Fed Watch

Fed starts big, but points to smaller rate cuts ahead

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The Fed doesn't look overly concerned about a hard landing, but rather signals its commitment "not to get behind" in cutting rates

- **The Fed cut the policy rate by 50 bps to a 4.75-5.00% target range in a split vote (11 to 1) on greater confidence in the disinflation process and a strong commitment to support the labor market.** Inflation no longer has the spotlight in the policy statement. Despite observing that inflation "remains somewhat elevated", FOMC participants have finally "gained greater confidence that inflation is moving sustainably toward 2%," thus triggering their long-standing self-imposed test for beginning to cut rates. Concerns around the labor market had been slowly creeping up over the previous meetings to the extent that the Committee now "judges that the risks to achieving its employment and inflation goals are roughly in balance." With job gains having "slowed" instead of "moderated," the FOMC reinforced the dovish tone adopted in the previous meeting and in Powell's speech at Jackson Hole by stating that it is not only "strongly committed to [...] returning inflation to its 2% objective," but also to "supporting maximum employment."
- **At the press conference, Powell tried hard to clear up that opting for a 50bp cut instead of a 25bp cut does not mean the Fed is "in a rush" to cut rates aggressively from now on.** As we argued earlier this week (see here), financial markets failed to reach a strong consensus on the magnitude of today's movement. The implied probability in the futures market for a 25bp cut was at 85% following the CPI report released last Wednesday and following some Fed officials' comments who managed to talk just before the blackout period, such as Christopher Waller, who said that he was "open-minded about the size and pace of cuts," but also that he expected those cuts would "be done carefully." The odds in favor of a 50bp cut suddenly increased when a couple of media pieces suggested the increasing likelihood of such a move, something that has served the Fed as an unofficial, very short-term forward-looking tool in the past. Powell argued that the reason for opting for 50 bps was to signal both the significantly increased confidence among FOMC members that inflation is on a sustainable path towards 2% and the Fed's strong commitment not to get behind in cutting rates. To some extent, Powell also downplayed the big start to the easing cycle by stressing that the updated dot-plot pointed to a slower rate cut cycle ahead.
- **Most participants project the Fed will take down the policy rate to 4.25-4.50% by the end of this year and probably to 3.25-3.50% by the end of 2025.** This means there is room for either another 50 bp cut at any of the two remaining meetings of this year or, more likely in our view, two consecutive 25bp rate cuts. All 19 participants have multiple rate cuts this year: 17 out of 19 wrote down 75bp or more worth of rate cuts this year. Among those, 9 penciled out taking the fed funds rate to 4.25-4.50% and one to 4.00-4.25% (Figure 1). The medians for 2025 and 2026 were brought down to 3.4% (down from 4.1%) and 2.9% (down from 3.1%), respectively. Fourteen participants (a large majority) are split between taking the fed funds rate to a 3.00-3.25% and a 3.25-3.50% range by the end of next year, with two more projecting the Fed will need to take it to a 2.75-3.00% range. The long-run median fed funds rate estimate edged up from the 2.8% June projection to 2.9%. Overall, the updated dots reflect, in Powell's words, "a lot of common ground and a big change from June." The unemployment rate (UR) is now forecast to peak at 4.4% this year and next (up from 4.2% in 2025

previously), and to stay somewhat higher in 2026 (4.3% vs 4.1% before). Core PCE inflation is still projected to come down to the 2.0% target until 2026, but year-end forecasts for 2024 and 2025 were revised down to 2.6% and 2.2%, from 2.8% and 2.3%, respectively (Table 1). The updated forecasts reinforce both that the FOMC has gained “greater confidence” about inflation and Fed’s commitment to keep the labor market in a “solid condition”.

