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Fed takes giant leap, hints at smaller steps ahead

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The Fed skipped Neil Armstrong's small step, and opted to start its easing cycle with a giant leap, making up for what we judged (and what Powell almost conceded) to be a bit of a late start to that process. In cutting by 50 bps, the Fed avoided disappointing market expectations, although Powell denied that market pricing was a key factor. While the still-high level for real interest rates suggests that another half point reduction is in store for November, there are hints in the committee's projection, as well as its language, that it could return to smaller quarter point steps in December and beyond. Powell cautioned in the press conference against assuming that "this is the new pace". That might be a heads up to a bond market that seemed to be getting a bit carried away, and might have jumped to an even more dovish view given today's larger rate cut.

On the language front, while cutting by at outsized pace today, some caution was shown on inflation by stating the risks to its inflation and employment targets were "balanced", rather than titled towards more concern about the soft job market. The median dot forecast for further rate cuts moved up the timing for further cuts significantly, but still has the end point for 2025 3.4%, in line with our earlier forecast, and implying that the Fed will either be pausing or reverting to quarter point cuts next year.   Unless fiscal policy tightens post election, further cuts in 2026, where the dot forecast shows a trough in rates at 2.9%, might not be in the offing.

The easing path is seen as a defensive measure, one sufficient to keep the economy humming along at a healthy 2.0% growth rate over the next few years. The FOMC forecast has allowed for a modest further rise in the jobless rate to 4.4%, which is held through 2025 before starting to improve. That's a bit of a contradiction with Powell's earlier comments that the Fed didn't want to see "any" further deterioration in the labour market, in the sense that the Fed would have room to ease at a faster pace to prevent that nudge higher in unemployment. The inflation outlook is only slightly tamer that in the prior forecast, and still shows PCE inflation as essentially on target over the next two years.

Of course, the Fed is still data dependant, and how the economy performs could alter that rate path. But Q3 growth indicators have, if anything, been moving higher during the very days when the market was adding to its rate cut expectations. We're a bit more concerned than Powell about labour market softness. Consumption accounts for a huge share of current growth, and history suggests that the weaker hiring we've been seeing, rather than rising layoffs (which are not in evidence), often is a leading signal for the direction of the labour market. But the healthy performance of the US economy in the face of interest rates above 5% suggests that we might not need to take rates below 3% to get back to full employment.

Forecast implications:

We had called for a quarter point cut today, drawing on Waller's and Williams' pre-blackout statements that suggested they were in line with that outcome, followed by two 50 bp moves in November and December. Today's decision simply shifted the timing, rather than the likely magnitude of rate cuts in 2024. Look for soft inflation, and high real rates, to allow for another half point cut in November, followed by a quarter point cut in December, and further quarter point cuts through the first half of 2025. As a result, until we see a data surprise in one way or another, we're retaining our year-end forecast level for the funds rate in 2024 (a midpoint of 4.125%), and a trough at 3.375% by mid-2025.

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