US Macroeconomics

October 23, 2024

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Let the Data Speak

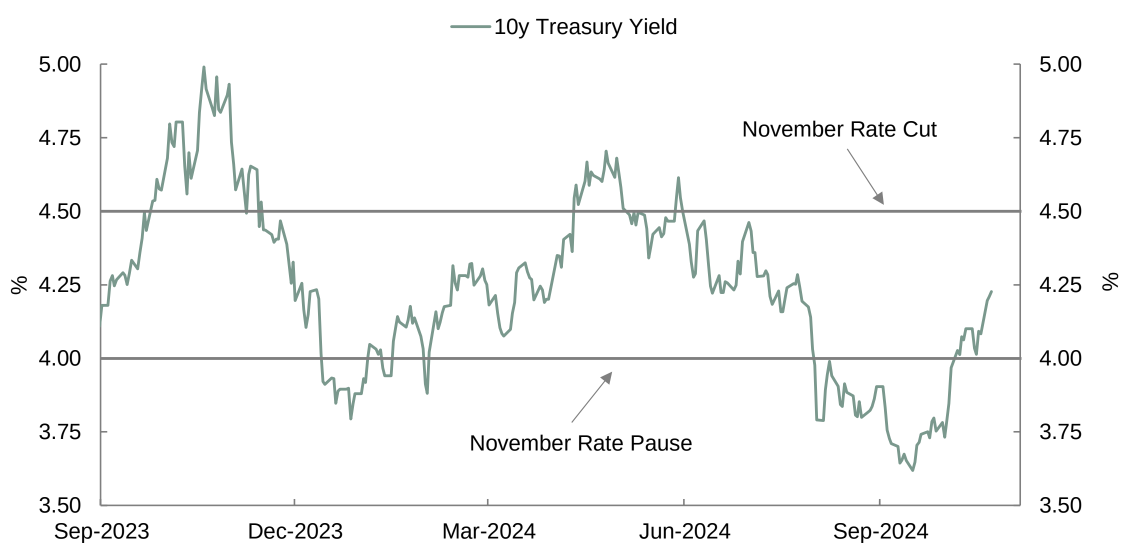
The Fed cut rates by 50 basis points (bps) last month because policymakers were worried the economy, and particularly the labor market, were rapidly deteriorating. Such a backdrop is the natural consequence of the 5.25% to 5.5% Fed funds target range sitting well above the Fed's highest estimate of the neutral rate (3.75%). By initially lowering rates 50 bps, the Fed gave itself the option to skip cutting in successive meetings.

While the current 4.75% to 5.0% target range is still too high relative to R-Star, real GDP growth has been solid, and the latest employment report was much stronger than consensus expectations. Despite this, the fed futures market is still discounting a near 90% chance of a 25 bp rate cut at the November 7 FOMC meeting, followed by 25 bp rate cuts over the ensuing five meeting through next June. This profile seems much too aggressive especially if the next jobs report shows continued strength.

While the headline figure will undoubtedly be distorted by the Boeing strike and the ancillary firms impacted by the walkout, and Hurricanes Helene and Milton, **a headline October nonfarm payroll gain of around 100k combined with a steady 4.1% unemployment rate would likely provide enough fundamental rationale for the Fed to stand pat next month**. Moreover, the Atlanta Fed recently reaffirmed its 3.4% estimate for Q3 2024 real GDP growth. At the same time, consumer price inflation surprised to the upside. Consequently, there is little economic rationale for the Fed to lower interest rates next month. If the Fed does cut interest rates, the recent rise in long-term interest rates is likely to continue and potentially head to accelerate from here.

The yield on 10-year Treasury notes is up 60 bps following the September 18th FOMC meeting, 37 bps of which has been due to a rise in *real* yields and 23 bps due to breakeven inflation. Real rates are rising because the economic data have been stronger than expected. And breakeven inflation is rising because the improvement in core inflation has slowed again. More rate cuts are likely to make fidgety bond investors more fidgety, thereby leading to increased term premium. How much higher could 10-year Treasuries go in the short-term? Our best guess is that another rate cut could push long-term yields up to 4.50% with most of the move occurring in breakeven inflation. Yet, a no-move in November would initiate a down-move in 10-year rates to 4.0% or lower.

If monetary policymakers are truly data dependent, then the high frequency economic statistics should dictate policy. Right now, the data support a rate pause. Consequently, **Fed-speak should sound noticeably more bearish over the next week** heading into the blackout period. Stay tuned.



Source: Federal Reserve, Bloomberg, SMBC Nikko

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