Fed Watch

Fed set to slow the pace of rate cuts to 25 bps

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It will likely continue to signal its plan to gradually normalize rates unless the labor market shows signs of rapid deterioration

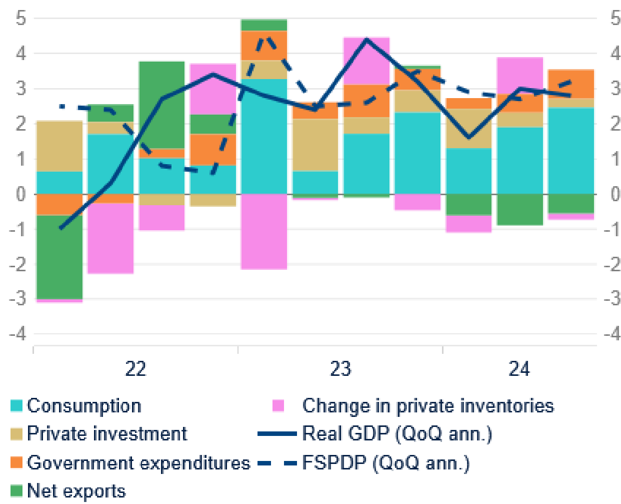
- **A positive outlook underpinned by the continued strength of consumer spending and recent upward revisions to GDP and GDI suggest that aggressive rate cuts are not warranted.** Last week's 2.8% QoQ SAAR advance estimate for 3Q24 real GDP growth continued to reflect the underlying strength of economic activity (Figure 1). The GDP headline figure was little changed—0.2 pp below—from the third estimate for 2Q24 because of a drag from imports, which grew at their fastest pace since early-2021 (11.2%), more than offsetting the growth pace of exports (8.9%). However, consumption growth accelerated to a six-quarter 3.7% high, driving final sales to private domestic purchasers to a strong 3.2% pace (up from 2.7% in 2Q) despite the significant deceleration of private investment explained by contractions in both nonresidential structures investment (-4.0%) and residential investment (-5.1%). Moreover, the annual revision to the national accounts from late September erased concerns that GDP would eventually be revised down in order to close a long-held discrepancy with GDI: a big 3.8% upward revision to GDI helped close the gap (Figure 2), and a 3.5% upward revision to real personal disposable income shed light on the robustness of consumer spending, still reflected by the continued strength of control group retail sales, which scored a 0.7% MoM rise in September. With bad news around industrial production and the manufacturing sector[1] stemming only from circumstantial events such as the recent hurricanes and some isolated labor strikes, FOMC members are likely to conclude that there is no need for further aggressive 50bp rate cuts in the near term.
- **Chances of a second 50bp rate cut vanished soon after the blockbuster jobs report for September. With the unemployment rate (UR) at 4.1%, the Fed is likely to cut rates by 25 bps.** While the initial estimation from July and August's jobs reports had signaled a faster-than-expected weakening of the labor market (the UR rose to a 33-month high of 4.3%), data from the intermeeting period have rather supported the view that the labor market remains strong. Most chances of a second 50bp rate cut were taken off the table in early October when the jobs report showed that the economy added +254k non-farm payrolls in September, but October's 12k jobs gain from last week's report sketched a less positive outlook: the reading was weaker than expected, even after considering the anticipated negative impact from Helene and Milton hurricanes and the strike at Boeing. Nevertheless, the stability of the unemployment rate at 4.1%, just below the 4.2% FOMC's longer-run median projection, will likely give Fed officials confidence that the labor market is still closer to maximum employment rather than at risk of a sudden deterioration. This doesn't mean that most FOMC members are likely to significantly re-weight the possibilities of a resurgence of inflationary pressures stemming from a tight labor market. With the pace of new jobs on a clear downward trajectory (Figure 3), FOMC members will rather keep emphasizing their commitment to supporting the ongoing strength of the labor market by continuing to cut rates, but at a more modest 25bp pace considering the overall signals of economic activity strength.

