

# Fed: frontloading to secure a soft landing

## Will other central banks follow and cut rates faster?

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FLASH NOTE

### SUMMARY

- The long-anticipated easing cycle in the US started with the Fed cutting by 50bps instead of the more traditional 25bps as we expected. However, Powell pushed back against the idea that 50bps will be the new 25bps, noting that the Fed is not in a rush to lower rates. Participants' interest rate projections continue to show a soft landing and a gradual path of policy normalisation.
- However, in our view, the September FOMC meeting signals an important dovish shift in the Fed's reaction function. Chair Powell wants to be more pre-emptive in securing a soft landing and his tolerance for further softness in the labour market seems quite low. Therefore, even though Powell and the median interest rate projections are signaling a series of 25bps cuts in the months ahead, we suspect even a small increase in the unemployment rate could tip the balance to a more aggressive frontloading of rate cuts.
- With today's fed funds rate of 4.875% still significantly above the FOMC's neutral estimate of 2.875%, we now expect another 50bps rate cut at the November meeting, followed by a 25bps cut in December.
- We continue to see a total of 100bps of cuts in 2025 to 3.125%, but likely more front-loaded. Risk is tilted towards a faster return to the neutral rate. If there is a significant spike in the unemployment rate, the terminal rate would move well below the neutral rate.
- We keep our ECB baseline scenario unchanged for a pause in October and a 25bp cut in December. Risks are tilted towards a larger move (50bp) in December. More importantly, the Fed's determination and the acceleration of disinflation in the euro area will probably lead the ECB to dial back its restrictiveness more rapidly in 2025.

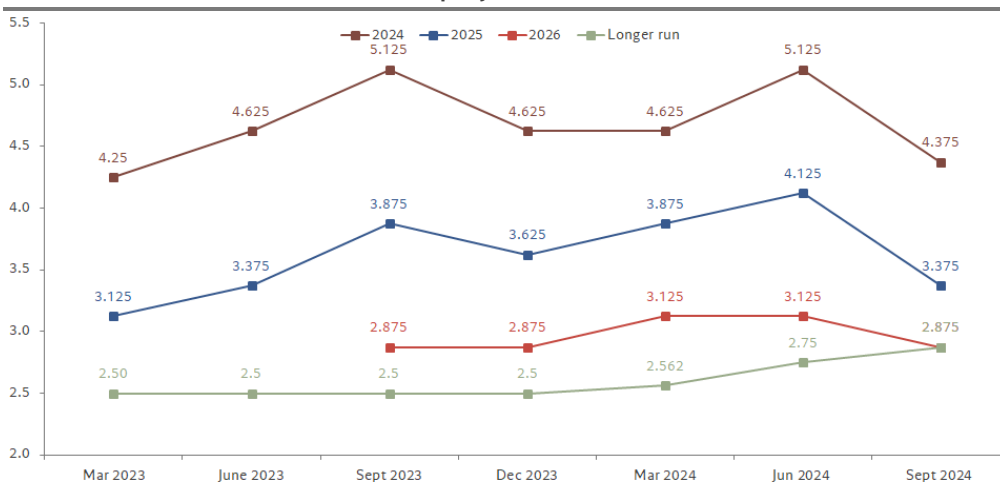
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## FED – FRONTLOADING CUTS WITH A DOVISH REACTION FUNCTION

Contrary to our expectations, the Fed opted to cut its policy rate by 50bps, instead of the more traditional 25bps. Governor Bowman dissented in favor of 25bps, the first dissent from a governor since 2005. This was a major win for Powell – the committee was likely leaning towards 25bps, but Powell had a preference for 50bps and ended up successfully persuading most of the voting members to get on board.

Interest rate projections were lowered significantly from June, but they remain above market pricing - the median dot showed 50bps more cuts in 2024, suggesting 25bps each at the Nov and Dec meetings. The median shows 100bps of cuts in 2025 to 3.375%, and 50bp of cuts in 2026 to 2.875%, in line with the median participant’s estimate of the neutral rate. The economic projections showed a higher unemployment rate and a lower inflation path in 2024-2026. There was minimal change to the committee’s longer-run estimates, with only the longer-run neutral rate estimate rising to 2.875% from 2.75%. Markets reacted initially in a dovish direction, but reversed course as the press conference got under way.

Chart 1: FOMC median interest rate projection, %



Source: Pictet Wealth Management, FRB, as of Sept 2024

Chair Powell described the choice for a larger rate cut as policy recalibration, essentially catching up for skipping a rate cut in July. If the Fed had the July employment report on hand at the last meeting, they likely would have cut by 25bps then. Powell pushed back several times against the idea that 50 will be the new 25, noting that the Fed is not in a rush to lower rates and no one should look at 50bps as the new pace.

Contrary to past easing cycles with a large initial cut, Powell remained overall upbeat about the labour market, and sounded very confident about inflation returning to target over time. But he did choose to emphasise the benchmark downward revisions to nonfarm payrolls from the QCEW data, and anecdotal data from the Beige book which show a slowdown in hiring.

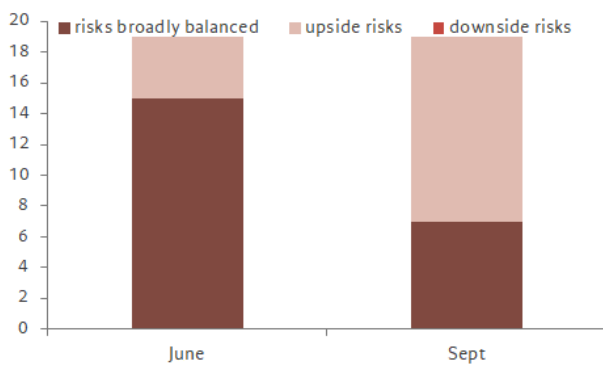
In our view, today’s meeting signals an important dovish shift in the reaction function. Powell noted that the time to support the labour market is when it’s strong, and the Fed won’t be waiting to see layoffs to give that support. Powell referred to

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the Beveridge curve, noting that further declines in job openings may translate directly into unemployment, a nod to upside risks to the labour market. In fact, the median unemployment rate projection for this year rose from 4.0% to 4.4% (above the current rate of 4.2%), with the majority of participants seeing upside risks to these higher forecasts, along with more balance risks around their core inflation forecasts (chart 2 and 3).

