

US job jitters prompts the Fed into action

Having signalled little prospect of meaningful interest rate cuts as recently as June, the Federal Reserve is now primed to cut rates on 18 September. Inflation fears have receded and it is the rapidly cooling jobs market that is firmly in focus



Now slowly marching to a rate cut beat, the Fed's Jerome Powell

Markets are pricing 100bp of rate cuts this year – we agree

The combination of a surprise Bank of Japan rate hike, a dovish pivot by the Fed and the subsequent soft jobs report sent financial markets into a tailspin last month. Fears that a huge unwinding of the yen carry trade could unleash a torrent of broader market dislocation saw financial markets price in the very real risk of an inter-meeting Federal Reserve interest rate cut.

Subsequent soothing words from officials and an improvement in the US data have calmed the situation, yet we are left in a position where the market is now fully discounting 100bp of rate cuts from the Fed this year, with the policy rate heading to 3% next year. This is significantly more than the Fed was signalling would be likely in its June forecast, where a single 25bp cut was indicated for this year, with the target rate reaching a mere 4.25% next year.

A cooling jobs market is now the primary focus

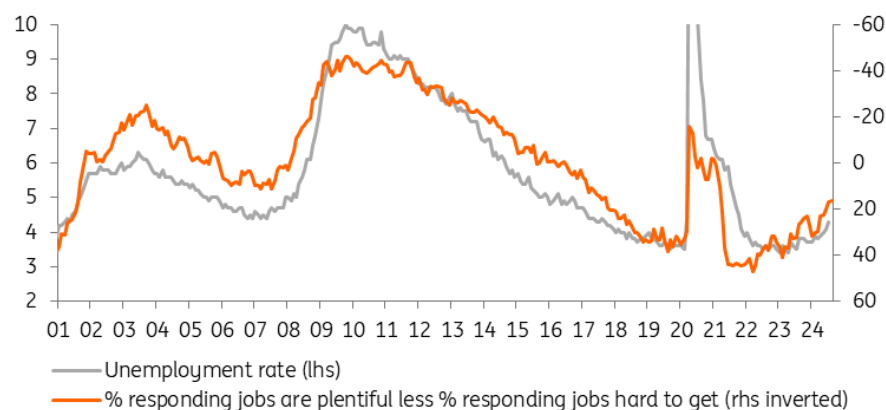
The Fed has had to play catch up to recent events, and it recognises that if it is going to achieve its aim of a “soft landing”, it is going to need to adjust policy more quickly than thought. Thankfully,

inflation is playing ball. We have now had three consecutive months where both measures of core inflation (core CPI and core personal consumer expenditure deflator) have come in at or below the 0.17% month-on-month run rate consistent with 2% annual inflation.

This means the Fed can put more focus on its second target of maximum employment. Here, things are looking more worrisome. The unemployment rate has risen from 3.4% to 4.3%, which is above the 4% rate the Fed predicted for the end of the year. This has, in turn, triggered the Sahm rule, a momentum measure of changes in the unemployment rate that has historically been consistent with recession.

On top of that, the Bureau for Labour Statistics has revised away a third of the jobs that had been thought added in the 12 months to March 2024. With the BLS having made incorrect assumptions about job creation in small businesses, this raises serious questions about whether the apparent slowing in job creation since April has been worse than reported.

Unemployment is rising and households sense jobs are harder to come by



The Fed recognises it needs to move policy to a more neutral level

Even before the recent spike in volatility, the July FOMC meeting minutes suggested “*the vast majority of members*” thought it would be “*likely appropriate*” to cut the Fed funds target rate on 18 September while “*several*” officials had seen a plausible case for a cut at the July meeting. Fed Chair Jerome Powell made it clear where he stood at the recent Jackson Hole conference – “*the time has come for policy to adjust. The direction of travel is clear.*”

A 25bp move on 18 September is slightly favoured by markets right now. Still, if we get a sub-100k on payrolls and the unemployment rate ticks up to 4.4% or even 4.5%, then 50bp looks likely, given Powell’s comment that “*we don’t seek or welcome further cooling in labour market conditions*”. Even if they just move by 25bp, there is still the possibility of a 50bp at some point, with softening business surveys and hiring indicators suggesting that the Fed should manoeuvre policy from “restrictive territory” to a more neutral level relatively swiftly.

How quickly and how fast will be determined by the rate of deterioration in the jobs market. So far, the rise in the unemployment rate has been caused by labour supply growth outpacing labour

demand. However, full-time employment has fallen in year-on-year terms for six consecutive months, and as the chart above shows, households are noticing the slowdown. There is a clear perception that jobs are becoming much harder to get, and a period of belt-tightening from consumers may be required. This runs the risk that a “soft landing” scenario could quickly turn into something much weaker that necessitates a more aggressive response from officials.

Author

James Knightley

Chief International Economist, US

james.knightley@ing.com

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