The case for US interest rate cuts

Market interest rate cut expectations have swung wildly this year on fluctuating data and cautious messaging from Federal Reserve officials. Nonetheless, we are seeing broadening evidence that can justify the Fed starting to move policy from a restrive stance to a slightly less restrictive one from September onwards

We continue to look for the Federal Reserve to cut interest rates from September

Firstly: One good month on inflation needs to become a trend

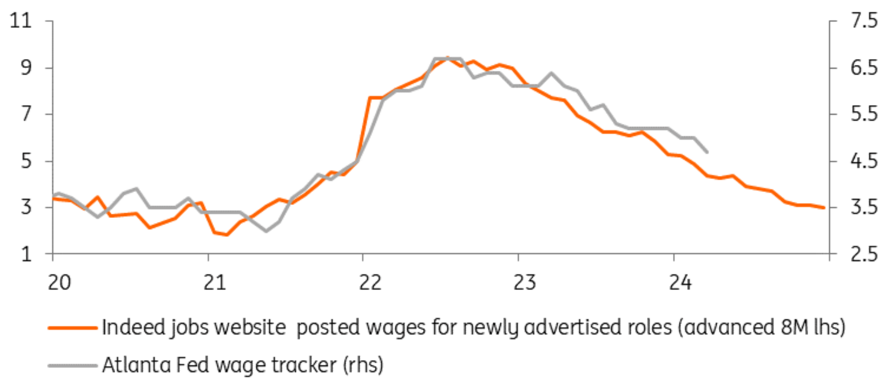
We continue to look for the Federal Reserve to cut interest rates from September on the basis that it believes monetary policy is restrictive at 5.25-5.50% in an environment where they view the neutral interest rate as being around 2.6%. They don't want to cause a recession if they don't have to and if the data allows them to start making monetary policy slightly less restrictive, we think they will take that opportunity.

For them to be comfortable taking that course of action, we think they need to see three things. Firstly, core inflation must show evidence of easing. First-quarter numbers were far too hot, but we have had a 0.2% month-on-month reading in the Fed's favoured measure of inflation, the April core PCE deflator. If we can get two or three more in quick succession, which would indicate price pressures are moderating, that will be a necessary, but not a sufficient outcome that leads to a rate cut.

Secondly: More slack in the jobs market and cooler wages

Secondly, if we see evidence of labour market slack, the Fed will likely be more convinced that inflation pressures will continue trending towards target and stay there. The unemployment rate has risen from 3.4% to 3.9% and if that moves convincingly above 4% to say 4.2% with more evidence of cooling wages that too will help swing the argument in favour of rate cuts. The plunging quits rate, weak ISM employment readings, and subdued small business hiring amidst growing labour supply supports this story.

Wage trackers pointing to ongoing cooling in pay rates and inflation (YoY%)



Source: Macrobond, ING

Thirdly: A consumer slowdown

Then thirdly, we need to see softening consumer spending, which has been the primary driver of economic activity over the past couple of years. There was some evidence of that happening in 1Q GDP revisions and weak April monthly data, but we need to see more. As we wrote last month, the bifurcation of the consumer makes this a difficult call since the top 20% of households by income spend the same as the bottom 60% of households.

The top 20% are in great shape with their high incomes meaning inflation is more of an irritation rather than a severe constraint. They also have housing and stock market wealth that has risen hugely and also benefit from high interest rates – they can put their cash in money market funds at 5-5.5% while their mortgage borrowing costs may be closer to 3.5%.

It is a very different situation for those lower-income households where high inflation has been a much greater burden. There is also growing evidence that pandemic-era accrued savings for these households have been exhausted and financial strains are emerging with credit card and auto loan delinquencies rising sharply. There is evidence to suggest that discretionary spending is starting to be trimmed and with the NY Fed telling us 18% of US credit cards are within 90% of their maximum limit, we expect this to become increasingly apparent

US elections and the case for 2025 rate cuts

The resilience of the US economy to higher rates has been remarkable but we do expect the stresses being felt by lower-income households to become more evident and a consumer slowdown to emerge. So, if we get the combination of cooler inflation, a looser jobs market and stalling consumer spending growth we believe the Fed will indeed look to move monetary policy from "restrictive" to "slightly less restrictive" with 25bp rate cuts at the September, November and December FOMC meetings.

We acknowledge there are a range of possibilities. Should inflation fail to slow then the Fed will not cut rates, but that could create a more stressed economic environment that leads to steeper interest rate cuts next year.

With regards to 2025, we also recognise that the US elections will have a heavy influence on the path of Fed policy. For example, Donald Trump's key policy differences versus Joe Biden are more tax cuts, more immigration controls, more tariffs and the potential for major geopolitical shifts. Our sense is that this would be more supportive of domestic demand while limiting labour supply and putting up business costs, which could end up being a slightly stronger growth story for the US, but one with higher inflation rates, too. This could mean that the Federal Reserve would be more wary of cutting interest rates aggressively under a Trump administration versus a Biden-led administration.

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