

At the September meeting, the U.S. Federal Reserve Open Market Committee decided to reduce the Fed funds rate by -0.50% to a new range of 4.75-5.00%. There was one voter dissent, where a member opted for only a quarter-percent cut.

The formal statement was updated to reflect the new easing bias, noting that inflation has simply “made further progress...but remains somewhat elevated.” Also noted was that the committee’s labor and inflation goals “are roughly in balance.” Later in the statement, labor was again mentioned in a reminder of the Fed’s dual mandate in “supporting maximum employment” in addition to its inflation objective. The new quarterly Summary of Economic Projections (SEP) put the Fed funds rate expectation at 4.4% for year-end 2024 (down from 5.1% in June), 3.4% for 2025, 2.9% for 2026 and 2027, while the anticipated long-term rate ticked up a tenth to 2.9%.

There hasn’t been this much mystery shrouding a policy change in some time, and surprise announcements have not been common in recent years. Before the meeting, CME Fed funds futures markets evolved toward the chances of a -0.50% cut at as high as 60%, and a -0.25% move at around 40%, after wavering between the two for much of the past month (wisdom of futures markets is correct again). Chances remain high for cuts in November and December, with odds pointing to a year-end rate of around 4.25%. The furthest-out estimate in Dec. 2025 shows the highest probabilities for Fed funds at around 3.00%.

Economy. U.S. GDP growth for the 2nd quarter had been revised up a bit to 3.0%, while the Atlanta Fed’s GDPNow estimate for Q3 rose a half-percent from last week to a similar 2.9% level. The SEP noted Fed member median GDP growth estimates at 2.0% for year-end 2024 (versus 2.1% in June), 2.0% for 2025, 2026, and 2027, with 1.8% as the longer-run assumed rate. Economic growth continues to run above long-term trend, led by robust personal consumption (over 85% of the Q3 estimate), followed by non-residential fixed investment (CHIPS Act and IRA). The far larger services component has continued to lead the way over manufacturing, which remains weaker overall. If the current ‘soft landing’ narrative stays intact, high growth could argue for putting the brakes on the pace of rate cuts, in fear of overheating. Debate has continued, though, with some observers noting that the deceleration of growth in some sectors warrants more front-loaded cuts as ‘insurance’ to combat this second-order deceleration before it falls to the point where easier monetary policy would be less effective in offsetting downside risks.

Inflation. On a trailing 12-month basis, Aug. CPI came in at 2.5% on a headline level, and 3.2% for core, removing food and energy. PCE inflation for July came in at 2.5% headline and 2.6% for core, showing little change in recent months, but also at a far better level than a year ago. The SEP’s Fed member median core PCE estimates were 2.6% for year-end 2024 (versus 2.8% in June), 2.2% for 2025 (from 2.3%), and 2.0% for 2026 and 2027, with 2.0% retained as the long-term target. Inflation news has moved from the front page to the back in terms of policy priority, as the faster pace from earlier this year appeared to be the result of seasonality and catch-up effects. At the same time, still-high shelter inflation (5% year-over-year) remains a problem, in no small part from the way it’s measured, including sizable lags versus real-time data. The improvement in overall inflation should be taken as a positive, as opposed to the hyperfocus on it during the past few years, and the current slowing pace toward normal has seemingly given the Fed enough reason to cut rates. At the same time, easing too fast runs the risk of reigniting some inflation just as the issue is being put to bed (a problem experienced in the 1970s that the Fed is not keen to repeat), not to mention possible inflationary impacts from government fiscal spending looking ahead.

