US Daily: July FOMC Preview: Moving Closer to a Cut (Mericle)

- Encouraging inflation news and a further rise in the unemployment rate have pushed Fed officials closer to cutting. The FOMC is set to hold steady next week but is likely to revise its statement to hint that a cut at the following meeting in September has become more likely.
- Specifically, we expect the FOMC to revise its statement to say that the unemployment rate has "risen slightly but remains low," that there has been "further progress" (dropping "modest") toward the 2% inflation goal, that the risks to the two sides of the mandate "are in" (not "have moved toward") better balance, and—most importantly—that it now needs only "somewhat" greater confidence in the inflation outlook in order to start lowering interest rates.
- We suspect that an acceptable July CPI report would likely be enough to clinch a September cut. Whether the FOMC deviates from the broader plan implied by the June dot plot to normalize the funds rate at a gradual pace of 25bp per quarter as inflation returns to target will likely depend mainly on the labor market, which has sent mixed signals lately, and on fiscal policy after the election. We now see the risks to the Fed path as tilted slightly to the downside of our baseline of quarterly cuts, though not quite as much as market pricing implies.

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July FOMC Preview: Moving Closer to a Cut

Recent comments from Fed officials—recapped in our July FOMC Chatterbox—suggest that they will remain on hold at their meeting next week but have moved closer to a first interest rate cut.

The main reason that the FOMC is closer to cutting is the favorable inflation news from May and June. After firmer inflation prints in Q1—which we attribute mostly to residual seasonality and the usual month-to-month noise—the news improved substantially in Q2. We expect the July round of inflation data to be favorable as well, as Exhibit 1 shows, because catch-up inflation is fading, we should see payback for the January OER spike with a six-month delay reflecting the six-month rotation in the sample of rental units, and residual seasonality in the PCE inflation numbers should swing negative again.

Exhibit 1: Encouraging May and June Inflation Reports Have Moved the Fed Closer to a First Cut

Date	Event	Period	MoM	3m annual.	6m annual.	YoY
May 15	Core CPI	April	0.29	4.11	4.04	3.62
May 31	Core PCE	April	0.26	3.46	3.25	2.79
June 12	Core CPI	May	0.16	3.30	3.74	3.41
June 12	**FOMC meeting**					
June 28	Core PCE	May	0.13	2.93	3.32	2.62
July 11	Core CPI	June	0.06	2.10	3.31	3.28
July 26	Core PCE	June	0.18	2.31	3.38	2.63
			GS Forecasts (% change)			
July 31	**FOMC meeting**					
August 14	Core CPI	July	0.22	1.80	2.95	3.27
August 30	Core PCE	July	0.18	1.96	2.71	2.69
September 11	Core CPI	August	0.25	2.16	2.73	3.29
	Core PCE Estimate	August	0.16	2.09	2.51	2.75
September 18	**FOMC meeting**					

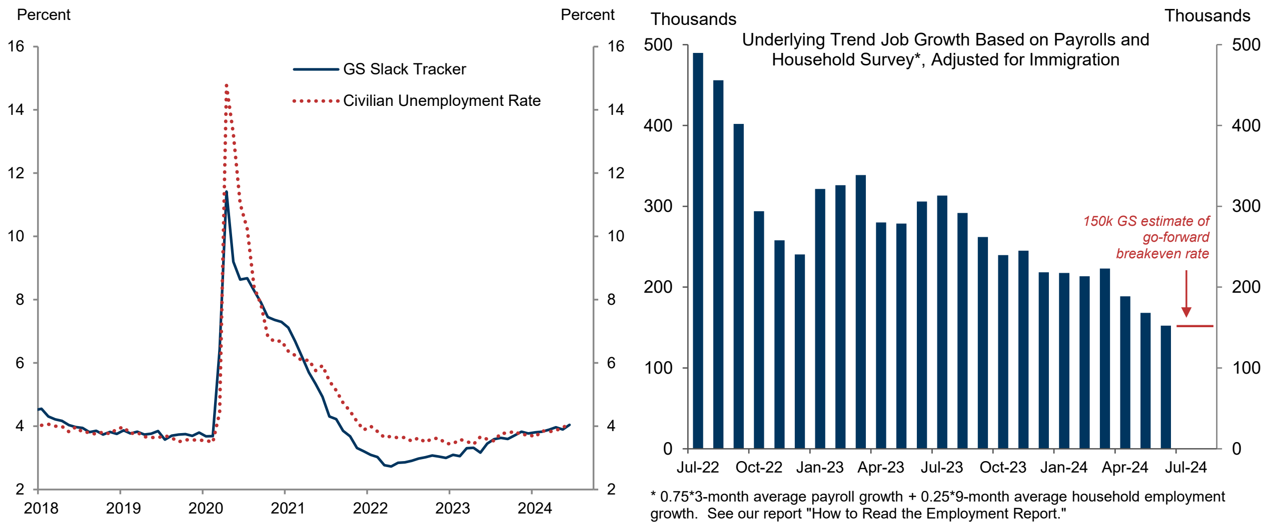
Source: Goldman Sachs Global Investment Research, Department of Labor, Department of Commerce

