Fed Watch

Summer brings "good data" to the Fed; enough for a strong dovish shift?

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FOMC participants might be inclined to suggest a September rate cut, but a strong signal at Jackson Hole next month is more likely

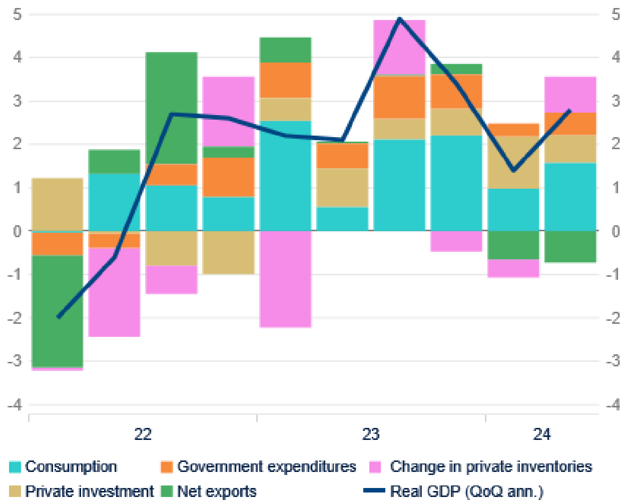
- **Last week's GDP figure is unlikely to prompt Fed members to revive concerns about re-emerging upside risks to inflation, but it has most likely closed the door to a rate cut this week.** The advance estimate for 2Q24 real GDP released last Thursday pointed to a 2.8% QoQ SAAR, double the growth rate of the previous quarter. At first glance, the headline figure was a bit of a surprise on the upside since the last Atlanta Fed's GDPNow estimate was 2.6%, which increased notably in recent weeks following strong retail sales and industrial production reports (it had previously anticipated a growth rate as low as 1.5% in early July). However, a closer look at the data suggests that the economy is unlikely to have regained strong underlying momentum. Consumption did increase at a stronger 2.3% pace (up from 1.5%) on higher goods purchases, but services consumption decelerated from 3.3 to 2.2%, a good sign for supercore inflation. Gross private investment grew by 8.4% (up from 4.4%), but a slump in nonresidential structures (-3.3%) and residential investment (-1.4%), coupled with a positive contribution of the change in private inventories component, were enough to keep unchanged the growth rate of final sales to private domestic purchasers at 2.6% (Figure 1).
- **The lack of surprises from the labor market suggests that it is increasingly close to having found a balance that the Fed will probably seek to avoid jeopardizing.** The predominance of "little changed" figures from recent JOLTS reports suggest that the demand side of the labor market has largely normalized. Despite the slight increase in the job openings rate in May (from 4.8 to 4.9%), it is still on a clear downward trend that points to further room to fall in absolute terms, while the ratio of vacancies to unemployment has returned to pre-pandemic levels. Besides, although the private quits ratio has remained unchanged in recent months, it suggests that wage growth still has ample room to continue to cool. The single employment report during the intermeeting period pointed to a slightly above-expectations 206,000 gain in non-farm payrolls in June, but a c. 50,000 decline in temporary help employment coupled with downward revisions to past months' figures and a further rise in the unemployment rate to 4.1%, continued to tip the balance towards a market that is more at risk of weakening than of restarting a period of strength (Figure 2).
- **Following reassuring inflation data in the inter-meeting period, FOMC members likely regained some confidence in the disinflationary process.** Figures from June's CPI inflation report as well as from May and June's PCE inflation releases most likely qualify as "good data." Core CPI inflation increased 0.07% MoM in June helped by a more muted 0.3% increase in rent and owners' equivalent rent. Core PCE inflation was initially deemed to have increased by only 0.08% MoM in May, and while it was revised slightly up to 0.13% in last Friday's release, a 0.18% reading for June still means that core inflation has been running closer to target more recently, which is what Fed officials are looking for (Figure 3). Even so, the FOMC is unlikely to provide explicit forward guidance next Wednesday on an upcoming rate cut following this relatively short string of "good

data;" they are more likely to wait until Jackson Hole. In any case, these developments undoubtedly add to the case for a likely rate cut at the September meeting.

