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Market Note

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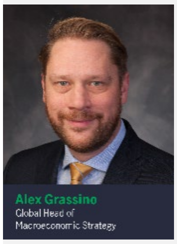

The US Federal Reserve (Fed) kicked off its long-awaited monetary easing cycle with a bang on 18 September (US time), electing to reduce its policy rate by 50 basis points (bps). While the size of the rate cut wasn't officially factored into many Fed forecasters' base-case scenarios, it wasn't a real 'surprise' decision either. In this Market Note, Alex Grassino, Global Head of Macroeconomic Strategy, provides his latest analysis on the Fed meeting.

The Fed's rate decision: Not so surprising, but what's the path forward?

Key takeaways:

<u>Our rate forecast</u>

If the US economy cools—and we maintain that it probably will—there may be future points at which some of the economic data surprises to the downside, potentially triggering a more aggressive policy response from the US Federal Reserve (Fed). Consequently, our current expectation is a further 75 basis points (bps) of easing, which would bring the federal funds rate to 4.25% (upper bound) by the end of 2024. Looking to 2025, we now anticipate that the policy rate will reach 3% before the end of the year.

<u>Three important themes to highlight</u>

- Labour market data releases will likely be volatile events for financial markets.
- As long as the US economy holds up, easier monetary policy in the form of lower rates generally favours riskier investment assets, short-term volatility notwithstanding.
- Other global central banks, particularly those in emerging markets, will likely feel more comfortable pursuing their own easing cycles with the Fed having taken a definitive step in that direction as well.

The US Fed kicked off its long-awaited monetary easing cycle with a bang yesterday, electing to reduce its policy rate by 50 bps. While the size of the rate cut wasn't officially factored into many Fed forecasters' base-case scenarios, it wasn't a real 'surprise' decision either. Over the past several days, market positioning had already been skewing toward the prospect of a 50-bps cut coming out of the Fed's September meeting, as various prominent (and mostly well-informed) members of the financial press began to suggest that it was, in fact, likely to be a much closer call than the consensus 25-bps cut that had been priced into markets following last week's Consumer Price Index (CPI) inflation print.

The Fed's latest Summary of Economic Projections (SEP) was largely unhelpful

Here are our takeaways from the Fed's latest SEP, released yesterday:

- The Fed's dot-plot chart, which summarises where the central bank expects its policy rate to be going forward, actually reads somewhat hawkish, at least relative to current market positioning. The Fed is telegraphing another 50-bps of rate cuts between now and the end of 2024, implying a slower easing cycle in its final two meetings of the year. The range of potential outcomes provided by Fed forecasters reinforces this view, suggesting that less than 50 bps would be the next most likely scenario. The expectation for 100 bps of easing in 2025 remained unchanged, while two additional rate cuts (which would bring the federal funds rate to 3%) are now baked into 2026. While we agree with the destination, we expect the Fed's journey there to be faster.

- The rest of the forecasts within the range of potential outcomes almost look like they were calibrated to give the Fed maximum optionality and flexibility in its decision-making process: all were characterised by a more benign inflation profile, trend-like GDP growth, and a higher unemployment rate signalling some incremental, but by no means alarming, cooling of the labour market.

The Fed's post-meeting statement and press conference were more telling

We'd instead turn our attention to the Federal Open Market Committee (FOMC)'s post-meeting statement and press conference. Since Fed Chair Powell's Jackson Hole speech, there has been a clear move away from the Fed being purely focused on driving down inflation toward reemphasising the other part of its dual mandate: full employment (i.e., a healthy job market). The FOMC essentially codified this shift in yesterday's statement, adding the line "The Committee is strongly ***committed to supporting maximum employment*** and returning inflation to its 2% objective."

In our view, the implication of this addition is that, while the base-case outlook is for gradual policy easing, there appears to be a low bar for the Fed to move more aggressively in cutting rates than what's being telegraphed as of this writing.

The size and shape of this easing cycle depend on whether we see downside surprises to the labour market and consumer data

We suspect that such scares may indeed occur in the months ahead. If the US economy cools–and we maintain that it probably will–there may be future points at which some of the economic data surprises to the downside, potentially triggering a more aggressive policy response from the Fed. Consequently, our current expectation is for a further 75 bps of easing, which would bring the federal funds rate to 4.25% (upper bound) by the end of 2024. Looking to 2025, we now anticipate that the policy rate will reach 3% before the end of the year; we'd previously called for the federal funds rate to hit our estimate of neutral a couple of quarters into 2026.

So, the Fed has finally begun easing–now what?

We see three important themes worth highlighting now that the Fed's easing cycle is finally underway:

- Labour market data releases will likely be volatile events for financial markets. Investors will assess the shape of the easing to come based on key labour market releases such as nonfarm payrolls, the Job Openings and Labor Turnover Survey (JOLTS), and jobless claims. Gauges of consumer confidence like retail sales are another potential flashpoint to watch.

- As long as the US economy holds up, easier monetary policy in the form of lower rates generally favours riskier investment assets, short-term volatility notwithstanding. While we do expect the economy to cool, we also acknowledge that the farther along the easing cycle path the Fed gets before seeing signs of economic weakness, the longer the landing strip for that elusive 'soft landing' becomes.

- Clearly, this Fed meeting and its potential ripple effects aren't just about the United States. Other global central banks, particularly those in the emerging markets, will likely now feel more comfortable pursuing their own easing cycles with the Fed having taken a definitive step in that direction as well. Recall that during the first half of 2024, a short-lived high-inflation, strong-growth environment effectively took Fed rate cuts off the table for the rest of the year, driving the US dollar higher and forcing other central banks' nascent easing cycles to pause. Bank Indonesia was a good example, having already cut its policy rate in anticipation of the Fed soon slashing its rate.

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