The other reason that Fed officials' tone has shifted is that the unemployment rate has risen 0.1pp for the last three months to 4.1%, up 0.7pp from its bottom or nearly 0.5pp on a three-month average basis. The left side of Exhibit 2 shows that our broader slack tracker has also continued to rise recently.

For now, the labor market is in a good place. It is roughly as tight as before the pandemic, a period that struck a very favorable balance between full employment and near-target inflation. And the right side of Exhibit 2 shows that trend job growth is running at roughly our estimate of the go-forward "breakeven rate" that would keep the unemployment rate stable and preserve that favorable balance.

But slack has been trending up and job growth has been trending down, and as Chair Powell has noted on a few occasions over the last month, further softening in the labor market would be undesirable. We think the labor market will most likely stabilize naturally in roughly its current state because, as the Q2 GDP report showed, final demand growth remains solid so labor demand growth ought to hold up as well. But cutting sooner rather than later could help to ensure that outcome.

Exhibit 2: The Labor Market Is in a Good Place, but Slack Has Been Trending Up and Job Growth Has Been Trending Down, and Fed Officials Will Want to Ensure That the Labor Market Stabilizes Here



Source: Goldman Sachs Global Investment Research

We expect these recent trends in the data will lead the FOMC to revise its statement at next week's meeting in ways that will hint that a cut at the following meeting in September has become more likely.

Exhibit 3 highlights four possible changes. First, we think the statement might acknowledge the increase in the unemployment rate while continuing to note that it remains low. Second, we expect the statement to drop the qualifier "modest" and just say that there has been "further progress" toward the 2% inflation goal, as Powell did in his interview at the Economic Club of Washington D.C., which came after the June CPI report. Third, we expect the statement to say that the risks to the two sides of the mandate "are in" (not "have moved toward") better balance, a slightly softer version of Powell's recent comment that they are "in much better balance." And fourth and most importantly, we expect the FOMC to say that it now needs only "somewhat" greater confidence in the inflation outlook in order to start lowering interest rates, in light of Powell's comment that "the three readings in the second quarter, including the one from last week, do add somewhat to confidence."

Exhibit 3: Exhibit 3. We Expect the FOMC Statement to Lower the Bar for a Cut By Saying It Now Only Needs "Somewhat" Greater Confidence That Inflation Is Moving Sustainably Toward 2%

Recent indicators suggest that economic activity has continued to expand at a solid pace. Job gains have remained strong, and the unemployment rate has risen slightly but remains~~ed~~ low. Inflation has eased over the past year but remains elevated. In recent months, there has been ~~modest~~ further progress toward the Committee's 2 percent inflation objective.

The Committee seeks to achieve maximum employment and inflation at the rate of 2 percent over the longer run. The Committee judges that the risks to achieving its employment and inflation goals are in ~~have moved toward~~ better balance ~~over the past year~~. The economic outlook is uncertain, and the Committee remains highly attentive to inflation risks.

In support of its goals, the Committee decided to maintain the target range for the federal funds rate at 5-1/4 to 5-1/2 percent. In considering any adjustments to the target range for the federal funds rate, the Committee will carefully assess incoming data, the evolving outlook, and the balance of risks. The Committee does not expect it will be appropriate to reduce the target range until it has gained somewhat greater confidence that inflation is moving sustainably toward 2 percent. In addition, the Committee will continue reducing its holdings of Treasury securities and agency debt and agency mortgage-backed securities. The Committee is strongly committed to returning inflation to its 2 percent objective.

