Fed Watch

A rate cut “could be on the table” at the September meeting

Javier Amador / Iván Fernández

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Fed shifts policy bias to neutral and hints it is increasingly focused on its maximum employment mandate

- **Wording of the statement drops tightening bias and turns more dovish.** One year after raising the policy rate for the last time, the Fed avoided surprising the market and instead chose to leave it at its 5.25-5.50% target range for the eighth meeting in a row. It was to be expected that last week’s GDP data would lead the FOMC to continue considering that “economic activity has continued to expand at a solid pace” and that Fed members would remain cautious and choose to keep the statement forward guidance unchanged: it continued to state that the FOMC “does not expect it will be appropriate to reduce the target range until it has gained greater confidence that inflation is moving sustainably toward 2%.” However, this meeting’s changes to the statement, which at first glance are subtle, give a clear indication that tackling inflation is no longer a top priority as the Fed is now focused on both risks to its dual mandate. The Fed acknowledged that job gains have “moderated” and noted that although “the unemployment rate [...] remains low,” it has “moved up.” With “some further progress” in recent months, inflation is now characterized as “somewhat elevated” as opposed to “elevated.” **The Fed is finally explicitly acknowledging that risks are broadly balanced: it is now “attentive to the risks to both sides of its dual mandate,” rather than “highly attentive to inflation risks.”**

- **The dovish tweaks of the statement were reinforced by Powell during the press conference, who said that a rate cut “could be on the table as soon as the next meeting in September.”** He even added that “there was a real discussion” about cutting rates at today’s meeting. As several FOMC members were commenting ahead of the meeting, Powell acknowledged that 2Q inflation data “have added to [their] confidence” on the path to 2% inflation. One of his initial comments suggested that there seems to be a consensus among FOMC participants around the broad idea that “the economy is moving closer to the point at which it will be appropriate to reduce [their] policy rate.” Powell did not deviate completely from the statement though, as he went on to point out that decisions ahead will continue to depend on the totality of the data, the evolving outlook, and the balance of risks, and that they are still looking for “more good [inflation] data [that] would further strengthen [their] confidence.” But at the same time, Powell hinted that fighting inflation at all costs is no longer a needed rhetoric, since he acknowledged that even in a scenario of “disappointing” inflation readings, the Fed would weigh those data against the state of the labor market. That is, were the labor market to show unexpected signs of weakness, the Fed would ease policy even in the absence of good inflation data.

- **With more confidence that inflation has likely resumed its downward trend, the Fed seems to be prioritizing another task: driving the economy through the path of a soft landing.** The labor market is in an “ongoing gradual normalization” that has broadly brought it back to 2019’s conditions, which Powell described as “strong but not overheated.” Although just a few months ago the Fed’s narrative was focused on emphasizing the need for a significant cooling of the labor market that was consistent with the disinflationary outlook, Powell is increasingly confident that “the labor market in its current state [is not] a likely source of significant inflationary pressures.” What’s more, he “would not like to see material further cooling in the labor market.” The minutes will shed more light on his insistence on not attributing this opinion to the entire Committee. In any case, Powell described the remarkable progress in inflation coupled with the relatively mild cooling of the labor market as “a historical unusual and such a welcome outcome.” The Fed seeks to take advantage of this recent greater confidence and growing chances of further “good data” in the months ahead to take the next step to ensure that this soft-landing process keeps going. In Powell's words, although the inflation problem is not completely resolved, "[they] can afford to begin to dial back the restriction in our policy rate."

- **Financial markets reacted strongly to today’s Fed hints that the start of the rate cut cycle is most likely just around the corner.** Both the 2- and 10-year Treasury yields dropped by around 10 bps to a 6-month low (4.26 and 4.03%, respectively), and the US dollar lost some of its mid-session gains ahead of the Fed’s meeting. Futures-implied chances of a September rate cut remain unchanged at c. 90%, while the outcome in which the Fed delivers at least two rate cuts before year-end is fully priced in: the probability of a fed funds rate at or above the 4.75-5.00% target range declined to 22% from 36% yesterday.

- **FOMC participants will likely use the upcoming Jackson Hole’s forum to convey more definitive signals around the increased chances of a September rate cut.** We continue to stick to our call that the Fed will most likely cut rates two times this year: in September and December. Looking ahead, as a rising unemployment rate has continued to gain importance in Fed officials’ minds, their focus will likely now be on pulling off a soft landing as inflation no longer seems to be the most important issue for the policy path.

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ENQUIRIES TO:
BBVA Research: Paseo de la Reforma 510, Colonia Juárez, C.P. 06600 Mexico City, Mexico.
Tel.: +52 55 5621 3434
www.bbvaresearch.com