US Macroeconomics

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Fed Cuts Not Imminent Despite Weak Data

The economy grew 1.4% in Q1 2024 but growth was narrowly concentrated in non-discretionary household services which grew 3.3%. In particular, health care spending surged 7.1%, and there was a big 5.6% increase in spending on financial services and insurance.

Away from consumer essentials, spending was soft. Goods purchases were down 2.3%, led by the highly cyclical durables subcomponent (-4.5%). In fact, when household services are stripped out of real GDP, the economy shrank 0.1%. This was the first drop since Q2 2022, when soaring inflation caused real output to decline.

Fundamental Q1 GDP weakness appears to have carried over into Q2, consistent with our long standing view that economic activity was going to sharply decelerate. According to the widely followed Atlanta Fed GDPNow, real GDP grew only 1.5%. Remember the model had predicted 3% Q2 real GDP growth as recently as two week ago. But last quarter's expected gain is even softer after accounting for the assumption that nearly one-third of the projected gain is due to government spending. It is no wonder that the unemployment rate continues to edge higher. Economic activity in the private sector is finally slowing in lagged response to Fed tightening.

Over the past three months, private payrolls are up an average of just 146k, the smallest gain since January 2021 (133k). But this is likely overstated given the propensity for downward payroll revisions. Moreover, the gains within private payrolls have been highly concentrated. More than half of the increase in private jobs has occurred in the health care and social assistance sector, an area of the labor market that is highly dependent on government spending and policy initiatives.

This deterioration in private service sector activity is also apparent from the ISM Services survey which sunk to its lowest level last month (48.8 vs. 53.8 previously) since the pandemic in May 2020. In light of downward economic momentum, we worry that Q2 real GDP could be even weaker than what the Atlanta Fed has currently penciled in. Would sub-1% growth lead to a September rate cut? Not necessarily.

The current three-, six- and 12-month annualized rate of change on the core PCE are 2.7%, 3.2% and 2.6% remain well above target. In addition, the respective growth rates in core PCE services excluding housing, a subsection of the core that Chair Powell has highlighted, are even higher at 3.3%, 4.1% and 3.4%. Given the Fed's singular focus on lowering inflation, policymakers would likely need to see several months of tepid inflation readings to be sure that prices were confidently moving back toward 2%.

And while predicted GDP growth may look troublesome, it is important to note the ongoing accommodation from financial conditions. The stock market is at an all-time high. Does the Fed really want to further stoke investor euphoria? And what about the Presidential Election? Surely the Fed does not want to cut interest rates unless it is compelling so as to remain above the political fray. And most importantly, there is the unpredictability of inflation.

Monetary credibility was damaged when policymakers thought inflation would be transitory in 2021. Then when inflation fell last summer and fall, Chair Powell pivoted toward 2024 rate cuts last December. But no sooner did this happen that inflation unexpectedly re-accelerated. Consequently, Chair Powell should be proceed cautiously.

Consequently, even though we remain downbeat on the economy's future growth prospects and continue to believe that a recession remains the most likely outcome among the no landing, soft landing and hard landing scenarios, the first rate cut is not expected until December 2024.

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