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TRENDMACRO LIVE!

On the July FOMC

Wednesday, July 31, 2024
Donald Luskin

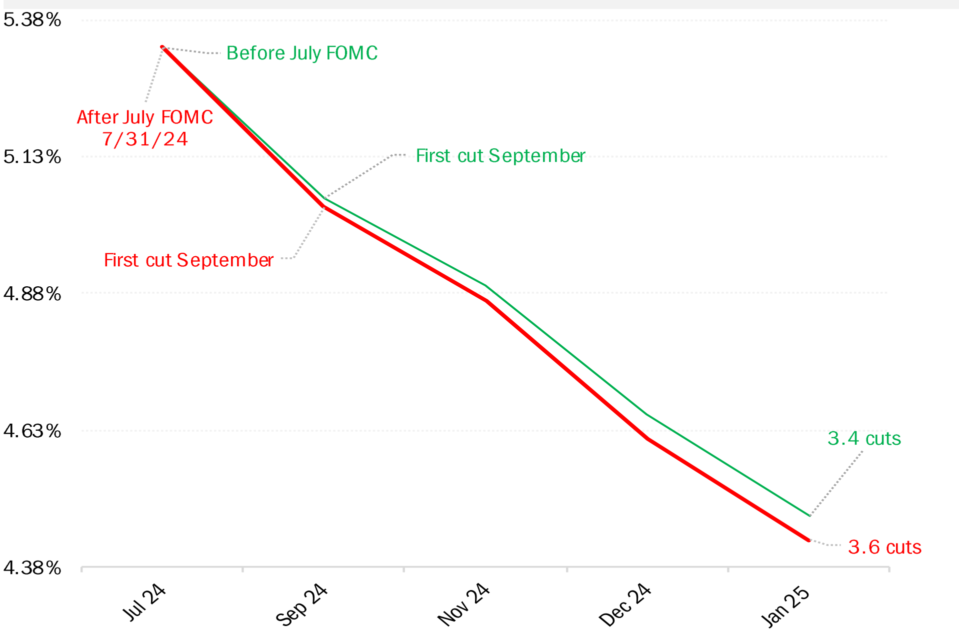
Powell puts a September cut "on the table" at least three times.

At the one-year mark for what turned out to be the end of the tightening cycle that began in March 2022, today's FOMC meeting was *freighted with very strong consensus expectations*. There was no probability of a rate cut today, but *a greater-than-100% futures-implied probability for the first rate cut to come at the September FOMC, which means it would surely have to be signaled today* (please see the chart below, and "FOMC Preview: A Political Decision?" July 29, 2024).

- *It wasn't as strong as we thought it would be, but we got the signal* in today's FOMC statement. Compared to the June FOMC statement,

  "…Inflation has eased over the past year but remains somewhat elevated. In recent months, there has been ~~modest~~some further progress toward the Committee's 2 percent inflation objective.

Fed funds futures curve (based on effective funds rate)



Source: Bloomberg, TrendMacro calculations

Update to strategic view

FEDERAL RESERVE, US MACRO, US STOCKS, US BONDS: The FOMC did not give the full-throated signal for a September cut that it seemed markets were expecting. But subtle changes in statement language, acknowledging progress on inflation and establishing a neutral balance of risks, seems to have been enough. Powell put a September cut "on the table" at least three times in the post-meeting presser, saying that data even in its current configuration would be sufficient to justify it. There will be two inflation reports before the September FOMC, and July's is sure to be outright deflationary. Jackson Hole in late August is effectively another FOMC meeting where a more definitive pre-announcement could be made. One year after the Fed stopped hiking rates, the economy has stayed out of recession and markets have performed well – implying the hiking was more normalization than tightening, in the face of a higher-than-previously expected neutral rate. Recent easing cycles have been associated with inferior market…

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"…The Committee judges that the risks to achieving its employment and inflation goals ~~have moved toward~~continue to move into better balance~~ over the past year.~~. The economic outlook is uncertain, and the Committee ~~remains highly~~is attentive to ~~inflation~~the risks to both sides of its dual mandate.

- *As of this writing , the futures-implied probability of a September cut is higher than it was before the FOMC announcement dropped* (please see the chart on the previous page).
- Apparently it's enough to have "some" further progress on inflation, not "modest."
- *Probably most significant, it seems to be enough for the FOMC to be no longer "highly attentive to inflation risks," but instead "attentive to the risks to both sides of the dual mandate."*
- We suppose that could be summed up as implying that, from here, there's no reason why the policy rate should not be closer to neutral, not "deep into restrictive territory" as Fed Chair Jerome Powell often says.
- At the post-meeting press conference, the first two questions pushed Powell to deal with the strong expectations for a September cut. Of course he gave all the usual health warnings about the totality of the data. Nevertheless, he said,

"… So if we were to see, for example, inflation moving down, we are more or less in line with expectations. Growth remains, let's say reasonably strong and the labor market is consistent with this condition. I would think that a rate cut could be on the table at the September meeting."

