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Fed Watch

Fed likely to stay committed to delay rate cuts despite mixed data

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Either one or two rate cuts by year-end in the updated SEP and dot-plot will be in line with recent calls for a cautious approach

- **A broad perspective from most of the intermeeting data suggests that economic activity has likely cooled down this quarter, alleviating concerns about the need for further policy tightening.** The second estimate for 1Q24 real GDP growth was revised down to 1.3% QoQ SAAR from 1.6%. Earlier last month, the Atlanta Fed's GDPNow forecast pointed to an above-4% growth rate for 2Q24, but more recent updates have been hovering around a 2 to 3% range following the most recent data. Following strong gains in February and March, retail sales showed no growth in April amid a 0.3% MoM decline in control group sales, the most notable drop in just over a year. Income and spending data for April indicated that personal consumption expenditures decreased 0.1% MoM in real terms, driven by a 0.4% decline in goods consumption, which more than outweighed a modest 0.1% increase in services spending. The drop in the manufacturing ISM index to 48.7 in May from 49.2 also suggests that the economy is likely losing momentum, and while the services ISM index rebounded to 53.8 in May after falling below the 50-point threshold in April, some survey respondents noted uncertainty over the upcoming presidential election and the continued effects of high interest rates.
- **Employment data were mixed following a stronger-than-expected jobs report last week, but the Fed is likely to consider that the labor market continues to gradually move towards a better balance.** The weaker-than-expected jobs report for April showed a below-consensus 175,000 non-farm payrolls gain, which was again mostly driven by a surge in health care and social assistance jobs. At the same time, a weak employment figure from the household survey drove the unemployment rate to tick up to 3.9 from 3.8%, while the 12-month growth rate of average hourly earnings dropped to a 3.9% three-year low. The April JOLTS data pointed in the same direction: the job openings rate fell to 4.8% in April, which is back in line with its pre-pandemic peak, while the private quits rate remained unchanged at 2.4% but below its 2019 average. On the other hand, last week's jobs report scored a stronger-than-expected 272,000 gain in non-farm payrolls, partly driven by stronger job creation in the government sector. The report also indicated a 0.4% MoM increase in average hourly earnings. While the totality of activity and employment data probably did not help FOMC participants to feel significantly more confident about the inflation outlook, a further increase in the unemployment rate to a two-year 4.0% high (Figure 1) driven by a sharp 408,000 drop in employment in the household survey that outpaced the 250,000 decline in the labor force, will likely invite them to carefully evaluate the balance of risks around their dual mandate.
- **Consumption resilience and the delayed pass-through of prices from newly-signed rental contracts into official inflation figures, have continued to drive core inflation stickiness.** Core CPI inflation rose 0.30% MoM in April, after averaging 0.4% MoM increases in 1Q24. Core PCE inflation, Fed's preferred measure, was 2.8% YoY in April, broadly unchanged from March, and although it showed a slightly lower monthly average increase in 1Q24 compared to core CPI, the 6-month annualized rate increased markedly to

3.2% after hovering around 2.0% in 4Q23 (Figure 2). April's milder increase allowed the 3-month annualized rate to ease somewhat (to 3.5% from 4.4%), but the 6-month rate is still set to increase further before easing again. The Fed likely remains comfortable with its current wait-and-see strategy, even after weaker activity data. It will likely continue to signal that members want to see at least three months of improving inflation data before starting to cut rates.

- **Intermeeting developments will likely not change the already-conveyed Fed message that more good data is needed to gain enough confidence in progress toward 2% inflation.** It is true that the May meeting minutes revealed some hawkish opinions from some participants, who noted "uncertainty regarding the degree of restrictiveness of current financial conditions" and mentioned "a willingness to tighten policy further should risks to inflation materialize," but with monetary policy deemed to be "well positioned to respond to evolving economic conditions and risks to the outlook," chances are that the real debate around the policy stance will continue to focus on for how long to keep the fed funds rate at its current level. Policy rate expectations were volatile amid mixed intermeeting data.The futures market implied probability of just one rate cut this year dropped from 50% a month ago to a 2-month low of 20% following the softer GDP, ISM and JOLTS data released recently, but jumped to 40% last Friday on the stronger than expected jobs report for May (Figure 3). Consequently, the 10-year Treasury yield ranged from 4.3 to 4.6% in the same period. The extent to which further data confirms that disinflation is still underway following a bump in the road in 1Q24 will determine markets' calm against the high-for-longer environment (see here for more on the recent evolution of US interest rates and broad financial conditions).
- **Surprising changes to the SEP are unlikely, as financial markets have generally adhered to the continued call for patience regarding an eventual beginning of a rate cut cycle this year.** The downward revision to 1Q24 real GDP, as well as the 2Q24 growth rate that seems to be running close to 2%, will likely be reflected in a downgrade to the March SEP 2.1% Q4oQ4 GDP growth median projection for year-end. The unemployment rate projection is also likely to marginally tick up following the recent consecutive increases that have already taken it to 4.0%. Yet, 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. A further delay of rate cuts is widely anticipated, which means FOMC participants will only formally catch up with the already market-implied high-for-longer outlook (Figure 4). It is unclear whether recent data will ease members' concerns enough to drive the median dots to two cuts this year or there will be several members that would lean to no cuts this year, driving up the median fed funds projection to only one cut by year end. Chances are probably for only one rate cut this year following May's strong job creation, but either one or two rate cuts by year end in the updated dots will be in line with recent calls for a cautious approach from FOMC participants. And with market expectations halfway between both scenarios, the new dot-plot is not likely to be disruptive whatever the outcome.
- **Signs of a somewhat weaker economy should allay hawkish members' concerns that monetary policy may not be restrictive enough, while heightening dovish members' concerns of a possible steep negative shift in the pace of job creation.** That is, as the period of policy restrictiveness extends, the risks of sudden disruptions to the labor or financial markets could become more acute. This could also be reflected in increasingly conflicting opinions about the unequal effects of monetary policy, as exemplified by the latest minutes which indicated that while many FOMC participants noted that low- and moderate-income households are coming into pressure from high rates, "a couple of participants noted that financial conditions [appear] favorable for wealthier households, which account for a large portion of aggregate consumption, with hefty wealth gains resulting from recent equity and house price increases." For now, we think that recent data supports our baseline scenario that the Fed will start a rate cut cycle in September and cut again in December.