[1] Industrial production fell 0.3% MoM in September and the initial 0.8% August's estimated gain was revised down to 0.3%. The ISM manufacturing index is still sitting below the 50-point threshold.

- **Evidence of economic activity and employment strength coupled with more disinflation in the pipeline suggest that the path to a soft landing is not as narrow as initially thought.** While a couple of weeks after the last meeting we confirmed that core PCE inflation continued to run at a target-consistent pace in August (0.13% MoM, 1.6% on a 1-month annualized basis), inflation data for September showed some stickiness which we think should not significantly alter the Fed's confidence in the disinflationary process. Core CPI prices increased by 0.3% MoM in September on more broad-based services price increases, driving slightly up the YoY rate to 3.3% from 3.2%, but any resurgence of inflationary pressures on services prices is unlikely to last amid a cooling labor market. Indeed, an encouraging development from the CPI report is that both rent of shelter and owner's equivalent rent increased by a more modest 0.3% MoM in September (down from the 0.50% MoM pace in August). Consistently, core PCE inflation also slightly accelerated to 0.25% MoM in September, keeping the 2.7% YoY inflation rate unchanged. The 3-month annualized rate rose to 2.3% (from 2.2%), but the 6-month annualized rate continued to cool to 2.3% from 2.5%. The PCE inflation data mirrored the broader-based nature of price increases depicted by the CPI report by showing that core services (ex-housing) prices increased at its fastest pace in six months (0.3% MoM). Nevertheless, the quarterly update to the Employment Cost Index released last week suggests there is room for further services disinflation, since private wages slowed down to 3.8% YoY in 3Q (from 4.1% in 2Q) despite the evidence of strong economic activity elsewhere.
- **The Fed will ignore this week's election outcome unless markets turn deeply stressed, but greater inflationary challenges in the face of a Trump victory may result in fewer rate cuts next year.** The roughly 60bp increase in mid- and long-term Treasury yields during the intermeeting period isn't entirely unexpected, given the overly steep decline in Treasury yields that occurred in July and August (Figure 4), when some market observers were even calling for an emergency FOMC meeting in order to discuss aggressive rate cuts aimed at preventing the economy from entering into recession following the upticks in the unemployment rate. Even with the recent uptick in Treasury yields, the market is far from having ruled out the possibility of further rate cuts. With a lower contribution from increased inflation compensation, the term premium climbed to a 2024-peak, suggesting that the uncertainty around the presidential election is also behind the recent rise in long-term yields, particularly since Trump reversed the betting odds gap with Harris (see here for more on the recent evolution of US interest rates). The futures market arrives at this meeting with a much broader consensus by pricing in 98% chances of a 25bp rate cut (vs 64% chances of a 50bp rate cut ahead of the previous meeting). The implied policy rate path shows that the futures markets now anticipate no more than six 25bp rate cuts (vs roughly eight last month) from this point forward until 2025-end.
- **FOMC members will likely continue to signal that their plan continues to be a gradual normalization of the fed funds rate.** We think it is just as unlikely that the Committee will consider a second 50bp cut as it is that it will consider pausing the rate cut cycle given the recent signals of economic activity strength. Instead, they are likely to agree to continue normalizing the monetary stance with more cautious 25bp rate cuts. Quoting Governor Waller's words from a couple of weeks ago, while they will "not want to overreact to [the intermeeting] data or look through it," they will likely "view the totality of the data as saying monetary policy should proceed with more caution on the pace of rate cuts." Against the backdrop of strong economic growth, with data pointing to a labor market headed towards equilibrium rather than showing signs of rapid deterioration, and with core PCE inflation gradually easing, we anticipate the Fed will cut the fed funds rate by 25 bps.