- **The futures market is almost fully pricing in that the Fed will cut rates by 50 bps this year (95% implied chances), and continue to anticipate roughly 100 bps worth of rate cuts next year.** Growing expectations that the Fed is about to begin a rate-cut cycle in September have not fully reflected along the entire yield curve, since stickier long-term yields are likely reflecting increased risks in the event of a Trump's second term. The 2-year yield has declined by 30 bps since late June on strong investors' demand at the most recent Treasury auctions, which likely indicates that buyers are seeking to lock in higher interest rates before cuts from the Fed, but the 10-year yield has been hovering in a narrow range around 4.3%, probably constrained by the market's perception of greater inflation risks on higher chances of inflationary trade and tax policies following the jump in Trump's odds after last month's first presidential debate (Figure 4). Perceptions of these risks could moderate going forward following the Democrats' recent candidates shift (see here for more on the recent evolution of US interest rates).
- **Fed officials have indeed turned more dovish with the disinflationary trend resuming in 2Q24 and the unemployment rate rising.** During his recent testimony before Congress, Chair Powell continued laying the groundwork for cutting rates soon signaling growing confidence that US inflation is moving towards the 2% target. Waller (voting member) said the FOMC is "getting closer to the time" when a rate cut "is warranted" as the Fed wants to keep the labor market in its current "sweet spot." He now sees more upside risk to unemployment than he has "for a long time." FOMC's Vice Chair Williams observed that recent inflation data were "getting [the Fed] closer to a disinflationary trend that [they] are looking for," while Goolsbee (non voting member) noted the Fed risks the "golden path" if it keeps policy as restrictive as it is now.
- **The Fed will likely continue to pave the way for starting to ease policy in September hinting that cooling inflation and a softening job market could give grounds for a policy pivot soon.** The FOMC is unlikely to change the wording of the statement to the extent of signaling that recent "good data" is enough to consider rate cuts now, but a further recognition of risks around their employment goal and some dovish tweaks are likely to further clear the way for chair Powell to send more definitive signals at Jackson Hole in August. We continue to think that a first rate cut is most likely in September.

The advance estimate for 2Q24 GDP has most likely closed the door to a rate cut next week

Figure 1. **REAL GDP GROWTH**
(%)



Source: BBVA Research / BEA

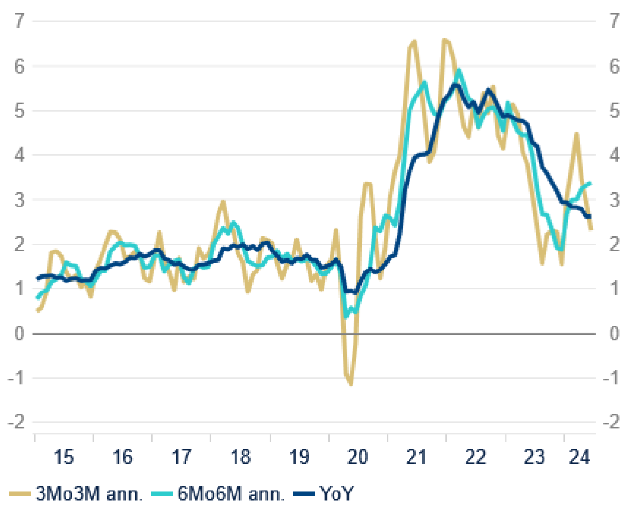
Jobs data continued to tip the balance towards a market that is more at risk of weakening

Figure 2. **UNEMPLOYMENT RATE**
(%)

Source: BBVA Research / BLS

Core inflation has been running closer to target recently, which is what the Fed is looking for

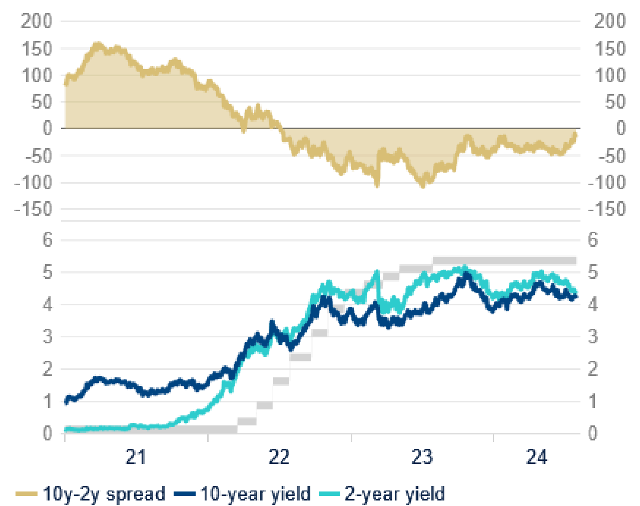
Figure 3. **CORE PCE INFLATION**
(%)



Source: BBVA Research / BEA

2-year Treasury notes' buyers are seeking to lock in higher interest rates before cuts from the Fed

Figure 4. **10Y-2Y TREASURY YIELD SPREAD**
(BPS AND %)



The gray area indicates the fed funds rate target range
Source: BBVA Research / Fed / Treasury

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