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PICTET WEALTH MANAGEMENT

Later and Fewer

We now expect a delayed and a shallower Fed easing cycle

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FLASH NOTE

SUMMARY

- Recent developments of elevated inflation, robust payrolls, and easing financial conditions strengthen the case for a policy hold. The door is closing on a rate cut as early as June, barring a sharp turnaround in the inflation data. We now expect two 25bps rate cuts this year, in July and December. This is a delayed start and a shallower path to the Fed's easing compared to our earlier forecast of a June start and 125bps of easing, a view we had held throughout volatile markets pricing in the past six months.
- The timing of the first cut hinges critically on the inflationary trajectory and it is a close call between July and September. The inflation path will be bumpy, but we expect core PCE inflation to slow and the 6m annualised reading to start improving by the July FOMC meeting. The Fed likely prefers to make policy changes at meetings with updated economic projections (Jun/Sept/Dec). However, this must be weighed against the risk of delaying until September, the last meeting before the presidential election.
- We continue to expect a measured pace of rate reductions in 2025 and a terminal rate for this cutting cycle above the Fed's median neutral rate estimate of 2.6%.
- Risks are two-sided. If inflation proves stickier than our forecast, the risk of even fewer cuts or no rate cut at all this year would rise materially. We think the bar is extremely high for a future hike though, as it would take a strong acceleration in inflation, not just inflation being stuck above target, to justify a hike.
- We also expect the Fed to be more sensitive to labour market weakness than strength. Recent immigration has helped boost job gains without generating wage pressures. However, if visible cracks start to show in the labour market, the Fed would react quickly by cutting rates more than expected.
- We continue to expect a tapering of QT, a slowdown in the pace of the Fed's balance sheet runoff, to be announced at the May FOMC meeting. This is a technical concern and should have little bearing on its interest rate policy.

A DELAYED START

This week's CPI report had taken on outsized importance because Chair Powell appeared willing to look past firm inflation readings in January and February, attributing much of the gains to residual seasonality. The latest CPI serves as a strong pushback against this belief.

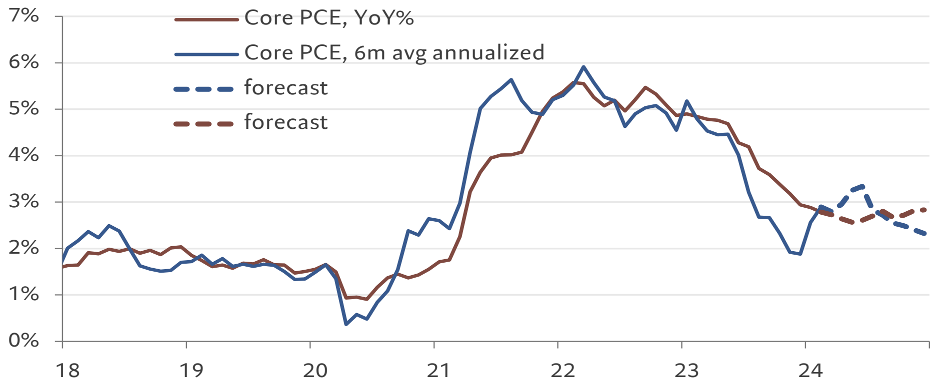
Inflationary pressures had abated during the second half of 2023, prompting the infamous "Powell Pivot" that fueled expectations of a first rate cut in March this year. But **the trend has reversed in Q1** with core CPI surprising again on the upside after two months of strong readings.

Strong inflation readings to start the year likely eroded the FOMC's confidence that inflation is moving sustainably towards 2%, a pre-requisite for cutting rates. Therefore, **the door is closing on a rate cut as early as June**. After a series of strong prints, the Fed would need to see a string of lower prints to be comfortable pulling the trigger. We don't think they are likely to gain enough confidence by the June meeting (the Fed only have two more inflation prints before then, with the second one coming on the day of the June 12 FOMC meeting).

