Confidence Bust

FOMC Post-Meeting Comment June 2024

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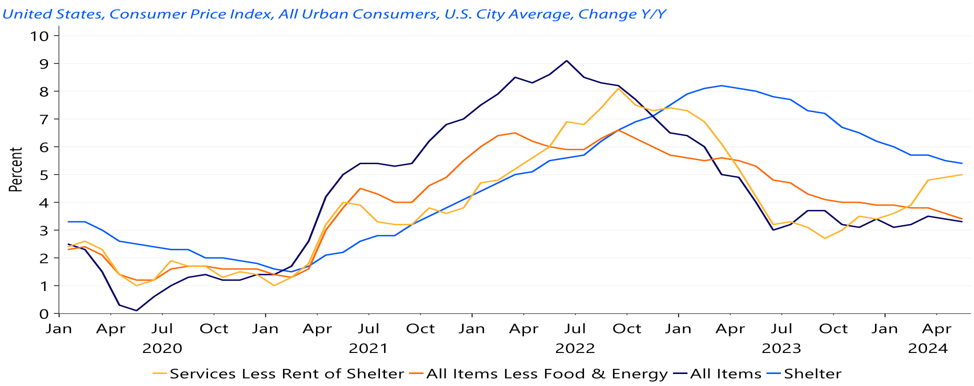
Summary

- The FOMC surprised the markets by reducing its median rate projection for 2024 to one rate cut from three rate cuts in the March projections. However, the modal rate projection was two rate cuts and it would only take two participants to shift the median to two rate cuts as well.
- Nevertheless, the Committee's confidence in progress on inflation clearly has been dented and this was evident in Powell's press conference. Today's better-than-expected CPI report was not enough to reverse this.
- We still expect the Fed to cut in September and December, more likely because of a deteriorating economy than because of progress on inflation.
- After two more cuts in March and June 2025, we think that the inflationary impact from Trump's universal tariff will stop the Fed's cutting cycle in its tracks.

Introduction

Today's lower-than-expected CPI readings had a stronger downward impact on the 10 year US treasury yield than the upward impact from the larger-than-expected reduction in projected rate cuts for 2024 in the dot plot. While the latter went to only one from three, the CPI report has given the markets the feeling that disinflation has resumed. From this perspective, the dot plot seems more a reflection of the recent past of disappointing inflation readings than today's encouraging CPI report.

Figure 1: CPI inflation remains sticky



Source: Macrobond

Today's CPI data were met with enthusiasm by investors hoping for rate cuts, because both headline and core CPI inflation fell. Headline inflation declined to 3.3% May from 3.4% in April and core inflation decreased to 3.4% from 3.6%. They also fell in month-on-month terms. This is encouraging for the Fed, but shelter inflation is still falling slowly, to 5.4% from 5.5%, and at a stable 0.4% month-on-month rate, it looks like downward potential is limited. What's more, services less rent of shelter actually rebounded to 5.0% from 4.9%. This part of inflation is closely watched by the Fed because it is wage-related and should be affected by the Fed's rate policy. So not all core data were encouraging. On the bright side, in month-on-month terms, this segment of core inflation slowed down further to 0.0%. So we may see a decline in year-on-year terms going forward. All'n all, the CPI report did show progress, but the underlying pace remains slow and sticky.

FOMC statement and projections

Today, the FOMC unanimously decided to keep the target range for the federal funds rate unchanged at 5.25-5.50% and to continue reducing its holdings of Treasury securities, agency debt and agency MBS at $60 billion per month. The FOMC statement was slightly more optimistic regarding inflation than in May with "modest further progress" instead of "a lack of further progress." However, the projections can only be compared with March, and both headline and core PCE inflation forecasts for 2024 and 2025 were revised upward. A logical consequence is an upward revision of the rate forecasts for 2024 and 2025. However, the median projections now imply only one rate cut of 25 bps in 2024, down from three in March. At the same time, the number of rate cuts per year for both 2025 and 2026 went up to four from three. This means that the total number of rate cuts for 2024-2026 remains unchanged at nine. In other words, the rate cuts have been delayed, but the FOMC still expects to get to 3.1% by the end of 2026. Meanwhile, the forecast for the longer run rate was revised upward to 2.8% from 2.6%. We expect this won't be the last upward revision. In fact, if we look at the dot plot, it seems that 4 participants are already at or above our own estimate of 3.5%.

The dot plot also shows that there are 7 participants at the median projection of one rate cut for 2024. However, the largest group consists of 8 participants anticipating two rate cuts. The smallest group is made up of 4 participants expecting zero cuts. In fact, it would only take 2 participants revising their forecast from one to two cuts to move the median in the same direction. Therefore, two rate cuts are not completely off the FOMC table yet.

The revisions to the projections for the real economy were modest. The unemployment rate projections for 2025, 2026 and for the longer run were all revised upward by 0.1 ppt. However, all GDP projections remained unchanged.

