Fed Watch

The Fed projects just one rate cut this year but signals four in 2025

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Changes to the SEP and the dot-plot do not rule out a rate cut in September; we think that two this year are still more likely than not

- **The Fed decided to hold the policy rate unchanged at its current 5.25-5.50% target range and offered a slight dovish wink following today's better-than-expected CPI report.** The only change in the policy statement suggests that FOMC members agreed that the disinflationary process is likely back on track after the unexpected bumpiness in the first quarter. The statement now indicates that there has been "modest" further progress toward 2% inflation, in contrast to the "lack" of further progress noted in the statement of the previous meeting. However, its is important to note that the statement still describe inflation as "elevated," and with economic activity still expanding "at a solid pace" and strong "job gains," FOMC members continue to stress that they do "not expect it will be appropriate to reduce the target range until [they] have gained greater confidence that inflation is moving sustainably toward 2%."
- **Taken together, broadly unchanged projections for GDP growth and the unemployment rate point to continued confidence in a scenario in which the economy grows around potential in 2024-26.** The median projection for real GDP growth in the updated SEP remained unchanged at 2.1% Q4oQ4 this year, as well as at 2.0% for both 2025 and 2026 (Table 1). This means that the downward revision to 1Q24 real GDP from 1.6% to 1.3% announced recently was not significant enough to alter most of FOMC participants' view on the activity outlook amid still strong private domestic final purchases (which excludes inventory investment, government spending and net exports), but the 0.1 pp decline in the central tendency measure (to 1.9-2.3 from 2.0-2.4) suggests that more than one participant did incorporate a somewhat slower pace of economic growth ahead. The median unemployment rate (UR) projection for the end of this year remained unchanged at 4.0% too, but it was revised up 0.1 pp for both 2025 and 2026 (to 4.2 and 4.1%, respectively). The long-run UR estimate was also fine-tuned to the upside to 4.2% (from 4.1%). Powell pointed out that the overall picture is "of a strong and gradually-cooling, gradually-rebalancing labor market [...] but not the superheated labor market of two years ago or even one year ago."
- **The Fed signaled just one rate cut this year still due the bump in the road of the first quarter; it seems to have been a close call as markets were pricing it in and as we argued earlier this week (see).** As we expected[1], core PCE year-end inflation was revised up from 2.6 to 2.8%, and slightly up to 2.3% (+0.1 pp) for year-end 2025. Admittedly, the new 2024 forecast could have sent an implicit hawkish signal on its own, but the fact that the Fed is still projecting to start cutting rates this year should have eased concerns about rates staying high for even longer. Chair Powell further allayed those possible concerns in the Q&A by explaining that inflation was very low in the second half of last year (i.e., there will be negative base effects in 2H24) and

[1] "[...] the 2.6% year-end core PCE forecast will likely be revised up since the 0.33% MoM average increase over the first four months of the year implies that core PCE inflation would need to rise at a below 0.2% monthly pace through year end to achieve the current projection."

acknowledging that the new inflation forecast was “conservative.” Thus, the Fed will likely stay focused on the signals sent by the three- and six-month annualized core PCE inflation rates to continue to build confidence that inflation is on a sustainable path down to 2.0%. Powell acknowledged that the Fed saw today’s CPI report as “progress,” but reiterated that they still “[want] to gain further confidence.” The median projection for the appropriate policy rate by year-end indicates that FOMC participants now expect a single rate cut this year rather than three (Figure 1). Powell avoided to strike a hawkish tone and said that either one or two rate cuts were a “plausible” outcome, just as markets were pricing it in. The dot-plot now signals four rate cuts next year (up from three in March). In Powell’s words, “the sense of [this] is that rate cuts that might have taken place this year [will] take place next year,” i.e., “there are fewer rate cuts in the median this year, but there’s one more in the next year.”