The timing of the first cut hinges critically on the inflationary trajectory and it is a close call between July and September. We expect inflation can start to slow in the months ahead, and have penciled in core PCE (the Fed's preferred gauge of underlying inflation) averaging between 0.20-0.25% in the next three months, a slowdown from an estimated pace of 0.33% in Q1. If our forecast materialises, 6m annualised core PCE inflation reading would start improving by the July FOMC meeting (chart 1).

The improvement would be more notable by the September meeting, and the Fed likely prefers to make policy changes at meetings with an updated dot plot and economic projections (Jun/Sept/Dec). However, this must be weighed against the risk of delaying until September, the last meeting before the general election. The Fed can of course move around elections, and they had. But the Fed may very well consider refraining from making their FIRST policy change so close to the election, so as <u>not to signal great urgency</u> - former president Bill Dudley argued against moving at the November 2016 meeting (six days before the election), suggesting that doing so would give the perception of unwarranted urgency.

Chart 1: Core PCE inflation YoY and 6m avg annualized rate, with projections



Source: Pictet Wealth Management, BEA, as of 11.04.2024

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A SHALLOWER PATH

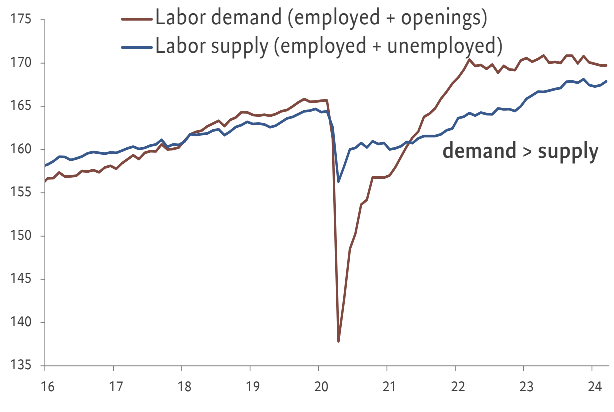
We previously expected inflation slowdown and labour market weakness to drive consecutive rate cuts in H2. **We now expect the Fed to follow a cautious approach and hit pause after the first cut, before resuming cutting at a quarterly pace in December.**

The labour market is showing continued strength, on net. **Labour demand and supply have been coming into better balance, but demand remains stronger and the labour market remains tight.** This should allow the Fed to remain patient in the face of elevated inflation and no longer justifies consecutive cuts (chart 2).

On the demand side, jobs are being added at a rapid pace, and recent gains have become more broad based. Job openings declined last year but then flattened out recently at a still elevated level. Since the start of the year, the ratio of job openings to people looking for work has been roughly flat after declining significantly in 2023. **On the supply side, surging immigration has contributed significantly to the labour force**. The share of the labour force that is foreign-born has risen sharply (chart 3).

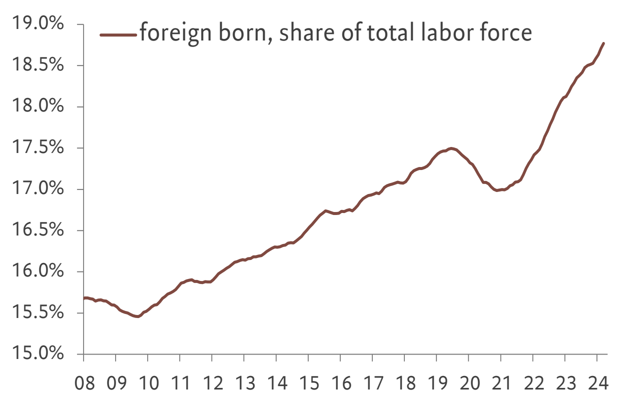
There are, however, signs of loosening. Employers have been reluctant to lay off workers, but they have been reducing hours. Surveys of hiring intensions, especially from small businesses, remain weak. The number of people quitting their jobs has fallen below the levels just before the pandemic. Less turnover reduces the need for companies to raise compensation to attract new talent. In fact, the most recent data suggest wage growth has continued to ease. Easing wage pressures would help the FOMC build confidence that inflation, especially labour-intensive core services inflation, can continue to decline.

