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Fed announcement: One or two?

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The Fed held rates steady today as expected and made minor changes to the statement, but signaled that rates will start to come down this year with one projected cut by the end of this year, below the market's expected two cuts in 2024. Its accompanying June projections also showed that the median voter expects to ease policy four times in each of 2025 and 2026. In the March projection, the Fed expected three cuts in each year of the projection horizon, so today's dot plot keeps the total amount of policy easing over the projection unchanged and just shifted the timing of cuts, likely as an insurance against the bumpier inflation seen in 2024. The Fed Funds Rate at the end of 2026 remains slightly above 3%. The median view on the long-run dot also continued to drift slightly higher as expected, rising to 2.75% from 2.6%. There were modest upward revisions to growth and inflation in the near-term years of the projection, but the unemployment rate was also revised higher in the later years of the projection.

While the median view of SEP was a bit hawkish given the market expectations of two cuts by the end of the year, the Fed does not have a high conviction of one cut this year versus two. Powell said as much in the press conference and voters are very closely clustered together with about the same number of people in one and two camp for 2024. There is more uncertainty beyond 2024, but even there the signal is clear that the economy will need less restrictive policy. Some participants may also have kept rates higher for longer for tactical reasons, which is not without precedent. Showing fewer cuts might have been aimed at ensuring financial conditions don't ease too quickly, and the cost of not following through on fewer cuts is low from a credibility stand point is low because the Fed is highly data-dependent. The same sort of thing happened in 2023, when the FOMC kept in an extra hike in their June and September projections of that year, only to remove them in December on better than expected data. Financial conditions tightened and the Fed ultimately remained on hold. Sometimes, the Fed can have its cake and eat it too.

But what this ultimately comes down to is the near-term path of inflation. On this point, Powell was very balanced, and openly admitted there was some "conservatism" embedded in the inflation projections and also that, there has been progress on inflation in the past two readings. There are two most likely scenarios here. One in which inflation looks more like a combination of what we saw in March and April, a little bumpy with slow progress which seems to be the SEP view for the rest of this year. Or one that looks like a combination of April and May, a mix of slow and fast progress. We have favored the later path because our reading is that a lot of the above target inflation readings was due to transportation services, and particularly auto insurance, adjusting to post-pandemic realities and was not a demand-driven uptick. There is good reason to believe that won't last given the trajectory of car prices and insurers future profitability looking much improved (For more details, see here) and so we expect more of a mix of fast and slow progress to target from here on out, which is why we are still in the two cuts camp. Adding to this, the labor market in a few months could start to shift from balanced to modestly weak. Payroll strength has been strong, but source data suggest that payrolls will likely be revised down historically, and no small part of the strength in job gains has been due to robust labor supply and hiring from sectors not sensitive to the business cycle (government and healthcare). The household survey and JOLTS data show a labor market that is losing steam and dynamism in a slow but steady fashion.

Overall, the Fed is just watching the data and erring on the side of caution for now. That is absolutely not a bad plan, but it is also not a hard commitment. The more important point from their perspective is that, even with some bumps along the way, monetary policy is working and an easing cycle is needed. They will let the data decide when we start the cycle, but the route is becoming clearer.

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