The Fed – cautious or bold?

The Federal Reserve is expected to cut key interest rates again for the first time next week. The speed and extent to which interest rates will then fall further depends on the data. If the risks of recession increase further, large interest rate cuts are also possible. However, we expect the interest rate cut to provide little impetus for the bond market, while the stock market will depend on whether or not there is a recession.

Bernd Weidensteiner
Dr. Christoph Balz

"Data requires action"

In a **recent speech**, Governor Waller expressed the view that the time has come for the Fed to act following the latest data:

- The inflation rate, as measured by the deflator of consumption expenditures excluding food and energy, has fallen by 3 percentage points since its high at the beginning of 2022 to 2.6% most recently. It is likely to fall further in the coming months. Finally, wage growth, which is decisive for service prices, has also slowed noticeably. In spring 2025, core inflation is likely to be only slightly above the Fed's target of 2%.
- At the same time, the labor market is showing increasing signs of weakness. In the three months to August, the number of people in employment rose by an average of just 116 thousand, compared with growth of more than 200 thousand at the start of the year. The unemployment rate has risen from 3.4% in April 2023 to 4.2% recently.

From the Fed's perspective, the assessment of the risks to the two parts of its mandate – price stability and maximum employment – has therefore shifted significantly: the central bank now sees higher risks to the employment part of its mandate, having long focused on high inflation. The Federal Reserve sees monetary policy as risk management, which is why it generally focuses on the part of its mandate that is more at risk in any given situation. Fed Chairman Powell made this shift in priorities clear by emphasizing that it is no longer aiming for a further weakening of the labor market.

Taylor rule supports rate cuts

A simple monetary policy rule also shows that the time is ripe for lower interest rates. According to the Taylor rule, the nominal short-term interest rate (fed funds rate) should correspond to the equilibrium nominal interest rate (the sum of the equilibrium real interest rate, which neither stimulates nor dampens the economy, and the inflation target), with a premium (*discount*) being applied if

- the inflation rate is above (*below*) the target of 2.0%
- the unemployment rate is below (*above*) its full employment level. [1]

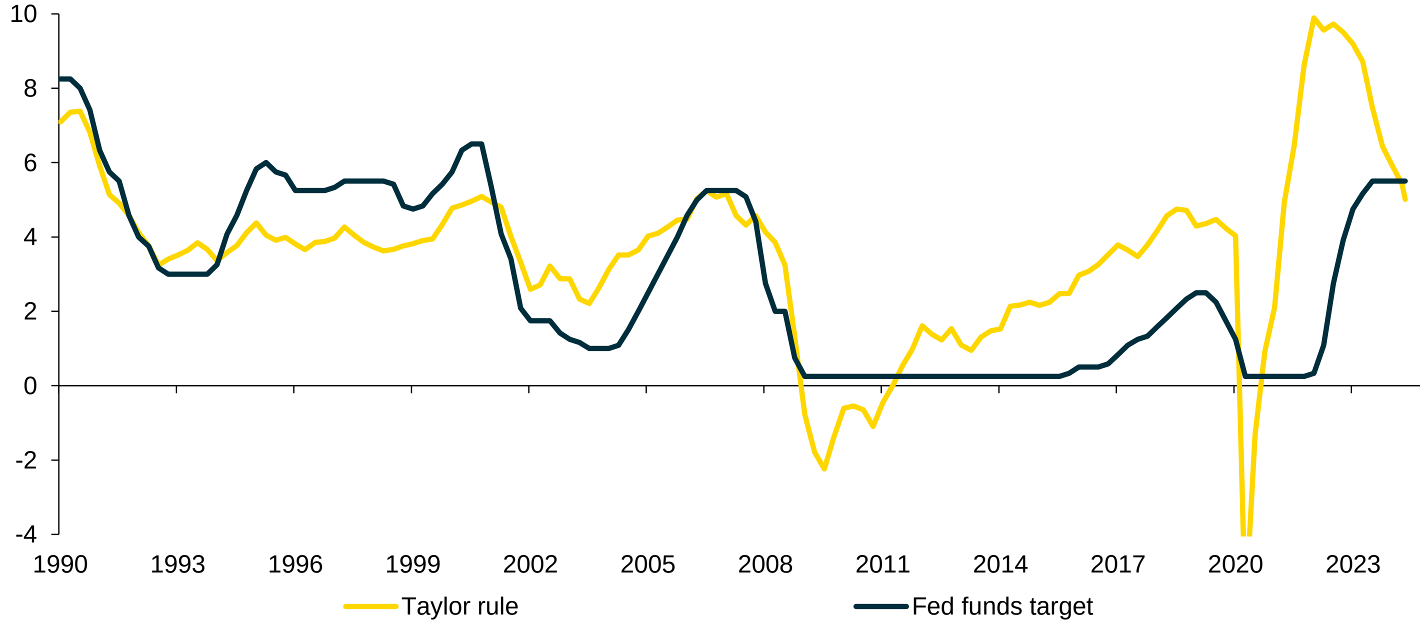
Even if one assumes a relatively high value of 2% for the equilibrium real interest rate (many economists and the Fed see it at 1%) and thus 4% for the nominal equilibrium interest rate, the current Taylor interest rate is only **5.1%:**

