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The FOMC Turns the Page on Inflation

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The FOMC turned the page on inflation and started the next chapter with a 0.50% rate cut in September.

I would describe the third quarter of 2024 with an adjective that is rarely associated with fixed income markets: exciting. Starting in early summer as inflation waned and labor markets softened, the quarter crescendoed into the FOMC's interest rate decision on September 18th. Come September, futures markets whipsawed as traders jostled for positioning, attempting to determine if the FOMC would cut by the "standard" 0.25% or if a larger 0.50% cut was forthcoming. Up to the moment of the decision, the market was nearly evenly divided between 0.25% and 0.50%. It was the most anticipated FOMC meeting in recent memory, and potentially of all time, and it did not disappoint. Chairman Powell and Co. voted to cut the Federal Funds rate by 50 basis points (0.50%) to once and for all turn the page on the inflationary period of the past few years. Today, the Federal Funds rate range is 4.75%-5.00%.

The data said "cut". Powell obliged.

Chairman Powell is notorious for emphasizing the Fed is "data dependent" and that the FOMC was satisfied in waiting for more data before embarking on a rate cutting cycle. Fortunately, economic data clarity arrived over the last few months.

1. *Inflation moderated* – Headline CPI continued its descent toward the 2% year-over-year objective. Core CPI is a bit behind Headline CPI, but most indicators point to continued cooling in the data. In the September meeting statement, the Committee noted it "gained greater confidence that inflation is moving sustainably towards two percent."
2. *The labor market weakened* – Monthly job gains slowed as we entered September, expanding on average at a 116,000 pace over the prior three months. This was well below the estimated level required to maintain a neutral unemployment rate (i.e. to not increase nor decrease each month). The September FOMC statement noted that job gains "have slowed," a change from "moderated" in the prior statement. While just a minor change in language, this confirms the FOMC acknowledges the softening labor market and that they're recalibrating accordingly. The FOMC's economic projections also confirm this, with the unemployment rate forecast lifted to 4.4% from 4% as of June.

Overall, while the risks to the dual mandate of inflation and employment are "roughly in balance," the balance of risks has essentially flipped this year. The danger of reigniting inflation is now much lower whereas the risk of higher unemployment has increased meaningfully. Given such a set-up, the FOMC made the relatively easy decision to cut rates in September and to do it convincingly to stem undesirable further cooling in the labor markets.