Consumption accelerated to 3.7% QoQ, driving final sales to private domestic purchasers to 3.2%

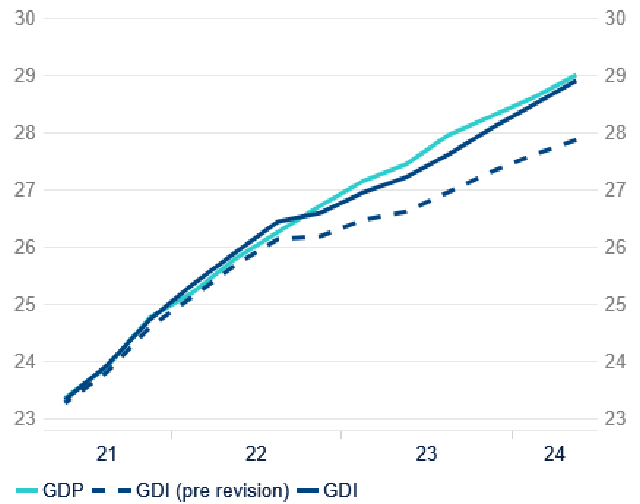
Figure 1. **REAL GDP GROWTH** (%)



Source: BBVA Research / BEA

A big 3.8% upward revision to GDI helped close a long-held gap with GDP

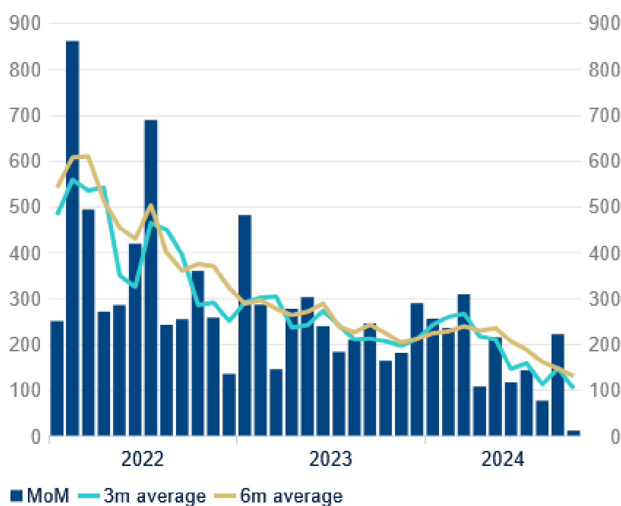
Figure 2. **GDP AND GDI** (TRILLION USD)



Source: BBVA Research / BEA

The labor market keeps cooling despite overall signals of economic activity strength elsewhere

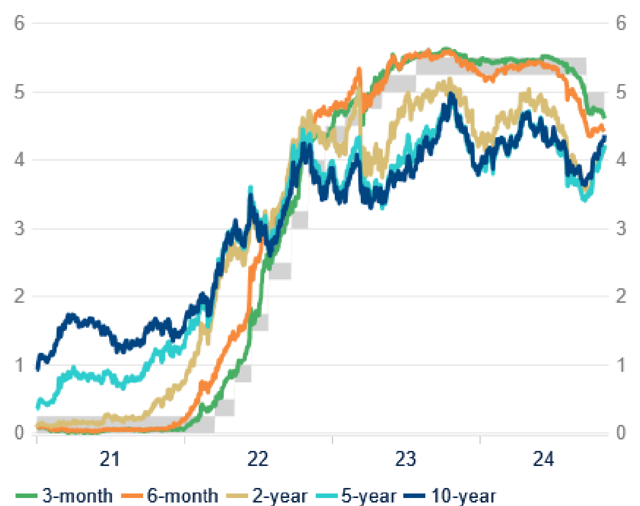
Figure 3. **CHANGE IN NONFARM PAYROLL EMPLOYMENT** (THOUSANDS)



Source: BBVA Research / BLS

The uncertainty around the presidential election is also behind the recent rise in long-term yields

Figure 4. **TREASURY YIELDS** (%)



The gray area indicates the fed funds rate target range
Source: BBVA Research / Fed / Treasury

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