Employment. Labor conditions include nonfarm payrolls leveling off, job openings slowing, and the unemployment rate rising from very low cyclical levels up to 4.2%. The latter triggered the ‘Sahm Rule’ a month ago—a formula now with a household name for its past accuracy in predicting upcoming recessions (even though it was created as an ‘on’ switch for potential government fiscal response, as opposed to being a monetary policy tool). The SEP pegged the Fed member median unemployment rate at 4.4% for year-end 2024 (versus 4.0% in June), 4.4% for 2025 (from 4.2%), 4.3% for 2026 (from 4.1%), 4.2% for 2027, with 4.2% retained as the long-term expectation. One unique element this time is that the evolving unemployment rate seems to be due to a larger labor force,

influenced by immigration, rather than job losses. Labor conditions do not seem to be what one might call 'weak' by any means but have fallen back enough from the peak for Chair Powell to mention it on several occasions. Debate continues on the strength of underlying labor market conditions, but some continued slowing, coupled with fewer inflation worries, has given the Fed additional rationale for easing. On the positive side, real wages continue to rise, in addition to the lack of layoffs, which tend to be a more problematic component of a weakening labor market and have tended to ramp up when a recession is in full force. Part of the Fed response is to try to get ahead of potential negative trends.

In short, this was the meeting markets have been waiting for—the jumping-off point of a Fed easing cycle—after a period of the sharpest hikes since the early 1980s and a 12-month pause. Since early summer, the question had changed from whether the Fed would cut rates at all, to whether it would be a smaller or larger cut. Both paths have been debated intensely among economists and strategists in recent weeks, noting pros and cons, as well as market signaling implications. That discussion is a further indication of the balance of risks the Fed is now evaluating. While a -0.50% move certainly sent a strong easing statement, the Fed traditionally hasn't gone that far under normal conditions, with the worry that it could signal panic or a looming crisis being at hand (historically, that's when larger cuts were done). Current conditions are still relatively benign and had been pointing more toward a -0.25% cut, which several notable economists would have preferred.

Of course, the easing of interest rates in general has been a positive for financial conditions, at the very least by removing the burden of higher financing costs; it's become a consensus view that 5.25-5.50% was unnecessarily high. Another question is whether the Fed has waited too long to ease. That remains to be determined, but starting in one month over another might not matter enough to affect the outcome. The economic trajectory has been a deciding factor in the Fed's future path, which could go in one of two directions: (1) the 'soft landing' base case of about 1-2 cuts per quarter through the next year or two, versus (2) more and larger cuts should growth and/or the labor market fall off a cliff. The stock market has historically performed better in the first scenario, and less well in the second, where conditions are correlated to a high chance of recession (before bottoming during the recession and rebounding, if in typical contrary fashion). Bonds have tended to fare well generally when rates fall, as would be expected, but the magnitude depends on the change in the yield curve's slope, with more subtle and drawn-out impacts in the slower rate cut scenario, but a market preference for government bonds in a recession scenario.

Where should rates end up? It's too soon to speculate, as this policy shift into easing moves into 2025 and possibly beyond. The spread between the 2-year U.S. Treasury and Fed funds rates was -1.8% (very inverted) as of last night, which implies a sharp yield drop over that timeframe. While many look to past policy for an answer (where easing of a few percent is about the norm), the ideal rate level is based on a variety of drivers including expected inflation, expected economic growth and/or real yield levels, technical supply/demand dynamics, the unique attribute of safe haven status globally for U.S. Treasury assets, as well as the rising potential influence of massive government fiscal deficits and rising national debt level. For the latter, lower yields reduce government interest costs, while the risk remains that global markets may someday demand a higher rate (implied 'credit spread' of sorts) at the longer end of the curve if the high spending continues. However, many other 'safe haven' nations are in similar or worse shape from the standpoint of debt-to-GDP, which has kept worries at bay.

Unfortunately, at some point, rate cuts are not-so-great news for users of money market/cash instruments, who have been offered a respite from risk-taking by camping out in 5% yields courtesy of the Fed and inverted yield curve. With extremely short maturities, money markets are one of the most responsive segments to policy yield changes in either direction. So, 5% yields can quickly turn to 4% and even 3%, if rates fall back to historical norms and the curve further un-inverts. As cash safe havens then become less attractive, many investors may become interested in re-entering other asset classes to achieve potentially better long-term real returns, such as in a diversified asset allocation portfolio.

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Sources: CME Group, Federal Reserve Bank, U.S. Bureau of Economic Analysis, U.S. Bureau of Labor Statistics,
FocusPoint Solutions calculations.