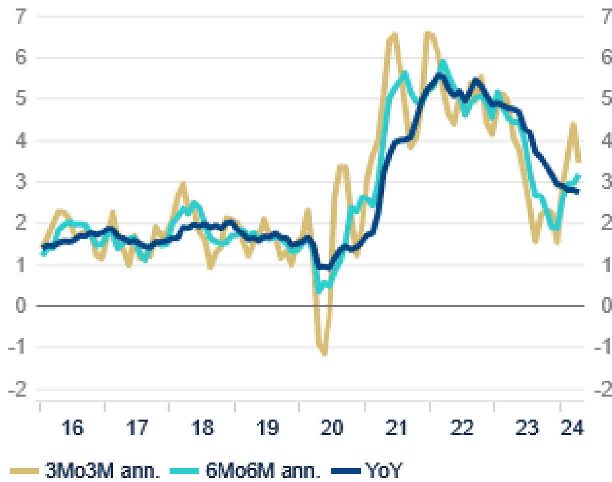
FOMC participants will likely remain cautious amid a further increase in the unemployment rate

Figure 1. **UNEMPLOYMENT RATE**
(%)

Source: BBVA Research / BLS

The 6m ann. core PCE inflation rate increased to 3.2% after hovering around 2.0% in 4Q23

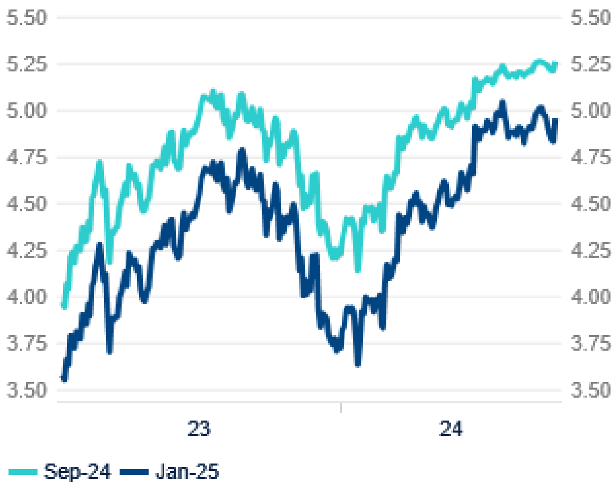
Figure 2. **CORE PCE INFLATION**
(%)



Source: BBVA Research / BEA

Chances of just one rate cut this year jumped from 20 to 40% after last Friday's jobs report

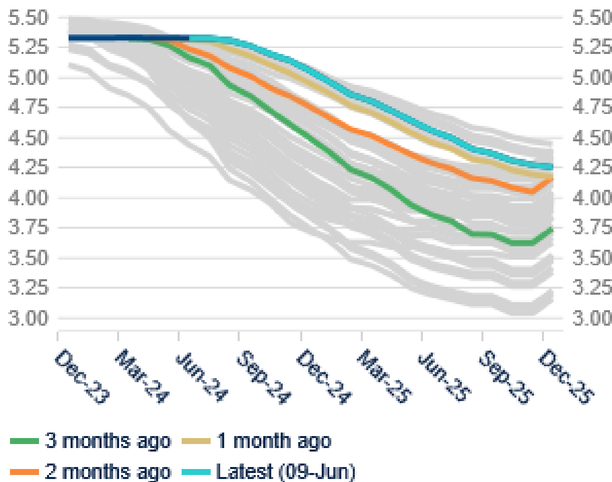
Figure 3. **FUTURES-IMPLIED POLICY RATE PATH**
(%)



Source: BBVA Research / CME

Financial markets' expectations on the future path of monetary policy shifted significantly

Figure 4. **FUTURES-IMPLIED POLICY RATE PATH**
(%)



Gray lines indicate weekly implied rate paths since a year ago
Source: BBVA Research / CME

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