- *That sounds to use like if everything in September is the same as it is today, there would be a cut.*
- But it's better than that. There will be two more jobs reports and two more inflation reports by the September FOMC. We're not sure what jobs will do, but the consensus for Friday's payroll report would be a sequential decline in jobs gains. And here on the last day of the month, our "Truflation" real-time inflation gauge is saying CPI will show outright deflation for July at an annual rate of 2.3%, the second deflationary month in a row.
- *As the data evolve, surely confirming directionally the spirit of the Fed's more relaxed view on inflation and a more symmetrical balance of risks, there will actually be another chance to pre-announce a September cut: the annual confab at Jackson Hole.*
- This is always effectively a bonus FOMC meeting, and there is a long tradition of using it to signal policy turning points. Powell will likely give the keynote speech on Friday morning, August 23, and that will leave almost a month till the September FOMC.
- *Seems to us like September is a sure thing.*
- The next battleground is how rapidly the coming easing cycle will play out, and how deep it will go. We continue to believe that the FOMC is starting to see the economic evidence proving that their current policy is not as deeply restrictive as they have said (we're

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… performance, but those followed policy plateaus in which the Fed was too tight for too long. That is not the case this time

[Strategy Dashboard home]

still waiting for that recession the Fed tried to cause, and that everyone has expected for more than two years). That means an easing cycle can be more leisurely and terminate at a higher funds rate. We'd be very surprised if the termination will be as low as the Summary of Economic Projections' "dot plot" for the "longer run" funds rate, at 2-3/4%, or even at the 3-1/8% "dot plot" given for year-end 2026 (again, see "FOMC Preview: A Political Decision?"). We'll get a lot more telemetry on that at the September FOMC when the SEP is published again – we expect both those "dots" will be revised higher. It wouldn't surprise us to hear it discussed at Jackson Hole.

Setting aside the matter of a September cut, this is a good time to take cognizance of the fact that *we just passed the one-year anniversary of what turned out to be the final rate hike in this cycle*, at the July 2023 FOMC (see "On the July FOMC: The Most Unkindest Hike of All" July 26, 2023). It is interesting to observe, with the benefit of hindsight, what this has meant to equity and fixed income markets.

- The S&P 500 outperformed the average over half a century of one-year periods following the terminations of tightening cycles. Its high-water mark was higher, its low-water mark was less low, and its end-point for the year was higher (please see the top chart on the following page).
- Compared to *all* one-year periods, this last year's high-water mark was less high, and its low-water mark was lower. Not good, but that's typical of post-termination years. The very significant difference is that the one-year end-point this time was significantly higher than the average of all one-year periods – by a factor of more than two.
- *All this would tend to support our contention all along that the Fed has not been as tight as it has been saying it is. Hiking to 5-3/8% failed to cause a recession, and apparently once it become clear that the hiking cycle was over, recession expectations impounded in stocks significantly cleared, despite what might seem a disappointment that the peak rate has been held so long.*
- For bonds, the post-termination year was very different than the average. The high-water mark for the percentage change in the 10-year Treasury yield was drastically higher, and the low-water mark was drastically less low (please see the bottom chart on the following page). The end-point, with yields up 8%, was directionally opposite the average (down 10%) and almost all other prior experiences. The experience of the last year looks more like the average of *all* years.
- *This, too, would tend to support our contention that the Fed has not been decisive in this business cycle. Yields are higher now – indeed, at levels not seen since before the Global Financial Crisis – not because of anything the Fed has done, but simply because the pandemic experience triggered the end of the post-GFC era of "secular stagnation" characterized by systematically low rates and yields.*