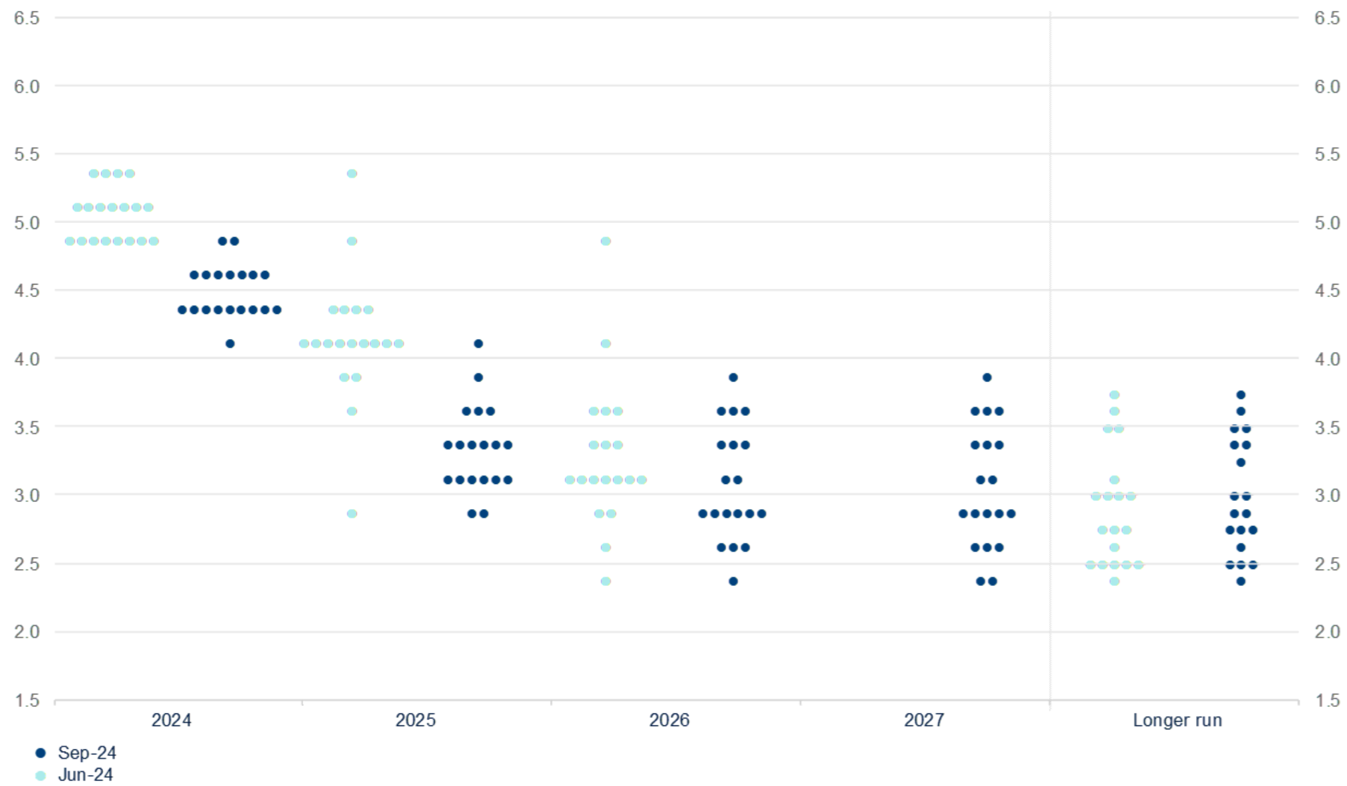
- **Fed’s quest to preserve the soft landing began today: it unequivocally confirmed that its focus has shifted to the labor market.** We argued that the Fed would not wait for weak labor market conditions before softening the policy stance, but with economic and labor market data consistent with a slowing rather than a weak economy, we thought the Fed was more likely to start the easing cycle with a 25bp rate cut. Yet, given that the Fed intends to “maintain the strength [of] the economy,” and that “the time to support the labor market is when it is strong,” the Fed opted to start big instead of small to “recalibrate” the policy stance to begin the process “of moving towards a more neutral stance.” Today’s big move does not signal the Fed is overly concerned about a possible hard landing, and thus, “no one should look at [today’s big 50bp rate cut] and think this is the new pace,” but rather signals the Fed’s commitment “not to get behind” in cutting rates. Although the Fed is “prepared to respond” if the labor market weakens unexpectedly, it is not on a “preset path”, and would cut rates more slowly if inflation proves sticky.
- **We now expect the Fed to take the policy stance to the 3.0% neutral steady-state level by September of next year.** We anticipate two 25bp rate cuts at the upcoming November and December meetings and six consecutive 25bp rate cuts next year. Heightened downside risks to the full employment goal (not our baseline scenario) would trigger a faster pace, while stickier-than-expected inflation would make the Fed move more slowly. Having said this, in view of monetary policy lags, achieving a soft landing is clearly now the Fed’s main worry.

To some extent, Powell downplayed today’s big start to the easing cycle by stressing that the updated dot-plot pointed to a slower rate cut cycle ahead

Table 1. **FOMC PARTICIPANTS’ SUMMARY OF ECONOMIC PROJECTIONS** (SEPTEMBER 2024, %)

Variable	Median					Central tendency					Range				
	2024	2025	2026	2027	LR	2024	2025	2026	2027	LR	2024	2025	2026	2027	LR
Change in real GDP	2.0	2.0	2.0	2.0	1.8	1.9-2.1	1.8-2.2	1.9-2.3	1.8-2.1	1.7-2.0	1.8-2.6	1.3-2.5	1.7-2.5	1.7-2.5	1.7-2.5
Jun-24	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
Unemployment rate	4.4	4.4	4.3	4.2	4.2	4.3-4.4	4.2-4.5	4.0-4.4	4.0-4.4	3.9-4.3	4.2-4.5	4.2-4.7	3.9-4.5	3.8-4.5	3.5-4.5
Jun-24	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
PCE inflation	2.3	2.1	2.0	2.0	2.0	2.2-2.4	2.1-2.2	2.0	2.0	2.0	2.1-2.7	2.1-2.4	2.0-2.2	2.0-2.1	2.0
Jun-24	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
Core PCE inflation	2.6	2.2	2.0	2.0		2.6-2.7	2.1-2.3	2.0	2.0		2.4-2.9	2.1-2.5	2.0-2.2	2.0-2.2	
Jun-24	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		
Federal funds rate	4.4	3.4	2.9	2.9	2.9	4.4-4.6	3.1-3.6	2.6-3.6	2.6-3.6	2.5-3.5	4.1-4.9	2.9-4.1	2.4-3.9	2.4-3.9	2.4-3.8
Jun-24	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

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



Source: BBVA Research / Fed

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