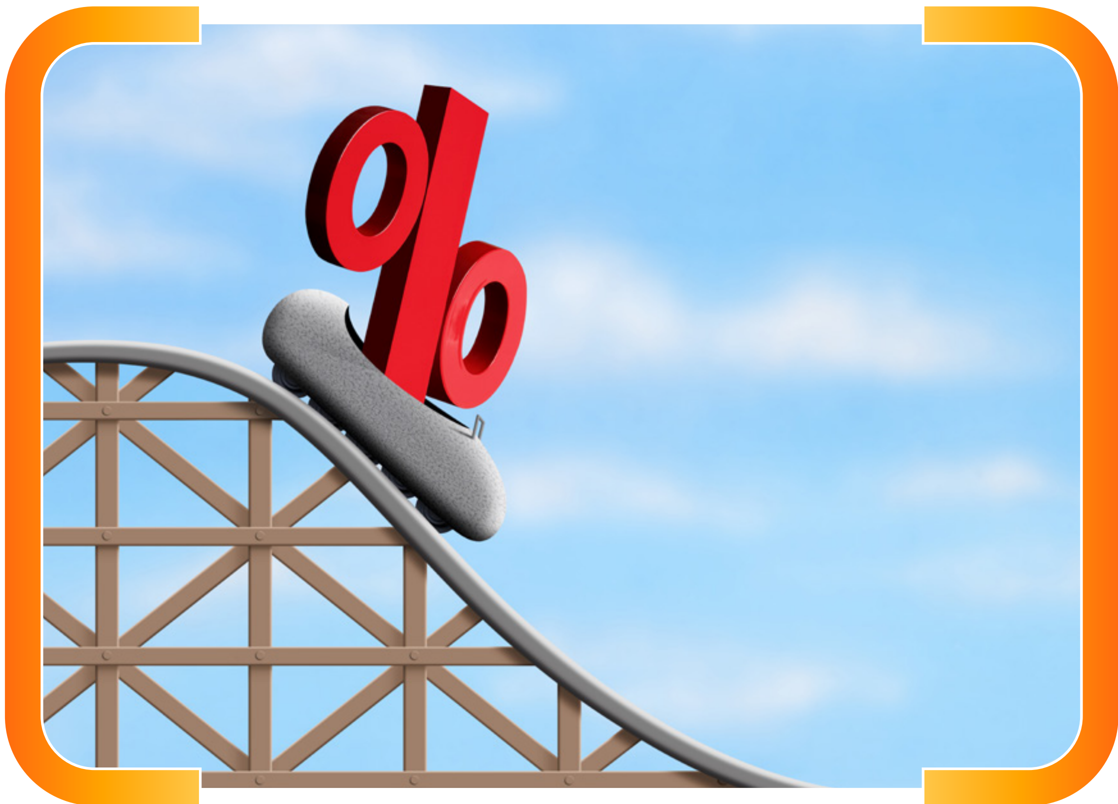
A jumbo rate cut to start the easing cycle



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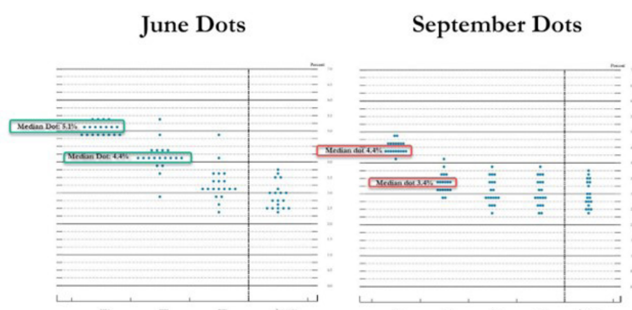
The Federal Reserve has cut interest rates by 50 basis points in their first rate cut since March 2020, meaning the long awaited "Fed pivot" has officially begun. By starting their monetary policy easing cycle with an aggressive 50 basis points rate cut, it seems that the Fed decided to focus on the labour market part of their dual mandate rather than the inflation one.

Here's a summary of the Federal Reserve's decision:

1. Interest rates cut by 50 bps for first time since 2020
2. Rate cuts 2 more 25 basis point in 2024
3. Fed governor Miki Bowman dissented in favour of a smaller 25 bps cut. It's the first dissent by a "governor" since 2005
4. Gained "greater confidence" that inflation is moving to 2%
5. Have an evolving outlook as "carefully assess incoming data"
6. Rate cuts of 100 bps in 2025 and 50 bps of cuts in 2026



This is a clear Fed pivot, signalling that they believe the disinflation trend remains in place, as well as that they now see making unemployment their top priority as the labour market has weakened. Their decision sounds almost like a risk management one.

