Hole symposium to show they're re-evaluating the outlook and will be cutting their growth and inflation forecasts and raising their unemployment projection in September.

This, we believe, will pave the way for three rate cuts this year in September, November and December, with at least three more next year.

The 2yr and 10yr are heading to 4% in anticipation of first cut by September

The spread from the 2yr yield to the effective funds rate has hit a new low at -93bp as we build to a first rate cut in the cycle ahead. The magic level is -100bp, as traditionally, once we hit that level, the market is fully primed for a first cut and the beginning of a sequence of cuts. The 2yr yield is now in the 4.4% area, and tracking towards 4% as a call in the coming couple of months. Getting to 4% can be fast. The only reason for a longer-term call is the Fed is not expected to cut at the upcoming meeting, but it seems it is more minded to cut on 18 September. It is possible, however, for the Fed to give the move a push should they use the July meeting to nod towards the likelihood of a cut at the September meeting.

The 10yr yield is also tracking towards 4%. Now in the 4.2% area, the inversion of the curve is under 20bp. As the 2yr yield and the 10yr yield head towards 4%, the curve completely flattens out, and from there, we build an upward-sloping curve as the Fed continues along the rate-cutting process over subsequent months.

Commentary on liquidity conditions and the shrinking of the Fed's balance sheet is usually buried in the detailed statement and rarely voluntarily opined on at the press conference. We expect something similar this time. The Fed has already pre-positioned with an early (in our view) tapering of the quantitative tightening process. This continues in the background and has not yet hit levels where particular concerns for liquidity circumstances are warranted.

That said, we find it noteworthy that balances going back to the Federal Reserve on the reverse repo facility have been sticky in the UD\$400bn area, a material change from the big falls seen through 2023 and into early 2024. We view this balance as a manifestation of excess liquidity and, ideally, should shrink in line with the quantitative tightening process. If it doesn't, then bank reserves, now at \$3.3tn, will be pressured to fall. Should they get under US\$3tn, then we have a contradictory material tightening in liquidity conditions, just as the Fed starts to ease interest rate

policy.

FX: Some downside risks to the dollar

Lower US short-dated rates have taken the dollar roughly 1.5-2.0% lower through July, although its bilateral performance has very much been driven by the unwinding of carry trade strategies. Probably one of the first questions for the market will be whether the Fed feels the need to steer the market towards a September rate cut by changing the language in the FOMC statement. For example, the June 2019 statement used the below turn of phrase before the Fed delivered a rate cut in July:

'The Committee continues to view sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2 percent objective as the most likely outcomes, but uncertainties about this outlook have increased. In light of these uncertainties and muted inflation pressures, the Committee will closely monitor the implications of incoming information for the economic outlook and will act as appropriate to sustain the expansion'

The Fed may prefer to keep its options open rather than commit to this kind of language, but there's certainly a risk. Up until the Fed's last press conference in June, Chair Powell had been reliably dovish, and the dollar had softened. But in June, Chair Powell surprised on the more conservative side, perhaps to be consistent with the Fed's Dot Plot message of one rather than three expected rate cuts this year.

But as above, we think the direction of travel for US short-term rates is lower and the FOMC meeting presents a negative risk event for the dollar. Given still heavy short positioning in the yen, USD/JPY risks probably still lie to the downside (the Bank of Japan will have decided policy earlier in the day) and EUR/USD could nudge higher on the view that near-term easing from the world's most influential central bank will support faltering global growth prospects.

Equally, if dovish Fed rhetoric does not emerge by 31 July, the dollar is unlikely to rally too far. The Jackson Hole Fed symposium in late August is another chance for the Fed to signal a September rate cut.

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