- Equilibrium interest rate of **4%**
- plus a premium for the excessively high inflation rate to bring it down again: (2.6%-2.0%)*1.5 = **0.9%**
- plus a premium because the unemployment rate of 4.2% is lower than the full employment level of 4.4% (estimated by the CBO): 4.4%-4.2% = **0.2%**.

Certainly, the results of the Taylor rule should not be put on the gold scale. However, the fall in inflation and the rise in the unemployment rate have caused the “Taylor interest rate” calculated using the rule to fall significantly. At 5.1%, it is now slightly below the current key interest rate corridor of 5.25% to 5.50% (Chart 1), in contrast to previous years.

Chart 1 - Fed funds rate now above the Taylor rule

Fed funds rate (upper bound of target range) and Taylor rate, in %



Source: Fed, BLS, S&P Global, Commerzbank Research

25 basis points – or even 50?

Next week, the Fed's main priority will be to initiate the rate cut process. A move of 25 basis points will suffice, which we expect. We also see this expectation confirmed by the higher than expected inflation data for August. In addition, a cut of 50 basis points could be evidence for many investors that the Fed is really worried about the economy and may have waited too long to turn interest rates around; the Fed is unlikely to want to give such an impression. After all, the Fed does not believe that the US economy is already in a recession or heading towards one (another quote from Governor Waller's recent speech). At the starting point of the interest rate cuts, the Fed clearly wants to remain flexible. A large rate cut runs the risk of taking flexibility away from the Fed. This is because expectations of further aggressive rate cuts would then probably become entrenched.

... and what happens next?

The Fed considers the inflation problem to be essentially solved, meaning that it is likely to focus its monetary policy on keeping the increased risks to economic growth in check. The Fed will therefore carry out a whole series of interest rate cuts, especially as inflation is likely to ease somewhat until spring 2025. The Fed will probably cut its key interest rates by at least 150 basis points, reaching a low of 4.00% in the spring of next year.

However, the extent and pace of further interest rate cuts will depend on the economic data published in the coming months. So far, the data is consistent with our forecast that growth will weaken over the course of 2024, but that a recession will be avoided. This is also supported by the fact that the Fed's bank survey on lending conditions and various overall indicators summarizing the situation on the capital markets suggest that financing conditions will have improved in 2024. The economy should then gradually regain momentum; in the second half of 2025, we expect price pressure to gradually increase again. We give this scenario a probability of two-thirds.

Risk scenario: recession

However, the risks for this scenario have increased in recent months. This is not least due to the fact that residential construction, which was still making a positive contribution to growth at the beginning of the year, slumped again in the summer. The question is also how long US consumers will be able to maintain their relatively high rate of consumption. The savings rate has fallen significantly and currently stands at just under 3%, well below the 6% recorded before the coronavirus crisis.