Source: Goldman Sachs Global Investment Research

We suspect that an acceptable July CPI report would likely be enough to clinch a September cut. The Fed leadership appears close to convinced already, and leaving the question open until the final August round of data would risk making the decision more sensitive to one last CPI report than it should be.

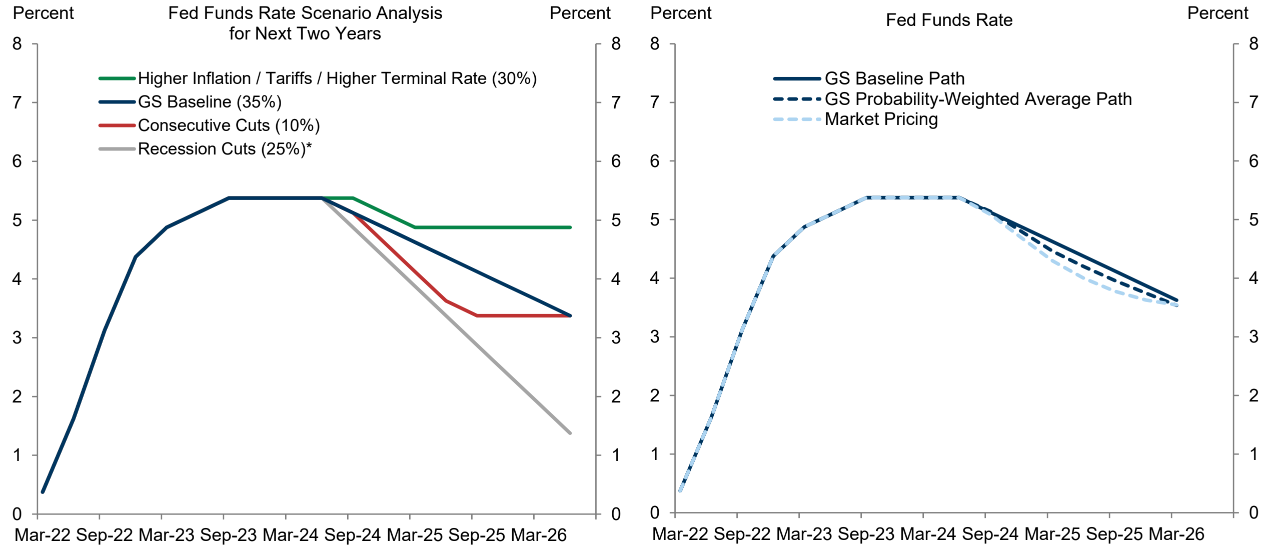
Beyond September, the June dots suggest that most FOMC participants envision cutting once per quarter as inflation continues to return to the 2% target, which is also our baseline forecast.

In the near term, the main risk is that the FOMC could instead cut a bit more quickly, perhaps at consecutive meetings at the outset, if labor market data soften more than we expect and the motivation for cutting shifts from normalization to actively pushing back against a slowdown in the economy.

For next year, we think the main risk to the baseline quarterly cutting path is the possibility that tariffs could boost the inflation numbers. Tariffs would cause a one-time increase in the price level but would not be a recurring source of inflationary pressure, so we would not expect the FOMC to hike in response. But our analysis suggests that an intermediate tariff scenario could keep inflation closer to 3% than to 2%, which could lead the FOMC to pause rate cuts. One key source of uncertainty, however, is how the equity market would respond to tariffs. If financial conditions tightened substantially in response to tariffs, as occurred in 2018-2019, then the net implications for the Fed would be less clear.

Exhibit 4 shows our updated scenario analysis of possible Fed paths. It now implies that the risks tilt slightly to the downside of our baseline path of quarterly cuts, though not quite as much as market pricing implies.

Exhibit 4: Our Fed Scenario Analysis Implies That the Risks Tilt Slightly to the Downside of Our Baseline Path of Quarterly Cuts, Though Not Quite as Much as Market Pricing Implies



* This is the probability of a recession happening at any point over the two-year horizon shown above. Our 12-month recession probability is 15%.

Source: Goldman Sachs Global Investment Research

David Mericle

Disclosure Appendix

Reg AC

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