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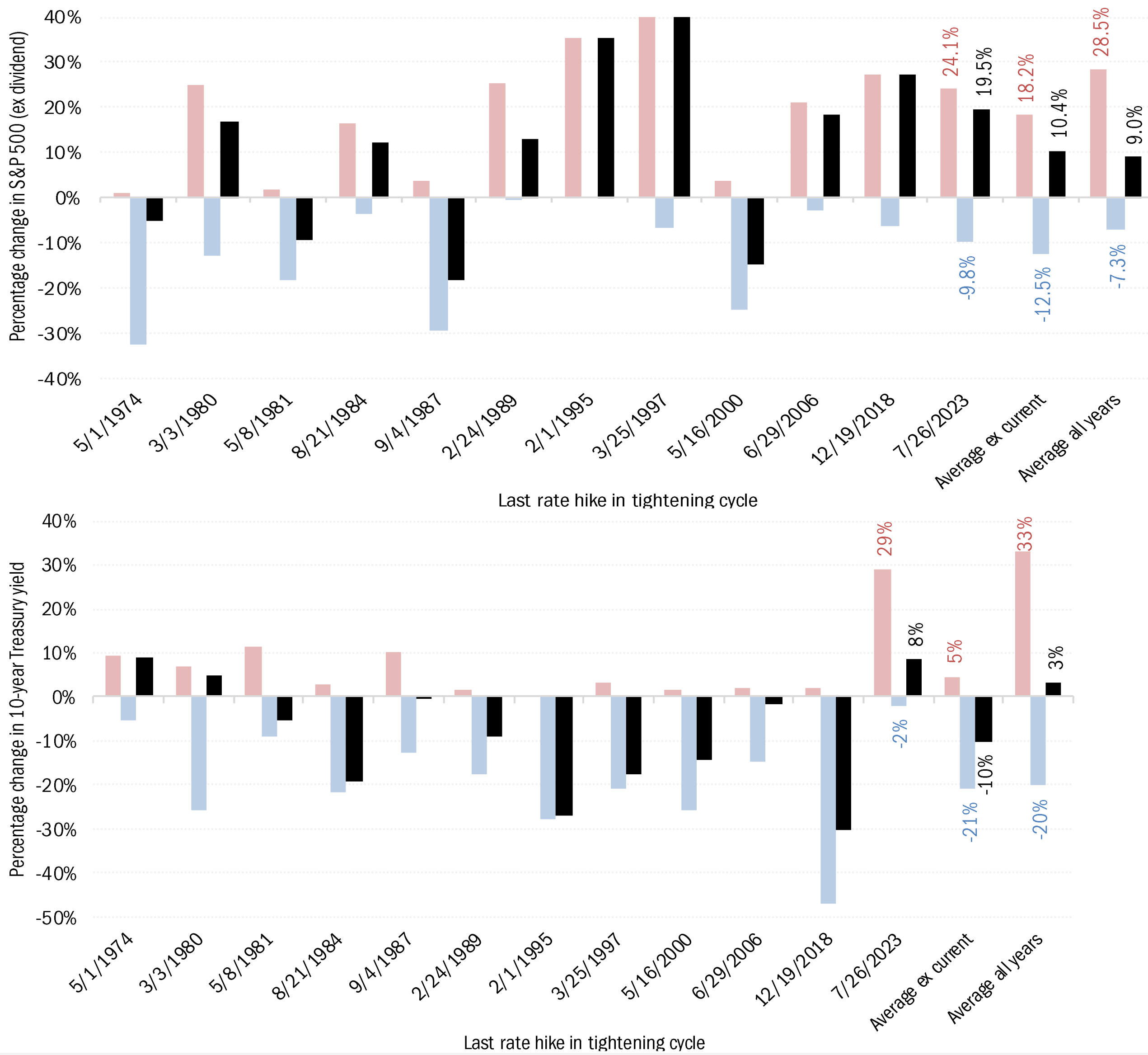
Change following last rate hike in Fed tightening cycle

Max move higher over coming year | Max move lower over coming year | Move at end of coming year



