

## Goodbye inflation, hello unemployment

With its decision to cut rates by 50 basis points, the Fed gives the labor market priority over inflation

### IN A NUTSHELL

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- This has been one of the most highly anticipated – and discussed – Fed meetings in recent history
  - A cut was almost a certainty, but there were compelling arguments on both sides for either 25bps or 50bps – the Fed went with 50bps, giving the labor market priority over inflation
  - We expect the yield curve should now steepen, and like the banking, healthcare and software sectors – valuations permitting
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## Inflation messed with the wrong central bank

So, the inflation fight is won. But now we have new worries on our plate. That appears to be the message from the U.S. Federal Reserve (the Fed) as they erred on the side of aggression and cut rates by more than we, and many economists, expected. Stuck between the rock of still high inflation, and the hard place of a softening labor market, ultimately the Fed decided that the latter was of more concern.

To be sure, this decision matters. For years the U.S. economy has lived with a Fed tightening cycle whose overarching intent was to kill an inflationary spike that was less transitory (remember that word?) than believed. Now it seems the Fed is declaring victory on that front, despite headline measures of inflation still running above their 2% target. Two questions stand out. Why cut in the face of those still high price pressures, and what new concern is it that the Fed now seems more concerned over?

To answer the first part, recall Greenspan's famed observation about steering an oil tanker – the decision must significantly preempt the result. Or, put another way, the Fed likely believes that, despite still being above its explicit target, the direction of travel for inflation is on the right track. Indeed, the belief now is presumably that not to cut risks inflation dropping too precipitously to the downside. That's fair enough. Like many Fed watchers we are firmly in the camp of believing that if you want stable inflation, prepare for volatile monetary policy. It's worth drinking unpleasant tasting medicine if your headache goes away.

The answer to the second part is arguably more important. And the reason is simple – we are at an inflection point. The price of money (which is what interest rates are after all) trended up for years post the Covid crisis as supply constraints spurred inflation. For a short while we plateaued. But now, like a rollercoaster that's peaked its crest, we must prepare for a very different ride, that of lower rates and cheapening money. Check your straps. And the main cause for this change of direction? Well, it appears as though it's the creep higher in the unemployment rate that most concerns the Fed. They aren't panicking about that by any stretch of the imagination, but they have stressed the need to support the labor market, and this move likely represents the

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first step in that new direction. The Fed is still of course fully committed to its dual mandate, and both inflation and labor markets matter, but we think this move represents a subtle shift in concern from the former to the latter.

## Economic and policy implications

“At the September FOMC meeting, central bankers cut the federal funds rate by 50 basis points (bps) to a new target range of 4.75% to 5.00% for the first time, after holding rates at elevated levels for 14 months. This was more than our expectation of a 25bps cut. More recently, there has been intense debate about whether the Fed needs to do more than 25bps to prevent the economy from slowing.

Markets have priced in a Fed that will quickly lower policy rates to what can be considered a neutral stance. The latest *Summary of Economic Projections*<sup>1</sup> shows that central bankers are indeed more concerned about the economy's momentum than before, as they expect higher unemployment this year and next. However, central bankers remain less dovish than the markets, indicating a preference to cut rates by a further 50bps this year and by 100bps in 2025, before returning to what can be seen as a neutral stance in 2026.

We view today's policy decision as an insurance policy to protect labor markets from further deterioration, which would be inconsistent with achieving a soft landing. In the press conference, Fed Chair Powell somewhat confirmed this view by referring to the decision as an "appropriate recalibration" with respect to cooling labor-market conditions. However, he reiterated that they are not on a preset course as they can slow down or speed up their efforts. Ultimately, this means that the Fed remains data dependent and that the dot plot is "not a policy plan" and 50bps is not the new pace as he puts it.

All in all, we think that starting the cycle of rate cuts with a bigger step is not without problems. On the one hand, it implies an increase in central bankers' confidence in forecasting inflation, while uncertainties about the labor-market outlook were likely the driving force behind the decision. This implies the risk that the Fed will have to "recalibrate" its reaction function to incoming data, as we have seen in the recent past. It's reminiscent of Powell's pivot in late 2023, which stalled the disinflationary process for months – even without a rate cut. Moreover, it at least feels a bit like a Fed that was actually pushed by the markets, not to mention the current political implications of a larger-than-usual move. What we do agree on, however, is that further cuts seem necessary, but at the same time we are keeping a close eye on inflation going forward, as we do not fully share the central bank's confidence. Among them, at least one dissenter seems to support our view.”

Christian Scherrmann, Chief U.S. Economist

<sup>1</sup>Source: Federal Open Market Committee as of 9/18/24

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## Asset-class implications

### Fixed income

“While today’s 50bps cut gets in front of economic downside scenarios that are not yet fully visible, if there at all, it’s admission of a mistake in not cutting in July. It also muddies future communications from the Fed, that they couldn’t better signal a 50bps cut, when data actually came in stronger during the blackout period. This is not 2022, when there was a surprise consumer price index (CPI) print and the Fed had very few choices. Today was an active decision, that illustrates the Fed has a singular focus on employment, which is still well below long-term averages even if it reaches their forecasted 4.4% unemployment rate. The Fed somehow delivered a dovish message beyond an already dovish market, that will be incentivized to continue to ask for additional large cuts, in response to what we’ve been told is a “normalizing” dataset. While there may not be immediate risk to inflation reaccelerating, giving preventive antibiotics to a patient that’s not sick has long-term consequences. This was a victory for Powell to only have one dissenting opinion and vindication for the market, but both should be careful what they wish for; if the Fed continues to cut aggressively it may find itself doing so in response to a hard landing.

We see potential for more steepening of the yield curve. That said, in our view, it will be hard to deliver on, let alone go beyond, the amount of cuts the market has already priced in. At the moment, it's hard to tell whether it will be a bull or bear steepening, but we think it will be reliant on whether we see a hard or soft landing, and also if today is a tacit acknowledgment of the acceptance of longer structural inflation over time.

George Catrambone, Head of Fixed Income, Americas

### Equities

“The Fed seems to care much more about protecting against a downturn, than about any potential upturn in inflation. I think today’s move decreases the odds of a recession, and I expect that the yield curve will now steepen as a result. In my view, the banking sector could win to this, as should solid growth stocks – at reasonable valuations – in the healthcare and software sectors.

I agree that the chances of a recession, and the chances of accelerating inflation are about equal, or “in balance” as Powell said. But, I think the threat or damage to the economy (and the Fed) should inflation accelerate again is greater than what a small recession would cause. This is why I think the risk of cutting by 50bps today, was a greater risk to take than cutting by 25bps today or even waiting until Nov and cutting more aggressively then.

On the other hand, at least the economy is better prepared now for potential tax hikes. Without tax hikes and a lower deficit, the ten-year yield might move higher, not what stocks and real estate need.”

David Bianco, Chief Investment Officer, Americas

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## Glossary

One **basis point** equals 1/100 of a percentage point.

The **consumer price index (CPI)** measures the price inflation as a percentage, year over year, of a basket of products and services that is based on the typical consumption of a private household.

The **federal funds rate** is the interest rate, set by the Fed, at which banks lend money to each other, usually on an overnight basis.

**Inflation** is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

**Monetary policy** focuses on controlling the supply of money with the ulterior motive of price stability, reducing unemployment, boosting growth, etc. (depending on the central bank's mandate).

A **recession** is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

The **U.S. Federal Reserve**, often referred to as "**the Fed**," is the central bank of the United States.

**Volatility** is the degree of variation of a trading-price series over time. It can be used as a measure of an asset's risk.

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