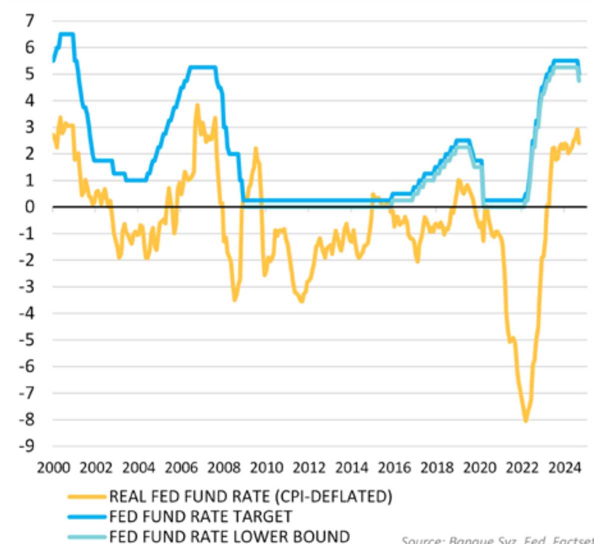
Among the reasons why the Fed cut 50bps this week:

1. Inflation risk is lower than employment and consumer risk;
2. The sticky component of inflation is shelter. For shelter inflation to go down, we need to see more housing supply, and for this we need to get lower mortgage rates = jumbo rate cut does help;
3. They must get front-end rates lower as this colossal wall of debt matures (source: Lawrence McDonald, Bloomberg).

Economic growth and the elections will shape the path of future rate cuts

The Fed's projections and comments made by Jerome Powell during the press conference set a clear trend for USD short term rates in the months ahead. Monetary policy will continue to be relaxed as the current conditions are still restrictive, even after yesterday's decision: the real Fed Fund rate, i.e. the Fed Fund rate minus the inflation rate, remains at a level not seen since 2007. With inflation now firmly on a downward trend and unemployment rate moving up, the monetary policy must be adjusted toward a more neutral stance. The neutral level for the Fed Fund rate likely lies in the 3% area currently, leaving ample room for more adjustment going forward.

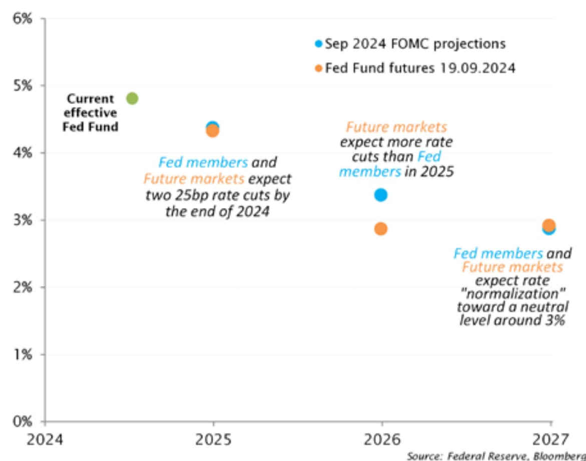
More rate cuts will be needed to bring the real Fed Fund rate down toward a neutral level



Source: Banque Syz, Fed, Factset

The uncertainty now surrounds the trajectory of the coming rate cuts, as well as the "landing point" at which this rate cut cycle will end. Yesterday's projections of Fed members point to a gradual easing of financial conditions following the large initial movement that kick-started the cycle. Mr. Powell was explicit yesterday in signalling that additional 50bp cuts should not be expected at this stage: "I do not think that anyone should look at this [yesterday's 50bp cut] and say "Oh, this is the new pace". Indeed, the Fed appears to have in mind a front-loaded easing in 2024 to adjust what are very restrictive conditions, before moving to a more gradual path in 2025 with likely quarterly 25bp cuts if the "soft landing scenario" does indeed materialise.

Two 25bp rate cuts in 2024, more uncertainty around the 2025 trajectory



Source: Federal Reserve, Bloomberg

At this stage, risks to the economic outlook are tilted downward even if recent economic data continue to picture solid economic expansion. The main uncertainty surrounds the evolution of the job market. The slowdown in job creation this year has initially brought relief to the Fed as it eased upward pressures on wages and prices. If this trend extends further, it will likely undermine consumption and GDP growth, with a looming risk of recession. This risk appears to be a key concern for the Fed. The fact that it opted for a "jumbo" rate cut to start the cycle is a sign of the Fed's intention to now prevent any further deterioration, and Mr. Powell stated clearly that they could go faster in cutting rates should economic conditions deteriorate. In that respect, future markets appear to be more pessimistic than the Fed and believe that a faster easing in monetary conditions will be required. Future rate markets currently price more rate cuts for 2025 than expected by the Fed (-150bp vs. -100bp). Economic data in the coming months, and especially the dynamic of the job market and of households' consumption, will therefore be key for the evolution of the Fed's monetary policy. Any significant deterioration will likely trigger an acceleration of the easing path for Fed Fund rate.

On top of the "usual" uncertainty surrounding economic developments, there is also another key factor that may influence the Fed's policy in 2025: fiscal policy. Depending on who becomes the next US President, and what kind of majority she or he has in the US Congress, fiscal policy could significantly impact growth and inflation dynamics next year. If policies are introduced that revive inflationary pressures, whether by increased support to low-and-middle income households or by higher tariffs on imports, the Fed might have to revise lower its rate cut expectations and aim at a higher endpoint for rates than it currently expects. For the Fed's policy expectations, the coming US election is also an important factor of uncertainty.

For further information

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