US Daily: September FOMC Recap: A Higher Bar and a Later Start for Rate Cuts (Mericle)

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- The FOMC's interest rate projections were somewhat more hawkish than expected today, with a solid 12-7 majority showing another hike in 2023 and the median penciling in 50bp of rate cuts in 2024, down from 100bp of cuts in June. We did not take this as a strong signal about a hike in November, in part because these projections came alongside an inflation forecast that still looks too high. We continue to expect that better inflation news, progress on labor market rebalancing, and a likely Q4 growth pothole will convince the FOMC not to hike again this year.
- We do, however, think that today's meeting raises the bar for rate cuts next year, and we have pushed the first cut in our forecast back from 2024Q2 to 2024Q4. We have long had mixed feelings about the likelihood of cuts because we are skeptical of some of the arguments that FOMC participants have made for them. Today, participants appeared to move away from the view that monetary policy tightening could weigh on growth with a long lag next year, which weakens one argument for cutting. We think this means that inflation will have to fall further than we previously assumed for the FOMC to cut.
- The median longer run rate dot remained unchanged at 2.5% today, against our expectation that it would rise to 2.75%, but FOMC participants do appear increasingly open to rethinking neutral. The average longer run dot moved up again to 2.76%, and Chair Powell volunteered that neutral might have risen and that the short-run neutral rate could be higher than the longer run rate shown in the dot plot, as a recent New York Fed blog post concluded. A further shift toward that view could further weaken the case for rate cuts next year.

September FOMC Recap: A Higher Bar and a Later Start for Rate Cuts

The FOMC's interest rate projections at its September meeting today were somewhat more hawkish than expected. A solid 12-7 majority showed another hike in 2023, against our expectation that a narrower 10-9 majority would project another hike, and the median dot implied just 50bp of rate cuts in 2024, against our expectation it would show the same 100bp of cuts as in the June projections.

We saw three takeaways from the revised economic projections. First, the FOMC's inflation forecasts still look too high and leave ample room for a downside surprise. Chair Powell said that Fed officials expect year-on-year core PCE inflation to come in at 3.9% in August, above our forecast of 3.79%, and the median projection showed 3.7% on a Q4/Q4 basis in 2023, above our forecast of 3.43%. Second, in lowering their forecast for the peak unemployment rate from 4.5% to 4.1%, FOMC participants signaled that they think a meaningful rise in the unemployment rate is not necessary to tame inflation. Third, by raising their 2024 GDP growth forecast from 1.1% to 1.5%, participants seemed to infer from the economy's resilience this year that the lags from tighter financial conditions to growth are fairly short.

We did not take a strong signal from the dots about a possible hike in November and we continue to expect that the FOMC will ultimately decide not to hike again in 2023. One reason to downplay the 2023 dots is that participants likely saw strategic value in showing another hike for now because it is simpler to take it out later than to take it out now and have to add it back. Another is that if inflation comes in below the FOMC's forecast, there would be a straightforward case for canceling the last hike. We also continue to think that further labor market rebalancing and the likelihood of an upcoming Q4 growth pothole, which Powell discussed at length, weaken the case for hiking again this year.

We do, however, think that today's meeting raises the bar for rate cuts next year, and we have pushed the first cut in our forecast back from 2024Q2 to 2024Q4. We have long had mixed feelings about the likelihood of cuts because we are skeptical of some of the arguments that FOMC participants have made for them. We are skeptical that neutral is as low as Fed officials think, that the gap between the funds rate and its estimated neutral rate is a good way of forecasting the economic outlook, that there are long-lagged effects of past tightening on GDP growth that will extend even into next year, and that a decline in backward-looking realized inflation—as opposed to forward-looking inflation expectations, which should hold steady—will raise real rates and weaken the economy. Instead, we think the more natural path to normalizing the funds rate is to simply wait until something goes wrong and then deliver either small cuts in response to a smaller growth threat, similar to the insurance cuts of 2019, or substantial cuts in response to a full recession.

Because of our skepticism of the rationales for cuts, we have long assigned only slightly more probability weight to a baseline path featuring cuts than to a path in which the FOMC instead holds the funds rate steady. Today's meeting reinforced our hesitation about possible cuts because the FOMC appeared to move away from at least one of the arguments for them, the concern that long-lagged effects of past rate hikes could weigh on growth next year if they are not reversed. If FOMC participants move further toward our view that cuts are not necessary, they could conclude next year that if growth remains solid and the labor market remains tight, rate cuts are not worth the risk.

For now, we think that if participants see a less obvious need to reverse rate hikes, then inflation will have to fall further than we previously assumed for the FOMC to cut. At the time of the first cut in our new 2024Q4 baseline, we expect that core PCE inflation will have fallen below 2.5% on a year-on-year basis.

The evolving neutral rate debate also has implications for the likelihood of cuts. The median longer run rate dot remained unchanged at 2.5% today, against our expectation that it would rise to 2.75%. But we saw several signs that FOMC participants are increasingly open to rethinking neutral.

First, the average longer run dot had already moved up from March to June and moved up again today to 2.76%. Second, Powell volunteered that neutral might have risen and that the short-run neutral rate could be higher than the longer run rate shown in the dot plot, as a recent New York Fed blog post concluded. We previously noted that this argument could further weaken the case for cuts next year if it evolved into an official FOMC view, and Powell's comment was a step in that direction. Third, Powell said in reference to the neutral rate that "we know it by its works," a phrase New York Fed President Williams has often cited. This suggests that FOMC participants might be willing to consider that neutral could be higher than they previously thought if the economy remains resilient at the current funds rate, an inference that many investors have already drawn.

David Mericle

Disclosure Appendix

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