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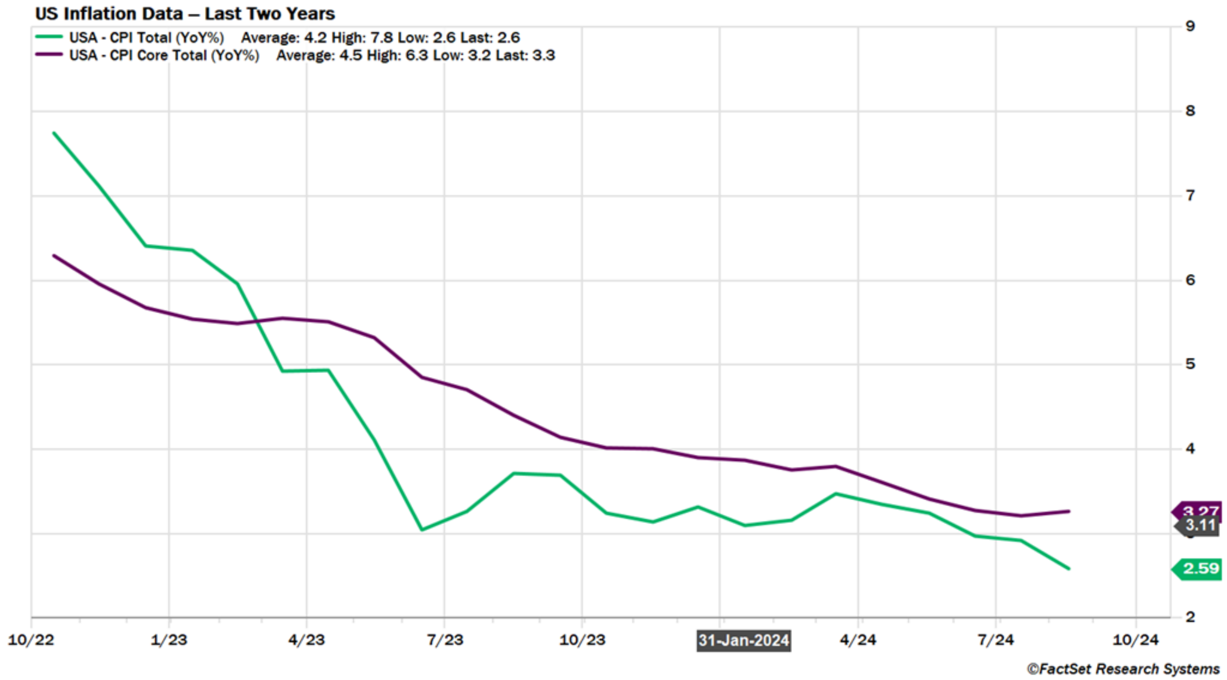
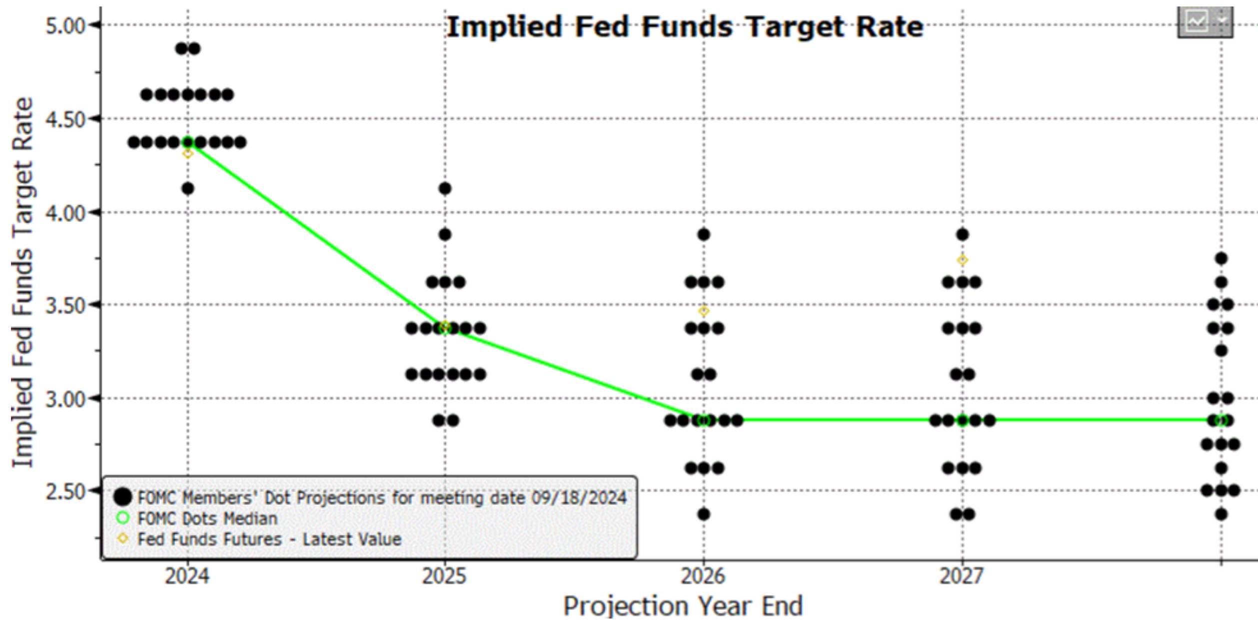


<u>FOMC "Dot Plot" – September 2024</u>

The median dot implies an additional 0.50% reduction in 2024, and 1.00% in 2025.



