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Economic Briefing

The Fed initiates rate cutting with a 50 bp step

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The Fed cut its key interest rates by 50 basis points today, bringing the fed funds target range to 4.75%–5.00%. The projections of the Fed's top officials suggest further interest rate cuts this year. The US central bank apparently considers the fight against inflation to have been won and is focusing on ensuring a soft landing for the economy.

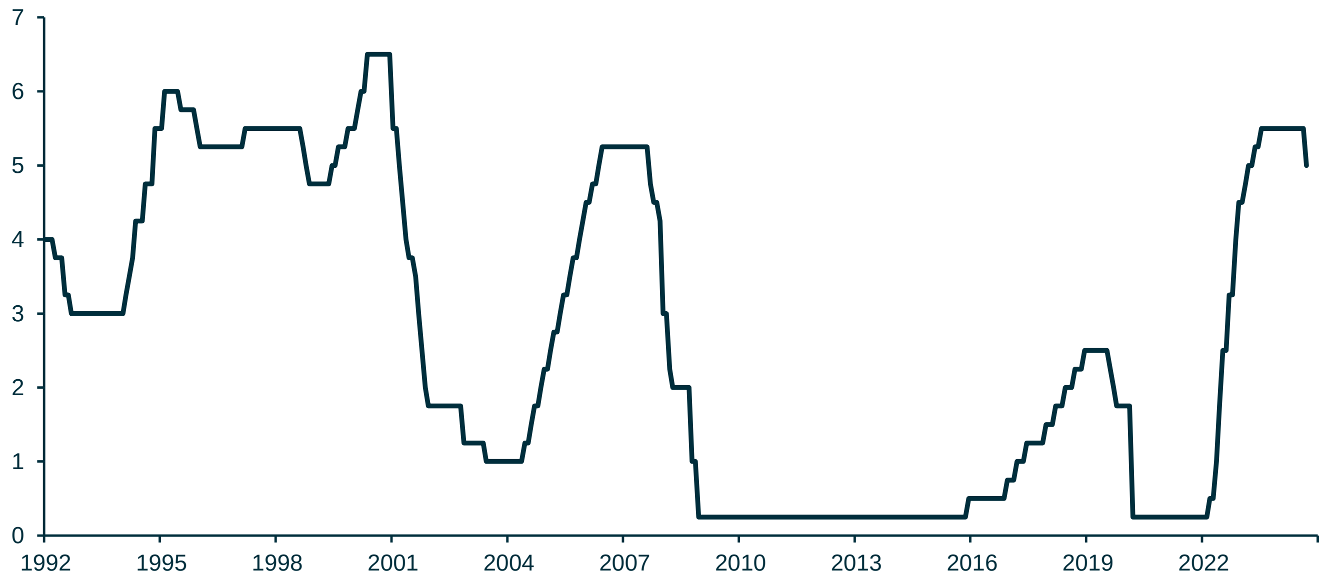
Fed cuts rates by 50 basis points...

The Fed cut the federal funds rate today by 50 basis points, bringing the target range to 4.75% – 5.00%. This means that the Fed is leaving the rate peak after 14 months (Chart 1). The consensus of the economists surveyed had expected only a 25 basis point rate cut by a large majority (we did too), whereas the financial market had given a much higher probability to a larger interest rate move. The Fed apparently did not want to disappoint this expectation. For the first time in a while, there was one dissenting vote; Governor Bowman argued in favor of a smaller interest rate move of 25 basis points. Dissenting votes from the ranks of the governors are rare.

According to the statement published after the meeting, the Fed has now gained greater confidence that inflation is moving sustainably towards the 2% target. This change is hardly surprising, as the Fed has always cited this as a prerequisite for a rate cut. Otherwise, the risks to the two parts of the Fed's mandate – maximum employment and price stability – are now roughly balanced (previously, inflation risks were weighted higher).

Chart 1 - After 14 months, the Fed leaves the rates peak

Fed funds target rate (after Dec 2008: upper bound of target corridor), monthly data in %