- **Financial markets were little changed following the big but expected shift in the dot-plot.** While the 10-year Treasury yield dropped from 4.40 to a 4.25 following the better-than-expected core CPI data released earlier today, it did not move much following the statement and updated SEP release neither during or after Powell’s press conference. The futures market continued to assign higher-than-50% odds of a rate cut in September, but the implied probability fell to around ⅔ chances after having moved up to c. 80% earlier today, when core inflation gave signs of having cooled down more than expected in May.

- **One of the most eye-catching changes to this meeting’s SEP is related to the longer-run projections for the fed funds rate, which was up 0.2 pp to 2.8 from 2.6%.** This suggests that some FOMC participants are starting to incorporate to a greater extent the likelihood that r* has risen, and which means that those participants would be those who could support further rate hikes if disinflation proved to stagnate or reverse. Yet, Powell downplayed the importance of this change in the Q&A and tried to bring the attention back to the current monetary policy stance, which is restrictive in his view.

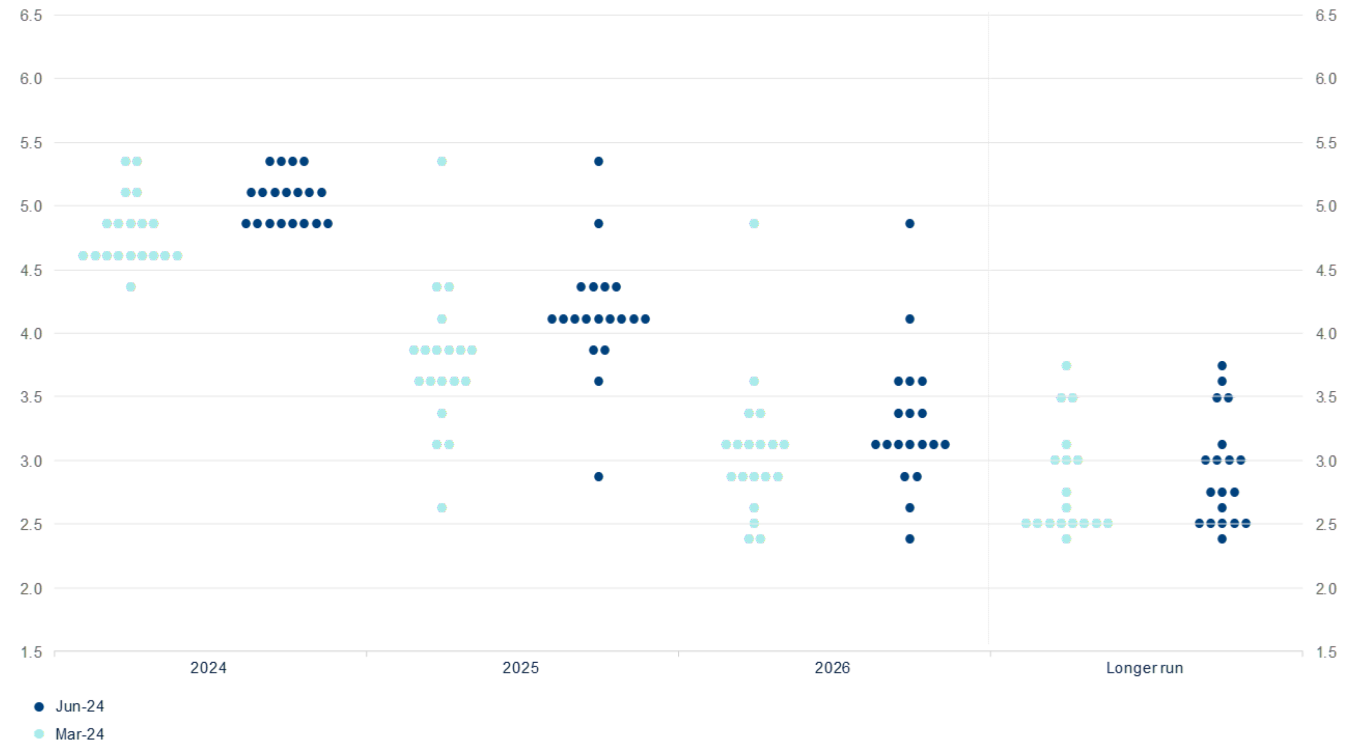
- **With the fed funds rate at its peak, growing chances of disinflation resuming in 2Q24 and more balanced risks, the Fed is likely to remain cautious in determining the timing of a first rate cut.** Although the inflation figures for the last two months point to a resumption of the disinflationary process, three bad inflation readings in 1Q24 tipped the Fed to be more cautious. The Fed thus continues to think that they can approach the question on when to start cutting rates “carefully.” Probably the main takeaway from today’s meeting is the absence of any hawkish flavor in either the wording of the statement or the press conference. The fact that Powell downplayed both the upward revision to this year’s core PCE forecast and the median projection of only one rate cut this year, suggests that more than one rate cut this year is not off the table. This view was reinforced by Powell’s emphasis during the Q&A that the Fed is well aware of the current context in which risks are two-sided. Thus, we stick to our call that easing core inflation will open the door for the Fed to cut rates two times this year, in September and December. A sooner or more aggressive policy response would require something not foreseen now, such as an “unexpected weakening in the labor market.” Likewise, another run of bad inflation readings in coming months would either delay the start of the rate cut cycle to 4Q24 or even close the door for any rate cut this year.