Source: Federal Reserve & Bloomberg

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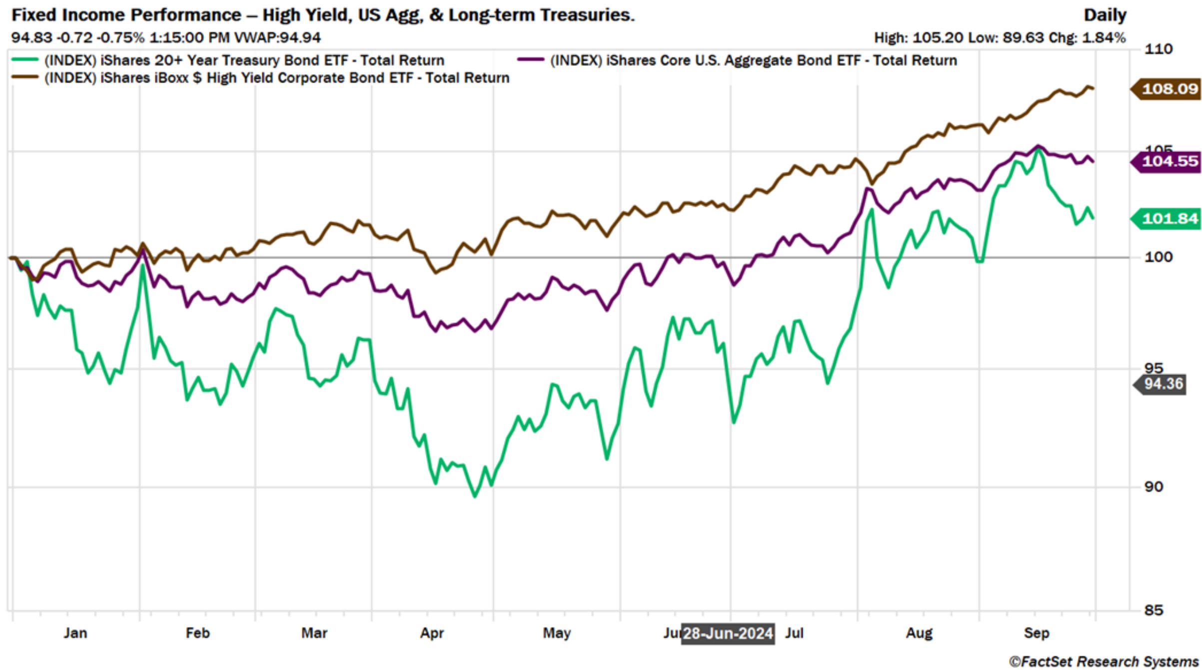
Year-to-Date Fixed Income Performance



A Few Fixed Income Factoids

1. *A footnote of the September FOMC meeting: There was a dissenting voice.*

   Interestingly, this last meeting recorded the first dissenting vote by a voting member since 2005. The vote was 11-1, with the dissenter preferring to cut rates by just 0.25%. The last dissenting vote prior to 2005 was in 2002, and the one before that was in 1995. It's quite a rare occurrence. The FOMC is a consensus building institution that prefers to present a unified front. Typically, it is successful in this pursuit. However, the feeling is not always unanimous.

2. *The Taylor Rule scores a point.*

   The Taylor Rule, discussed in our Q2 Wealth Report, is a formulaic measure of the appropriate monetary policy. Three months ago, I highlighted that the Rule suggested policy was finally "correct" at that point in time, but given the trajectory of the Rule's inputs a rate cut would soon be appropriate. As it turned out, the FOMC and Taylor Rule agreed.

3. *After two months of volatility, credit spreads are back to 17-year lows.*

   Credit spreads, a measure of additional yield over a risk-free security required for riskier bond issuers, are back to a 17-year low. The unwind of the Japanese Yen "carry trade" led to a brief spike in August. Then, weak labor market data contributed to a September spike before reversing. This spread narrowing has supported returns for corporate bonds versus Treasuries in 2024.

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