Fed Watch

The quest for a soft landing begins

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Fed's focus has shifted to the labor market; in view of monetary policy lags, achieving a soft landing is now the Fed's main worry

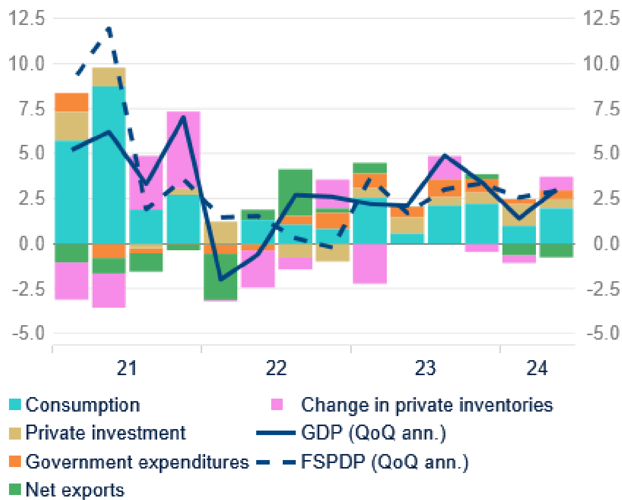
- **The continued strength of consumer spending despite some survey-based pessimism suggests the Fed is more likely to deliver a 25 bp rate cut this week.** The second estimate for 2Q24 real GDP growth released late last month (3.0% QoQ SAAR, up from the 2.8% advance estimate) helped ease some of the recent concerns around the possibility that the economy is on the verge of breaking down. The update reflected an upward revision to consumer spending, which has accounted on average for 60% of GDP growth over the past year and, together with positive contributions from private investment, has driven final sales to private domestic purchasers (a better measure of underlying economic momentum) to grow at a substantial pace over the same period (Figure 1). The strength has likely extended through 3Q24, as suggested by the most recent 2.5% real GDP nowcast from the Atlanta Fed. And while survey-based data has continued to suggest a dimmer outlook (with the ISM manufacturing new orders index falling to a 15-month low in August and a more pessimistic tone in the Fed's Beige Book), we believe that real activity data taken as a whole supports the view that the Fed will opt for a 25bp rate cut this week.
- **The weaker-than-expected July jobs report raised concerns of a recession and a more aggressive Fed's response, but we think the "gradually-rebalancing" narrative still holds.** The biggest surprise of the inter-meeting period came from a much weaker-than-expected gain of 114K nonfarm payrolls and a 0.2 pp rise in the unemployment rate (UR) in July to 4.3%, which sparked expectations that the Fed would have to aggressively kick off the easing cycle with a 50bp rate cut. Most of those concerns were driven by the fact that the updated jobs report brought the UR very close to triggering the so-called Sahm rule, which suggests that a recession has already begun when the three-month average of the UR increases by more than 0.5 pp above the minimum of that average over the preceding 12 months. We think a couple of reasons show those fears are likely overdone: first, the rise in July's UR was for the "right" reasons, since it was largely attributed to a rise in the labor force; and second, in contrast to past cycles, the UR jumped just 0.1 pp above the latest FOMC participants' 4.2% longer-lun median estimate (i.e., its steady state level). For now, we believe that both a relatively healthier 142K nonfarm payrolls gain and a 0.1 pp decline of the UR in August (Figure 2) tipped the balance in favor of a 25 bp rate cut this week, even as the payrolls figure for July was strongly revised down to 89K.
- **Inflation concerns have largely left the spotlight, but the continued stickiness of housing inflation will likely prevent the Fed from explicitly declaring victory on this ground.** The CPI reports for both July and August continued to confirm that prices resumed a broad-based disinflationary trend since 2Q24 following the first quarter's bump in the road. Headline inflation fell to 2.5% YoY in August from 2.9% in July. Core CPI inflation ran at a 0.2% MoM pace over the last two months, slightly above June's 0.07% figure but broadly consistent with a 2% YoY target inflation rate, with the 3Mo3M core CPI inflation rate running at 2.1%. In fact, CPI inflation would already be running below target were it not for the still significant contribution of housing inflation: both owner's equivalent rent and actual rent inflation rates have been increasing by around 0.5%

MoM, and explained 70% of the 3.2% YoY core inflation rate in August. The deceleration of housing prices has been puzzling, as it has been slower than what new rental contract prices have been indicating (Figure 3). However, the further slowdown of housing rent prices in the pipeline as well as mounting signs of labor market weakness likely give FOMC members enough confidence to begin a rate cut cycle this week.

