

US Goldilocks story gives the Fed scope to cut rates another 25bp

The labour market and economic activity remain in decent shape while inflation pressures are subsiding. This gives the Federal Reserve room to gradually cut interest rates further, thereby giving the economy more breathing space to keep growing robustly



Labour costs cooling with little evidence of job firings

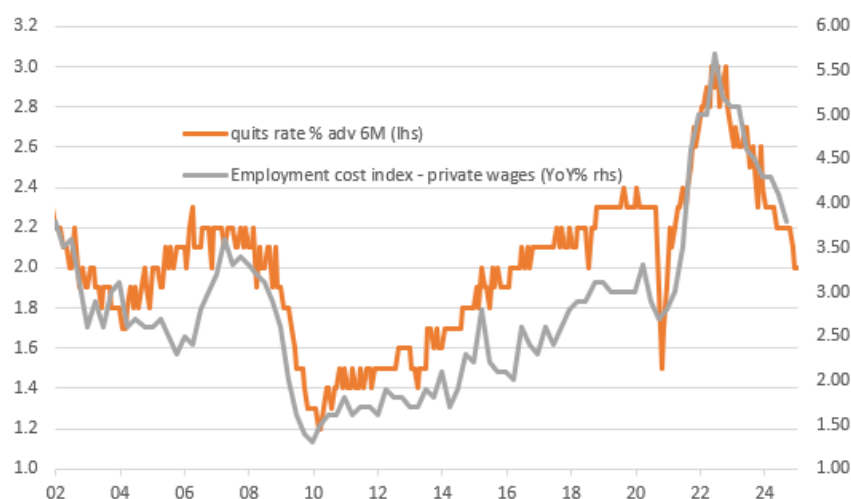
Today's US data flow is pretty good showing that activity/jobs remain in decent shape and inflation pressures are subsiding. Initial jobless claims dropped to 216k from 228k the week before while continuing claims dropped to 1862k from 1888k, although remain in an upward trend channel. Hurricane impacts are continuing to influence the numbers, but in general the story remains that very few people are being laid off (good news), but elevated continuing claims suggest that if you are one of the unfortunate few to lose your job it is becoming more challenging to find work (not good news).

Meanwhile, the employment cost index slowed more than expected to show growth of just 0.8%QoQ. This is a really important number for the Federal Reserve as it is a measure of all in employment costs (wages+bonus+benefits). It is the weakest increase since the second quarter of 2021 and implies pipeline price pressures are weakening and boosts confidence that inflation is

sustainably on the path to 2%.

Below is a chart showing how employment costs are rapidly normalising, which is what the Fed wants to see. The slowing quits rate – fewer people quitting so less incentive for employers to offer bumper pay rises – suggests we are rapidly converging on pre-pandemic norms.

Employment costs are cooling rapidly

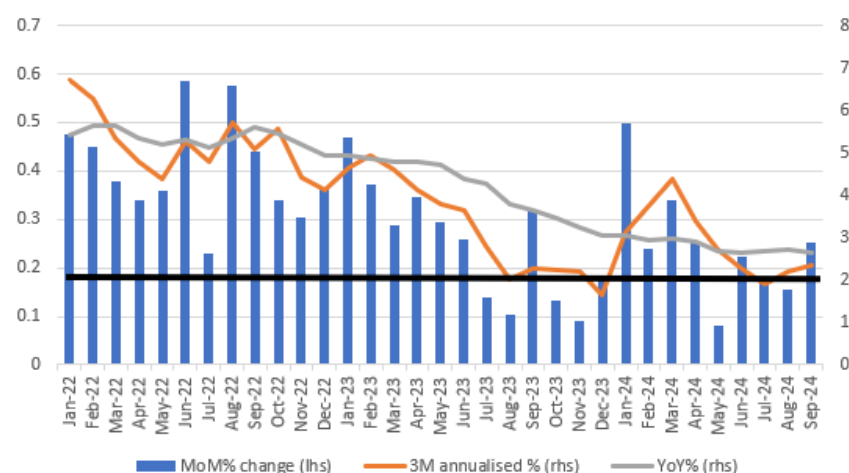


Source: Macrobond

Inflation on track for 2%

Rounding out the data, the personal income and spending report doesn't contain any major surprises since the key messaging was provided by the quarterly numbers from the GDP report yesterday. The small surprise yesterday was that the quarter-on-quarter annualised core PCE deflator (the Fed's favoured inflation measure) came in at 2.2%. This implied that we would see a 0.34%MoM outcome today, significantly above the 0.25% that the market was predicting. As we suspected though, the core PCE deflator saw upward revisions to July and August so the MoM outcome was indeed 0.254%.

Core PCE deflator is tracking towards 2%YoY



Regarding prices, the Fed doesn't need inflation to be at 2%YoY to allow further rate cuts. It just has to be confident that the month-on-month rates are tracking the right path. That is to average 0.17%MoM since 12 0.17%MoM readings generate 2%YoY inflation.

As the chart above shows, last month we were above 0.17%MoM (the black line), but we have seen several sub-0.17%MoM prints over the past year, whereas from 2021 to mid-2023 they were consistently too hot. All in all, these reports give the Fed the scope to keep cutting rates back to a more neutral level to give the economy a little more breathing space to continue growing strongly. We look for a 25bp rate cut next week.

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