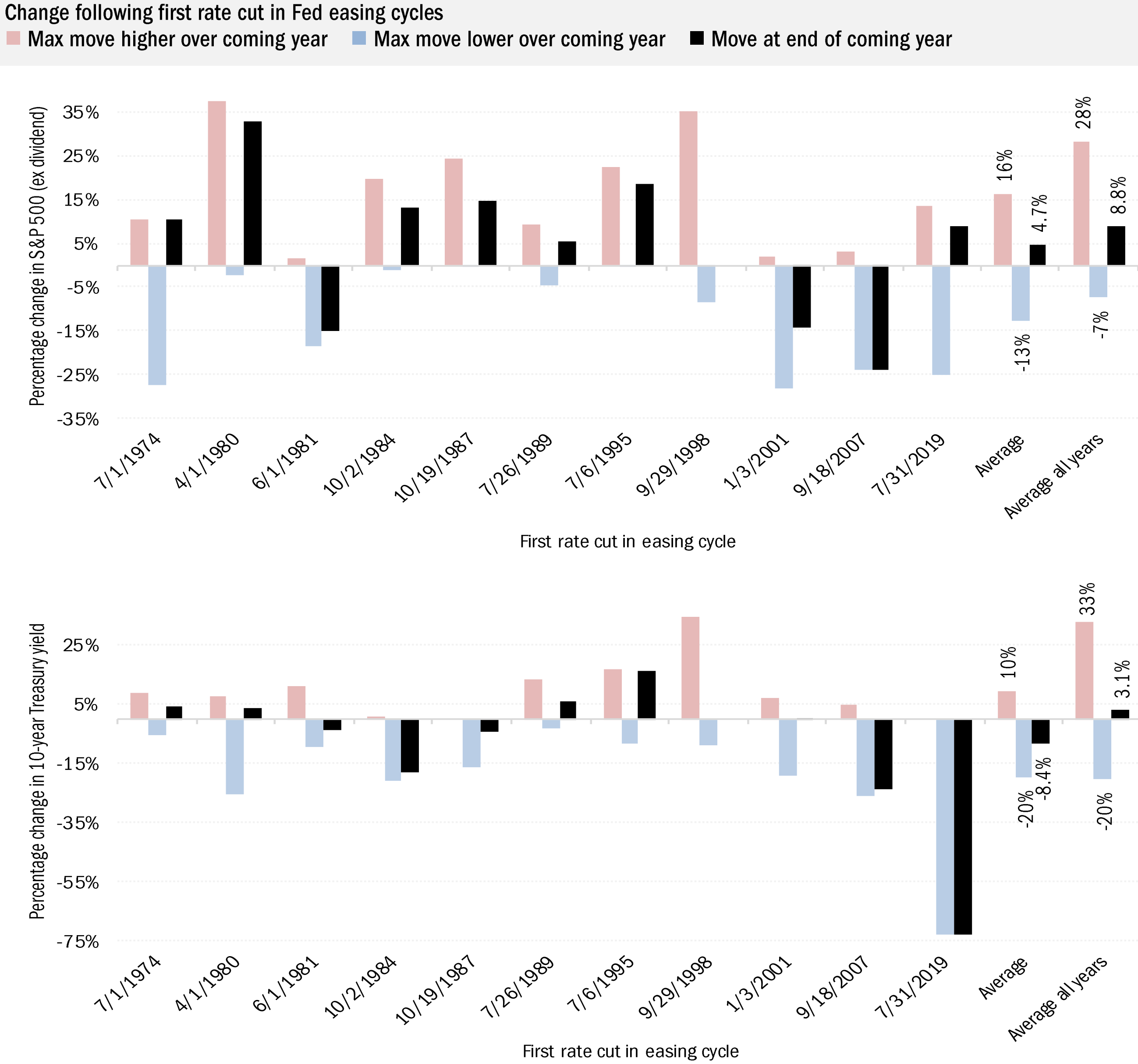
Source: Bloomberg, TrendMacro calculations

Let's use the same mode of analysis to consider what will happen in the year following the *first rate cut*, likely to come at the September FOMC.

- Equities tend to perform worse in the first year of an easing cycle than they do, on average, versus *all* years. The high-water mark is less high, the low-water mark is more low, and the end-point is lower – all by notable amounts (please see the top chart on the following page).
- It is also the case that equity performance over the last three easing cycles – the ones that began in 2001, 2007 and 2019 – were particularly bad.

- Bonds have performed better (please see the bottom chart below) with the high-water mark for percentage change in yields less high, the low-water mark the same, and the end-point directionally opposite (lower yields, as opposed to higher).
- *<u>The history lesson is that while both stocks and bonds, on average, have showed positive returns at the end of the first year of an easing cycle, stocks performed worse than average and bond performed better than average. On a risk-adjusted basis at least, bonds were the place to be.</u>*
- But that has been far from universally true across half a century of easing cycles – it's just been true on average. Many, but not all, easing cycles commence when the Fed sees that it has been too

Change following first rate cut in Fed easing cycles



Source: Bloomberg, TrendMacro calculations tight for too long, and starts cutting rates in a vain attempt to get ahead of the recession they themselves have caused. *That is absolutely not the set-up this time.*

This time around, the hiking cycle was really mostly normalization after too-low-for-too-long policy coming out of the pandemic. That's why it didn't cause a recession. If it didn't cause a recession, then the easing cycle won't be in response to recession, because there isn't one. Easing, too, will simply be normalization. All to the good.

Bottom line

The FOMC did not give the full-throated signal for a September cut that it seemed markets were expecting. But the seemingly subtle changes in statement language, acknowledging progress on inflation and establishing a neutral balance of risks, seems to have been enough. Powell put a September cut "on the table" at least three times in the post-meeting presser, saying that data even in its current configuration would be sufficient to justify it. There will be two inflation reports before the September FOMC, and July's is sure to be outright deflationary. Jackson Hole in late August is effectively another FOMC meeting where a more definitive pre-announcement could be made. One year after the Fed stopped hiking rates, the economy has stayed out of recession and markets have performed well – implying the hiking was more normalization than tightening, in the face of a higher-than-previously expected neutral rate. Recent easing cycles have been associated with inferior market performance, but those followed policy plateaus in which the Fed was too tight for too long. That is not the case this time.