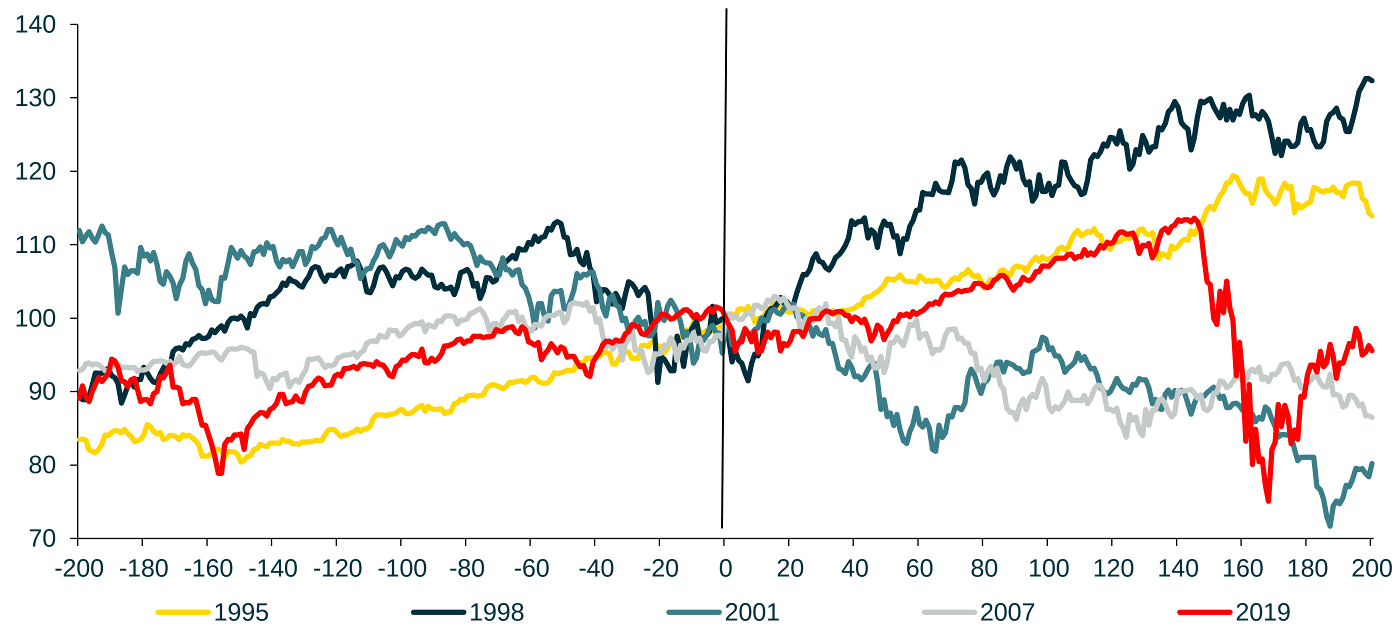
If the economy weakens more than expected, the Fed will also react more strongly. Fed Chairman Powell has already stated that they will “do everything we can” to support the labor market. The central bank has “ample room to react to any risks”. A series of large interest rate hikes is then likely and key interest rates would fall well below the 4% of our main scenario. We see a probability of one third for this scenario.

Recession question decisive for stock market

Whether there is a recession is crucial for the stock market in particular. In the past, the Fed's interest rate turnaround has only given US equities new momentum if there was no recession. This can be seen by looking at the S&P 500 index in the 200 trading days before and after the first interest rate cut (Chart 2). The Fed's rate cuts in 1995, 1998 and 2019 stabilized the economy and share prices rose sharply (although the 2019 rally was later ended by the pandemic). In contrast, share prices plummeted in 2001 and 2007 after the first interest rate cuts because the economy slipped into a recession, which resulted in a significant fall in corporate profits.

Chart 2 - Stock market performance depends on whether recession hits

S&P 500 index, trading days, indexed to 100 at time of first Fed rate cut (t = 0)



Source: Bloomberg, Commerzbank Research

Even lower Treasury yields?

Can the Fed's interest rate turnaround now be expected to provide further impetus towards even lower yields? The yield on ten-year US government bonds has already fallen from 5% in October 2023 to around 3.6%. This is similar to the trend prior to previous rate cuts, when yields fell sharply in the run-up to the first move as the market anticipated the interest rate turnaround. When the Fed then "delivered", however, there was no longer a clear trend in yields (Chart 3).

When a recession was avoided in 1995 and 1998, yields actually rose. Yields were most likely to fall during the 2007 financial crisis and in the special case of the pandemic, which occurred in spring 2020 around 150 trading days after the first rate cut and still triggered a recession.

As we assume that the US economy will not slide into recession and that inflation is therefore likely to remain above the Fed's target, we see only very limited potential for even lower long-term US yields.

Chart 3 - Treasury yield falls in the run-up to first Fed rate cut

10-year Treasury yield, trading days, change relative to first rate cut (t = 0) in basis points

Source: Bloomberg, Commerzbank Research

[1] For the Taylor interest rate, we use the variant in which the short-term nominal interest rate is set in quarter t according to the formula $i_t = r^* + p^* + 1.5^* (p_t - p^*) + (u^*-u_t)$

where

r^* = equilibrium real interest rate, assumption 2%

p^* = inflation target of 2%; thus r^*+p^* is the equilibrium nominal interest rate

p_t = inflation rate in quarter t measured by the PCE deflator excluding energy and food

u^* = natural rate of unemployment (CBO estimate)

u_t = unemployment rate in quarter t

There are other variants of the Taylor rule in which, for example, inflation expectations are used instead of the current inflation rate. Because a further fall in inflation is generally expected, this would lead to an even lower Taylor interest rate, i.e. it would not change the statement. Similarly, the output gap measured by the ratio of gross domestic product to its potential value could be used instead of the capacity utilization of the labor market. This would not change the result either. We prefer the above variant for didactic reasons, because it incorporates the Fed's two mandates, namely stable prices and full employment.

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In accordance with ESMA MAR requirements this report was completed 13/9/2024 07:46 CEST and disseminated 13/9/2024 07:46 CEST.

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