Chart 2: labour demand vs. supply, thous



Source: Pictet Wealth Management, BLS, as of 11.04.2024

Chart 3: labour force share, foreign born



Source: Pictet Wealth Management, BLS, as of 11.04.2024

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Chart 4: Wage measures show growth has continued to ease

Source: Pictet Wealth Management, BLS, as of 11.04.2024

QT TAPER ON TRACK

We continue to expect a tapering of QT (Quantitative Tightening), a slowdown in the pace of the Fed's balance sheet runoff, to be announced at the May FOMC meeting. The Fed aims to reduce the size of the balance sheet without causing undue damage to the funding markets. **This is a technical concern and should have little bearing on its interest rate policy**.

Since QT started in 2022, the significant balance sheet reduction has largely resulted from a drop in the usage of the ON RRP facility, while reserve balances have remained elevated (chart 5). However, with further decline in the ON RRP facility becoming increasingly limited, further QT will likely lead more directly to declines in reserve balances, potentially at a rapid pace. The Fed prefers to operate in an ample-reserves regime (neither abundant nor scarce), and **tapering QT sooner rather than later would help facilitate a smooth transition from abundant to ample reserves.** We expect the FOMC to target a gradual approach to the ultimate balance sheet level, i.e. slower for longer.

The latest FOMC minutes suggest the Fed will likely reduce the redemption cap on Treasury securities by half (or slightly more) to $30bn from $60bn per month, while keeping the cap on agency MBS unchanged at $35bn. The Fed prefers in the longer run a Treasuries-only portfolio.

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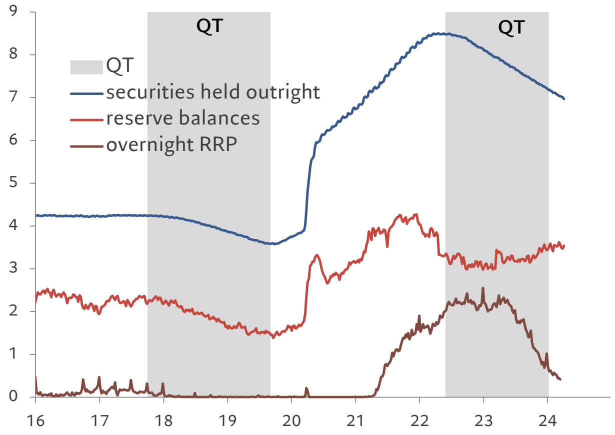
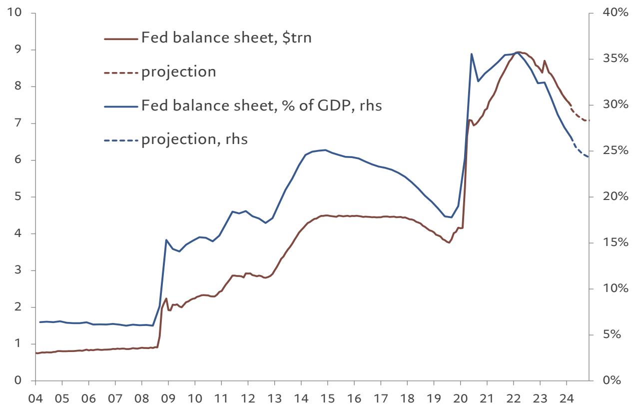
Chart 5: ON RRP and reserve balances



Source: Pictet Wealth Management, FRB, as of 11.04.2024

Chart 6: Fed balance sheet size with projections



Source: Pictet Wealth Management, FRB, as of 11.04.2024

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