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The Fed goes large

Investment event | 19 September 2024

Bold action

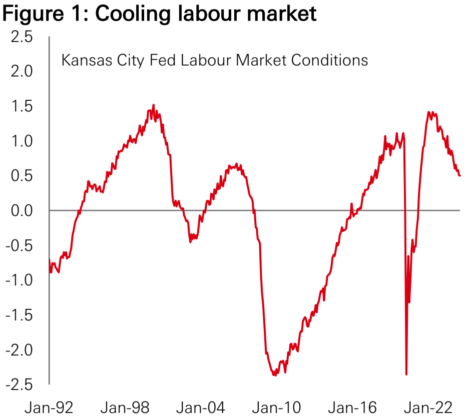
Ahead of the September Federal Open Market Committee (FOMC) meeting, there had been intense speculation as to whether it would cut rates by 25bp or 50bp. In the event, the Committee decided on the bolder course of action, cutting by 50bp. Chair Powell noted that there was “broad support” for the decision, with only Governor Bowman preferring a 25bp cut.

The choice to cut by 50bp reflects the FOMC’s judgment that the risks to its dual inflation and employment mandate have shifted into better balance – upside risks to inflation have moderated while downside risk to employment have increased. Indeed, Chair Powell highlighted that a broad set of indicators suggest the labour market is less tight than it was in 2019, but still in a robust state (Figure 1).

In explaining the decision to cut by 50bp, Chair Powell noted that the FOMC does not think it is behind the curve in terms of lowering the funds rate at an appropriate pace but went on to say that the 50bp move can be seen as a commitment that the FOMC will not fall behind the curve. That said, he also stated the FOMC is “not in a rush” and is only aiming to bring the funds rate back to a more neutral level.

Overall, Chair Powell stated the FOMC is becoming more confident that by adjusting policy appropriately, labour market strength can be maintained without taking risks with inflation.

Figure 1: Cooling labour market



Source: Macrobond, HSBC AM as of 18 September 2024

Soft-landing expected

The FOMC also published its updated projections at the September meeting. The main changes were:

- An upward revision to the estimate of long run growth. This means the economy is assumed to be able to grow more quickly without generating inflation, allowing the FOMC to cut the funds rate despite GDP growth remaining robust.
- Upward revisions to the unemployment rate in 2024-2026, pushing it above the FOMC’s estimate of the sustainable long run unemployment rate. This means the labour market is seen as having some spare capacity, supporting the decision to cut by 50bp.
- Modest downward revisions to the core inflation rate in 2024 and 2025.
- A marked downward revision (75bp) in the expected Fed funds rate for 2024 and 2025. As recently as June, the FOMC’s median expectation for the end-2024 funds rate was 5.1%. Now it is 4.4%, implying a further 50bp of rate cuts over the remaining two meeting of the year.

Figure 2: FOMC median economic projections

	2024	2025	2026	Longer run
GDP (% yoy) *June 2024 Fed projection*	**2.0** *2.1*	**2.0** *2.0*	**2.0** *2.0*	**2.0** *1.8*
Unemployment rate (%) *June 2024 Fed projection*	**4.4** *4.0*	**4.4** *4.2*	**4.3** *4.1*	**4.2** *4.2*
Core PCE inflation (%) *June 2024 Fed projection*	**2.6** *2.8*	**2.2** *2.3*	**2.0** *2.0*	**2.0** *2.0*
Fed funds rate (%) *June 2024 Fed projection*	**4.4** *5.1*	**3.4** *4.1*	**2.9** *3.1*	**2.9** *2.8*

*Source: US Federal Reserve, figures refer to Q4 * Longer run figure is headline PCE inflation rather than core PCE*

In sum, the updated projections ring “soft-landing” loud and clear – inflation reverts to target, unemployment levels off at an acceptably low level, growth remains solid, and the policy rate ultimately returns to a more neutral level over time.

The FOMC opted for a 50bp rate cut, reflecting its greater comfort with recent inflation data and a desire to deliver a soft landing for the economy

The FOMC projections point to a further 50bp of cuts in 2024 and 100bp of cuts in 2025

Our view:
If the FOMC can deliver a soft landing, the playbook is for a “great rotation” in markets. However, with policy still restrictive, recession risks remain a concern. We therefore continue to expect a more volatile phase for investment markets during the remainder of 2024

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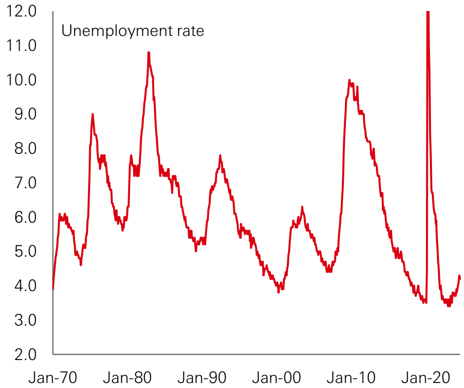
Where are the risks?

The key issue for investment markets is whether the Fed can deliver the forecast soft landing for the economy. At this stage, the macro data are consistent with that outcome – inflation is back on a declining trend and the labour market is cooling but not freezing. By taking the bolder course of action and cutting rates by 50bp before any signs of material weakness have emerged, the FOMC has increased the chances that it can achieve its desired outcome.

However, despite the 50bp cut and the revised policy outlook, the projections still point to a relatively gradual pace of rate cuts going forward; 25bp at each of the next two meetings followed by 100bp of cuts spread over the eight meetings in 2025. This means the FOMC is expecting the policy rate to remain in restrictive territory for some time to come.

Figure 3: Risk of sharp rise in unemployment



Source: Macrobond, HSBC AM as of 18 September 2024

Given monetary policy affects the economy with a lag of over a year, the risk is that the labour market continues to cool and growth falters. History tells us that if the unemployment rate continues to rise from its current level of 4.2%, there is a danger that it suddenly surges, marking the onset of a recession (Figure 3).

Investment implications

To secure a soft landing, we see a good chance that the FOMC will need to reduce the funds rate more quickly than it expects during H1 2025 (we see it in the 3.00-3.50% range by mid-year). If a soft landing is delivered, the playbook is for a "great rotation" in markets, with value, small caps, and Emerging Markets outperforming while Treasury yields drift lower, the yield curve "structurally steepens" and the USD weakens.

Nonetheless, as long as the policy rate remains in restrictive territory, recession fears can re-emerge on any signs of economic weakness. Moreover, other sources of risk, such as election uncertainty or geopolitical stress can come into play. We therefore continue to expect a more volatile phase for investment markets during the remainder of 2024.

Source: HSBC Asset Management.

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