- **The Treasury yield curve has fully priced in that a rate cut cycle will begin this week; the fed funds futures market remains divided on whether the Fed will cut rates by 25 or 50 bps.** Treasury yields plummeted following the weaker-than-expected jobs report for July, suggesting the Fed is likely behind the curve. Yields on 2- and 10-year Treasury notes have declined since late July by c. 70 and 40 bps to 3.6% and 3.65%, their lowest since September 2022 and June 2023, respectively. The decline of 3- and 6-month T-bill yields also suggest the Treasury market is fully convinced of a rate cut this week (see here for more on the recent evolution of US interest rates). The fed funds futures market has also fully priced in a rate cut, and is also pricing that the Fed will take the fed funds rate below 3.0% by year-end 2025 (Figure 4). But despite the futures market participants' consensus on the initial movement direction, opinions remain split on the magnitude, with a 60% implied probability of it being 50 bps. This is surprising, given the proximity to the FOMC meeting. It likely reflects investors' continued concerns since July's jobs report, despite other recent less gloomy economic indicators which, in our view, suggest that a sudden weakening of the labor market is unlikely for now and therefore support the more moderate 25 bp rate cut.
- **Fed's attention has shifted to the labor market outlook; we now expect a rate cut cycle of consecutive 25bp rate cuts at each meeting until the fed funds rate comes down to 3.0%.** A Fed's dovish shift was confirmed since the release of July's meeting minutes, which showed that "a vast majority" of FOMC officials were observing that "it would likely be appropriate to ease policy at the next meeting." This means the FOMC will 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 think the Fed will start the easing cycle with a 25bp rate cut. Looking ahead, the main risk is that the Fed is forced to make larger cuts if job creation falls sharply. Chair Powell already opened the door to a stronger policy response when he stated at Jackson Hole that the Fed "do not seek or welcome further cooling in labor market conditions" and that "[they] will do everything [they] can to support a strong labor market as [they] make further progress toward price stability." In the meantime, the updated Summary of Economic Projections (SEP) will throw more light on the likely pace of rate cuts.

Activity data taken as a whole supports the view that the Fed will opt for a 25bp rate cut this week

Figure 1. **REAL GDP GROWTH**
(%)



Source: BBVA Research / BEA

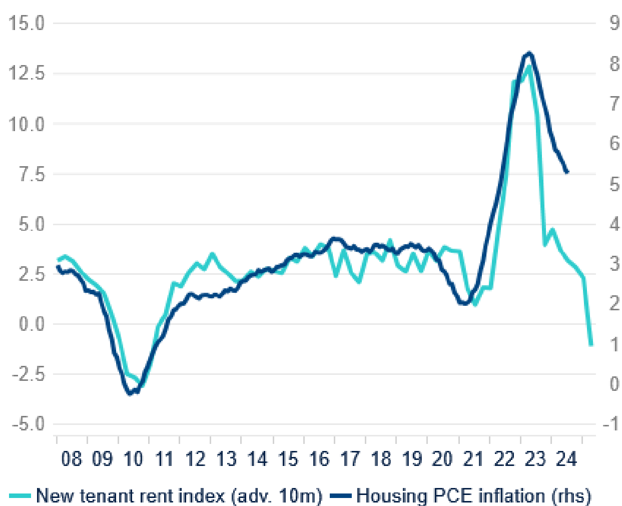
In July, the UR jumped just 0.1 pp above the latest FOMC's 4.2% longer-lun median estimate

Figure 2. **UNEMPLOYMENT RATE**
(%)

Source: BBVA Research / BLS

The stickiness of housing inflation will likely prevent the Fed from explicitly declaring victory

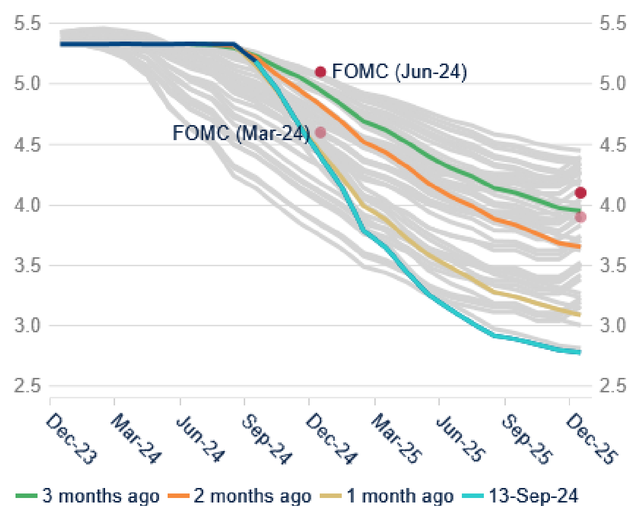
Figure 3. **NEW TENANT RENT INDEX AND HOUSING PCE INFLATION** (YoY%)



Source: BBVA Research / BEA / BLS

Markets are pricing in that the Fed will take the fed funds rate below 3.0% by year-end 2025

Figure 4. **FUTURES-IMPLIED FED FUNDS RATE**
(%)



The gray lines indicate weekly implied rate paths over the past year
Source: BBVA Research / CME / Fed

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