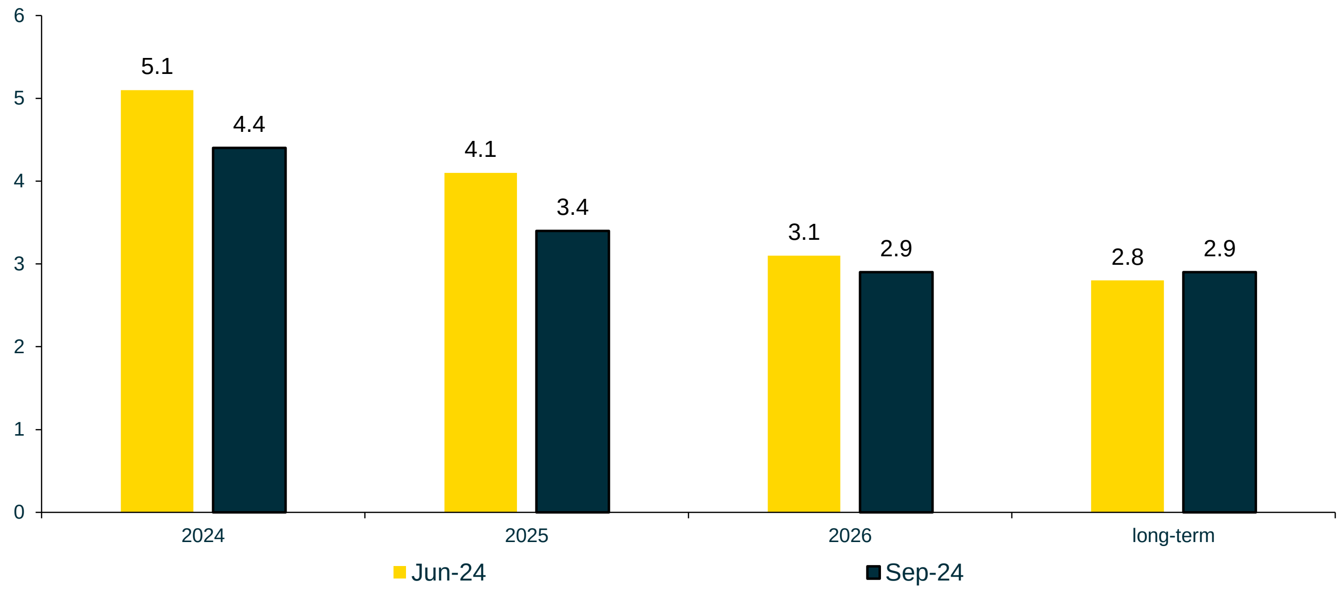
Source: Fed, S&P Global, Commerzbank Research

… further rate cuts are set to follow

The Fed also published an update of its staff projections today. The focus is on the dot plot, the estimate of the appropriate interest rate path. In June, the Fed still assumed that there would only be one 25 bp cut in the current year. The new dot plot sees the key rate at 4.4 % at the end of the year (corresponding to a target range of 4.25 % – 4.50 %), with a further 50 bp of cuts in the remaining two meetings of the year. As things stand, the Fed expects a further 100 bp of interest rate cuts by 2025 (Chart 2).

Chart 2 - Fed now sees quicker rate cuts

Median projection of Fed Board members and Fed Presidents of appropriate policy path, midpoint of target range at year-end in %



Source: Fed, Commerzbank Research

Press conference: mission accomplished?

Fed Chairman Powell wants the big interest rate move of 50bp to be seen as a sign that the Fed is very confident that inflation is indeed on track to reach 2%. The fact that all 19 Fed governors and Fed presidents expect several interest rate cuts in their projections for 2024 is a major change compared to the last projections in June. In doing so, Powell also put Bowman's dissenting vote into perspective.

The decision was based on the significant cooling of the labor market. This is now less tight than it was in 2019, just before the pandemic, in the view of Powell. As a result, the labor market is no longer a major source of inflation. Powell characterized the process of interest rate cuts that has now been initiated as a "recalibration" of monetary policy. Despite an initial interest rate move of 50 bp, the Fed is in no rush when it comes to rate cutting. Even if the Fed is keeping all its options open (the data will ultimately decide), this is still an indication that one should not necessarily expect further big rate cuts.

Powell announced today that the fight against inflation has ultimately been won. This means that the Fed now sees scope for ensuring that the full employment mandate is also achieved. The 200bp interest rate cuts expected by the end of 2025 should guarantee a soft landing for the economy. Given that the US economy is still doing well (growth in the third quarter is likely to be as strong as in the second quarter, at around 3%), the chances are quite good that the feared recession can be avoided.

With the dot plot, the Fed has sent a strong signal that further interest rate hikes totaling 50 bp are still on the cards in 2024. Next year, the Fed will probably cut rates further than our previous forecast, which expects the key rate to reach 4.00% in mid-2025. However, we remain less optimistic than the Fed that inflation will remain under control and expect inflation to pick up again later in 2025. It therefore remains to be seen whether the Fed can really cut as far as the current projections suggest.

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