Table 1: Median projections of FOMC participants, June 2024

Variable	*2024*	*2025*	*2026*	*Longer run*
GDP growth	2.1 (2.1)	2.0 (2.0)	2.0 (2.0)	1.8 (1.8)
Unemployment	4.0 (4.0)	4.2 (4.1)	4.1 (4.0)	4.2 (4.1)
PCE inflation	2.6 (2.4)	2.3 (2.2)	2.0	2.0 (2.0)
Core PCE inflation	2.8 (2.6)	2.3 (2.2)	2.0 (2.0)	
Federal funds rate	5.1 (4.6)	4.1 (3.9)	3.1 (3.1)	2.8 (2.6)

Source: FOMC, June 12, 2024 (March 20, 2024)

Our expectation, and that of many in the market, was that for 2024 the FOMC would take out only one hike. This suggests that the string of disappointing inflation readings in recent months has done some serious damage to the Committee's confidence that inflation is moving sustainably toward 2%.

Press conference

During the press conference, the lack of confidence was visible in Powell's bland performance. Actually, he did not have much to say. Not only is the FOMC data-dependent, they also seem clueless.

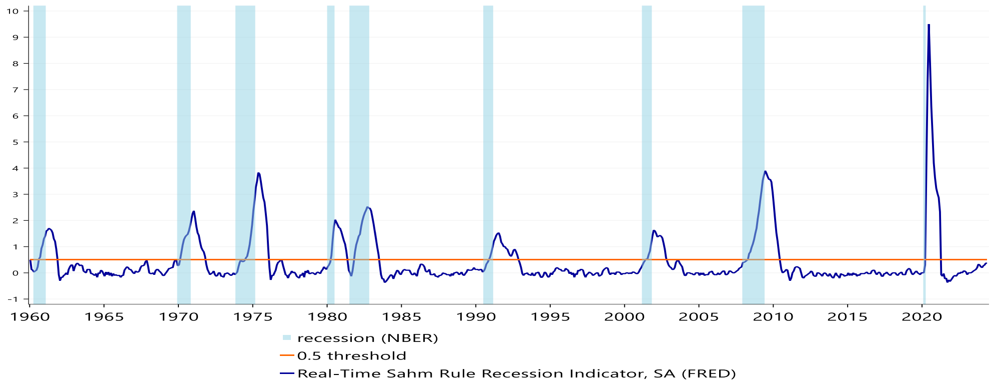
In his prepared speech, Powell said he welcomed today's inflation reading and he hoped for more. He said the FOMC was briefed on the CPI reading this morning. However, he would need to see more good data to bolster confidence on inflation. Powell repeated that if jobs would weaken unexpectedly, the FOMC will respond. In other words, there are still two routes to rate cuts: progress on inflation and a deterioration of the labor market.

During the Q&A, Powell repeated that they welcome today's inflation reading and want more like that. However, he did not want to say how many rounds of good inflation data would suffice for a rate cut. When asked why the FOMC went from three to one rate cut, Powell said the big thing was the inflation forecast. He said it will probably take longer, so rate cuts intended for this year will now take place next year. He said that today's CPI report was encouraging, but comes after a number of reports that were not.

Conclusion

The FOMC is still waiting for "greater confidence that inflation is moving sustainably toward 2 percent," but today's better-than-expected CPI report was not enough to avert a two-rate-cut retreat. Powell did not want to indicate how many good reports would be enough to gain enough confidence for a rate cut. The reality is that inflation is very sticky and the FOMC seems to be increasingly aware of this. In our stagflationary view, it is more likely that the Committee will take the second route to rate cuts, i.e. because of an unexpected deterioration of the labor market. Note that the FOMC's projected rate path is conditional on unemployment at 4.0% in the final quarter of 2024. With unemployment at 4.0% in May, this would imply that the FOMC is rebalancing labor demand and supply this year without increasing unemployment. We find it difficult to share their optimism. Therefore, we still expect two rate cuts this year, in September and December. However, not because of progress of inflation, but because of rising unemployment.

Figure 2: Sahm-rule-indicator is creeping up to the recession-threshold



Source: Macrobond

While markets focused on the strong establishment survey data in the Employment Report on Friday, with nonfarm payroll growth rebounding to 272K and average hourly earnings growth rising to 4.1% in May, the household survey actually showed a further rise in the unemployment rate to 4.0% in May from 3.9% in April. This means that we remain close to triggering the Sahm-rule with the recession-indicator reaching 0.37 in April and May. If this indicator reaches the 0.5 threshold, a recession should have started.

Looking further ahead, we find the 4 rate cuts per year projected for 2025 and 2026 unrealistic. Assuming that Trump wins the elections and imposes a universal tariff, a rebound in inflation is unavoidable. This would halt any cutting cycle by the Fed in its tracks. We still expect only two rate cuts for 2025, in the first half of the year. Once inflation rebounds, the window of opportunity for rate cuts closes.

Table 2: Rabobank forecasts of target range for federal funds rate in 2024 and 2025

FOMC meeting	*Size of rate change (bps)*	*Target range (%)*
January 30-31, 2024	0	5.25-5.50
March 19-20	0	5.25-5.50
April 30-May 1	0	5.25-5.50
June 11-12	0	5.25-5.50
July 30-31	0	5.25-5.50
September 17-18	-25	5.00-5.25
November 6-7	0	5.00-5.25
December 17-18	-25	4.75-5.00
January 28-29, 2025	0	4.75-5.00
March	-25	4.50-4.75
April-May	0	4.50-4.75
June	-25	4.25-4.50
July	0	4.25-4.50
September	0	4.25-4.50
November	0	4.25-4.50
December	0	4.25-4.50

Source: Rabobank

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