The median projection for the appropriate policy rate by year-end indicates that FOMC participants now expect a single rate cut this year rather than three, and four rate cuts next year (up from three in March)

Table 1. **FOMC PARTICIPANTS' SUMMARY OF ECONOMIC PROJECTIONS** (JUNE 2024, %)

Variable	Median				Central tendency				Range			
	2024	2025	2026	LR	2024	2025	2026	LR	2024	2025	2026	LR
Change in real GDP	2.1	2.0	2.0	1.8	1.9-2.3	1.8-2.2	1.8-2.1	1.7-2.0	1.4-2.7	1.5-2.5	1.7-2.5	1.6-2.5
Mar-24	2.1	2.0	2.0	1.8	2.0-2.4	1.9-2.3	1.8-2.1	1.7-2.0	1.3-2.7	1.7-2.5	1.7-2.5	1.6-2.5
Unemployment rate	4.0	4.2	4.1	4.2	4.0-4.1	3.9-4.2	3.9-4.3	3.9-4.3	3.8-4.4	3.8-4.3	3.8-4.3	3.5-4.5
Mar-24	4.0	4.1	4.0	4.1	3.9-4.1	3.9-4.2	3.9-4.3	3.8-4.3	3.8-4.5	3.7-4.3	3.7-4.3	3.5-4.3
PCE inflation	2.6	2.3	2.0	2.0	2.5-2.9	2.2-2.4	2.0-2.1	2.0	2.5-3.0	2.2-2.5	2.0-2.3	2.0
Mar-24	2.4	2.2	2.0	2.0	2.3-2.7	2.1-2.2	2.0-2.1	2.0	2.2-2.9	2.0-2.5	2.0-2.3	2.0
Core PCE inflation	2.8	2.3	2.0		2.8-3.0	2.3-2.4	2.0-2.1		2.7-3.2	2.2-2.6	2.0-2.3	
Mar-24	2.6	2.2	2.0		2.5-2.8	2.1-2.3	2.0-2.1		2.4-3.0	2.0-2.6	2.0-2.3	
Federal funds rate	5.1	4.1	3.1	2.8	4.9-5.4	3.9-4.4	2.9-3.6	2.5-3.5	4.9-5.4	2.9-5.4	2.4-4.9	2.4-3.8
Mar-24	4.6	3.9	3.1	2.6	4.6-5.1	3.4-4.1	2.6-3.4	2.5-3.1	4.4-5.4	2.6-5.4	2.4-4.9	2.4-3.8

Figure 1. **FOMC PARTICIPANTS' PROJECTED APPROPRIATE FEDERAL FUNDS RATE** (%)



Source: BBVA Research based on data by the Federal Reserve and Haver Analytics.

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