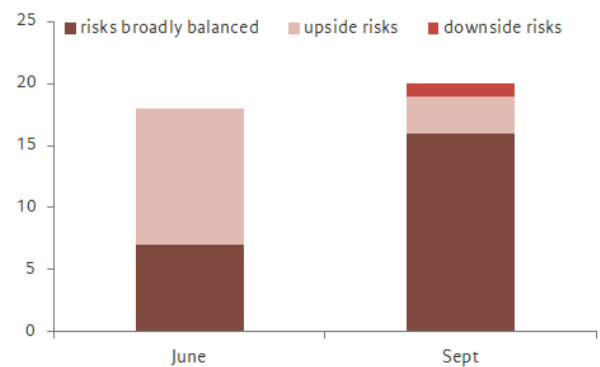
Chair Powell is determined to secure a soft landing. His tolerance for further softness in the labour market seems quite low. Therefore, even though Powell and the median interest projections are signalling a series of 25bps cuts in the months ahead with a 4.4% unemployment rate forecast in Q4, we suspect even a small increase in the unemployment rate could tip the balance to a more aggressive 50bp rate reduction.

**Chart 2: FOMC participants' assessments of risks around their unemployment rate forecast**



Source: Pictet Wealth Management, FRB, as of Sept 2024

**Chart 3: FOMC participants' assessments of risks around their core PCE inflation forecast**



Source: Pictet Wealth Management, FRB, as of Sept 2024

To be sure, the 19-member committee is heavily divided, with 7 officials pencilling in 75bps of cuts in total this year, 8 officials looking for 100bps of cuts in total, two officials seeing 50bps and one looking for 1250bps. However, we believe Powell is one of the 8 officials looking for 100bps of cuts. With today's fed funds rate of 4.875% still significantly above the FOMC's neutral estimate of 2.875%, we now expect another 50bps rate cut at the November meeting, followed by a 25bps cut in December. The decision will come down to the labour market data - there will be two more employment reports and one CPI report before the November FOMC meeting, two days after the US presidential election. If the labor market data could stabilize at today's level, then the Fed is likely to go with a 25bps reduction in November.

We continue to see a total of 100bps of cuts in 2025 to 3.125%, but likely more front-loaded. Risk is tilted towards a faster return to the neutral rate. If there is a significant spike in the unemployment rate, the terminal rate would move well below the neutral rate.

We are not changing our macro outlook for a moderate deterioration in the labour market and a slowdown in GDP growth in light of the changes to monetary policy. A more front-loaded cutting cycle would help lower financing costs and support the labour market on the margin, but borrowing costs remain elevated and policy transmission is likely weaker. For example, the housing sector is unlikely to rise strongly

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in the near term even with the recent decline in mortgage rates, as the prevailing mortgage rate of 6.6% is still significantly higher than the 4% effective rate on outstanding mortgages.

## FED DETERMINATION COULD PROMPT A MORE AGGRESSIVE RESPONSE IN EUROPE

The 50bp rate cut by the Fed lowers the bar for the European Central Bank (ECB) to dial back its restrictiveness more rapidly. To respond, the ECB could either cut its deposit rate by 25bp in October or by 50bp in December. The availability of new data favours a larger move in December rather than another 25bp cut in October. There is only a five-week gap between the September and October ECB meetings, and the ECB will have only one more flash HICP print and one more flash purchasing managers (PMI) report before then—probably not enough to shift the narrative. The ECB could decide to wait until December, when it will have a lot more data, including on wage growth (in particular, negotiated wages on 19 November and compensation per employee on 6 December), which is critical for the “wage-productivity-profits nexus” and for the inflation outlook. While our baseline scenario remains that the ECB will pause its rate cuts in October and lower rates again by 25bp in December, the risks are tilted towards a larger move (50bp) at the end of the year. More importantly, the Fed’s determination and the acceleration of disinflation in the euro area will probably lead the ECB to dial back its restrictiveness more rapidly in 2025.

The Swiss National Bank (SNB) will meet on September 26. We expect the SNB to cut its policy rate by 25bp to 1.0%, but risks are tilted towards a larger cut (50bp), especially following the Fed’s decision this week. It is worth noting that, in the past, 50bps rate cuts in Switzerland have come against the backdrop of a sharp appreciation of the Swiss Franc or accrued deterioration in economic conditions—for example, in July 2001, November 2008 and January 2015. While the current economic situation does not justify an acceleration in the SNB’s easing cycle beyond 25 bps, the repricing in policy rate expectations is putting pressure on the SNB to go further. Falling short of market expectations could further strengthen the Swiss franc. In any case, the probability we see the SNB’s policy rate falling below its 1.0% estimate of the neutral rate later this year or in 2025 has increased significantly, due to currency strength.

Lastly, in the UK, the Bank of England (BoE) left unchanged its policy rate in September. The more aggressive stance of the Fed is unlikely to alter our forecast for the BoE in 2024, which includes two additional 25bps rate cuts, one in November and another in December. However, the BoE is expected to lean towards clearer guidance and a more dovish stance, which could extend well into 2025 by delivering a more aggressive cutting cycle than the market is currently expecting.

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