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MARKET
SIGHT LINES

The Federal Reserve Cuts Rates 50 Basis Points: "Threading the Needle" Will Be Tough

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The Federal Reserve (Fed) cut its funds rate by 0.5%, or 50 basis points, in line with expectations, after having hiked rates 5.25% from March 2022 to July 2023 to soften demand and tame high inflation. Importantly, we also learned more about Fed officials' views of the future from its Summary of Economic Projections (SEP). In this week's Sight|Lines, we review the results of this Fed meeting and assess the risk of monetary policy error, in one direction or the other.

THE TAKEAWAY: THE FED ACTS AFTER MORE THAN A YEAR

Recent reports show inflation has cooled to near the Fed's 2% target, and, amid signs of a softening labor market, the Fed finally began its rate cut cycle. In summary:

- Both the August consumer price index (CPI) and producer price index (PPI) reports show inflation close to the Fed's 2% target over the last six months.
- The Fed reduced its policy rate 0.5%, with its statement signaling progress on inflation, a balanced focus in its dual mandate, and a focus on future data before additional cuts.
- The Fed released its updated Summary of Economic Projections (SEP), providing insight on the range of views of the members of the Federal Open Market Committee (FOMC).
- The median expectation is for two more quarter-point funds rate cuts rate later this year.
- This corresponds to the view that our economy will do well in 2024 and 2025.
- Importantly, the Fed expects inflation to cool toward the 2% target, but the median projections indicate that inflation is expected to remain above target until 2026.
- In his post-meeting press conference, Fed Chairman Jerome Powell stressed the importance of managing risks to both inflation and employment, suggesting a balance has been reached between those risks.
- Going forward, investors will focus on the risk of monetary policy error as the Fed tries to "thread the needle" to keep inflation under control while avoiding a recession.

IN-DEPTH: THE FED ACTS AFTER MORE THAN A YEAR OF ELEVATED RATES, SIGNALING GREATER CONFIDENCE INFLATION IS RECEDING AND BALANCE WITH ITS DUAL MANDATE

As the labor market has cooled and recent reports show inflation has eased closer to the 2% target, the Fed has started this next rate cut cycle and offered some perspectives about the future. Going deeper:

- Some monthly inflation measures have reached 0.17%, the monthly equivalent of the Fed's 2% target:
    - For the six months ended August, monthly CPI averaged 0.17%, and PPI averaged 0.15%.
- The Fed cut its policy rate 0.5%, with meaningful changes to its statement:
    - "The Committee has gained greater confidence that inflation is moving sustainably toward 2%, and judges that the risks to achieving its employment and inflation goals are roughly in balance."
    - "In considering additional 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 Fed's SEP provides helpful insight into the range of individual views, analyzing the individual projections of FOMC members, both voting and nonvoting:
    - The median expectations for the funds rate reflect two more 0.25% cuts this year and four next year.
    - The median projection shows a GDP growth rate of 2.0%, above the 1.8% long-term projection.
    - The median expected unemployment rate is 4.4% at the end of this year and next.
    - The median core PCE Inflation projection is 2.6% for 2024, but 2.2% for 2025 and 2% for 2026.
- In his post-meeting press conference, Powell shared confidence about inflation but was unwilling to provide a clear signal about further rate cuts, saying:
    - "We now see the risks to achieving our employment and inflation goals as roughly in balance."
    - "Our patient approach over the past year has paid dividends. Inflation is now much closer to our objective, and we have gained greater confidence that it is moving sustainably toward 2%."
    - "We are not on any preset course. We will continue to make our decisions meeting by meeting."
- Investors will focus on the risk of monetary policy error as the Fed tries to "thread the needle" to keep inflation under control while avoiding a recession, and Powell offered comments about this challenge:
    - "As inflation has declined and the labor market has cooled, the upside risks to inflation have diminished and the downside risks to employment have increased."
    - "Housing inflation is the one piece that is kind of dragging a bit."
    - "The U.S. economy is in good shape. It's growing at a solid pace. Inflation is coming down. The labor market is in a strong place. We want to keep it there."

CONCLUSION

After hiking its funds rate by 5.25% from March 2022 to July 2023, the Fed cut it by 0.5% amid signs of cooler inflation and a softer job market. We don't foresee a strong market reaction as a result of this cut, as much of it has already been priced in by markets. Fed officials SEP forecasts signal a policy path to try to "thread the needle" of keeping inflation under control while avoiding a recession, but the risk of monetary policy error, in one direction or the other, remains.

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