GENERALI ASSET MANAGEMENT

MARKET COMMENTARY

The Fed delays rate cuts and raises the neutral rate.

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- **Progress on inflation are not fast enough and the FOMC has reduced to one the median estimate of the cuts appropriate for this year. The median dot still sees the policy rate in the 3% -3.25% by 2026. Importantly, the neutral rate estimate was raised from 2.6% to 2.8%.**
- **Q1 bad data led to an upward revision of expected inflation, while the outlook for activity and the labour market was unchanged. Todays' good CPI prints were available to the FOMC members to adjust their projections.**
- **We think that our expectation of two rate cuts has still some validity. The S&P trimmed its gains fuelled by CPI numbers, while the two year yield after dropping to 4.68%, rose to 4.76%.**

After this afternoon's positive data on CPI inflation, the Federal Open Market Committee (FOMC) tempered expectations of quick rate cuts. While the median dots for this year now indicate just one cut, the pace of monetary easing remains unchanged from March. The Fed still anticipates a policy rate in the 3% to 3.25% range by the end of 2026. However, the FOMC's assessment is not uniform: Four members expect no cuts this year, seven anticipate one cut, and the remaining eight support two cuts. Notably, the terminal (or neutral) policy rate was revised upward from 2.6% to 2.8%—a hawkish signal.

The overall assessment of the economy has not changed significantly since the previous meeting. Despite choppy Q1 GDP figures, the economy is growing at a healthy 2% annual speed, even with the restrictive monetary policy stance. The labour market is currently 'tight but not overheated.' The exception is inflation: Bad Q1 figures led to a 0.2 percentage point increase in the year-end estimate of the core rate, prompting a delay in planned accommodation. The press release highlighted some progress, the only relevant change from May.

Recent indicators suggest that economic activity has continued to expand at a solid pace. Job gains have remained strong, and the unemployment rate has remained low. Inflation has eased over the past year but remains elevated. In recent months, there has been ~~a lack of~~modest further progress toward the Committee's 2 percent inflation objective.

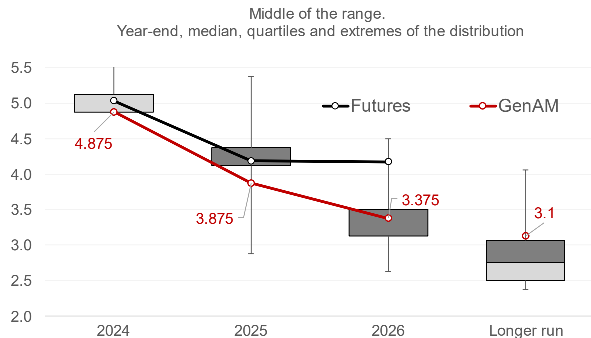
The upward revision in the year-end forecast, which implies a reacceleration in H2, was motivated as a conservative projection. However, the FOMC still expects an improvement in the monthly prints. Residual inflationary pressures can be found in services, especially housing. According to Powell, these pressures largely reflect a catching up of rising prices in other areas. Although wage growth does not appear to be the main driver of past inflation surges, further moderation is deemed necessary to bring inflation back to 2%. While FOMC members could, in principle, adjust the forecast based on today's CPI data, Powell confusingly stated that most did not use this opportunity.

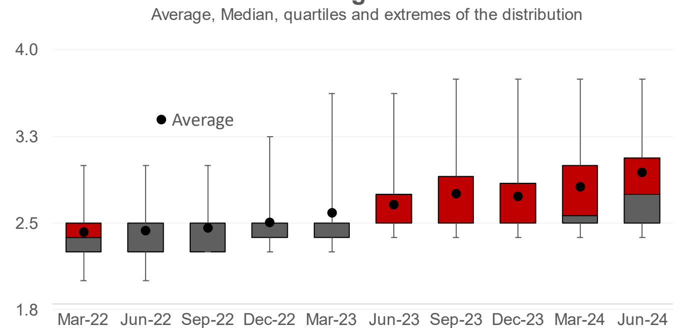
Powell reiterated that the FOMC needs to see a string of good inflation prints before deciding to cut rates. Precommitting to a date for starting easing is clearly not an option. As often happens, Powell downplayed the message from the dots (which represent individual assessments, not commitments). Ultimately, whether there are one or two rate cuts this year matters much less than the overall path of policy rates.

The FOMC remains entirely data-dependent, but it acknowledges that policy must stop being restrictive before it harms the economy. This motivation underlies the downward path for the policy rate, which may seem inconsistent with the macro projection showing steady economic growth around potential. Risks to financial stability do not rank high in the FOMC's mind, as banks are well capitalized and show no signs of stress.

Powell also downplayed the significance of the neutral rate. It is a long-run, non-measurable variable—a theoretical concept with almost no bearing on near-term policy. This likely signals the conviction that the Fed funds rate will not return to the low levels prevailing before COVID.

We will reconsider out Fed funds rate forecast once PCE inflation data for May are available, still we do not think that the current meeting rules out our expectation of two rate cuts this year.





	2024	2025	2026	Longer run
GDP growth (Q4/Q4 ann.)	2.1	2.0	2.0	1.8
Dec. projections	*2.1*	*2.0*	*2.0*	*1.8*
Unemployment rate	4.0	4.2	4.1	4.2
Dec. projections	*4.0*	*4.1*	*4.0*	*4.1*
PCE infl. (Q4/Q4 ann.)	2.6	2.3	2.0	2.0
Dec. projections	*2.4*	*2.2*	*2.0*	*2.0*
Core PCE infl. (Q4/Q4 ann.)	2.8	2.3	2.0	-
Dec. projections	*2.6*	*2.2*	*2.0*	-
Federal funds rate	5.1	4.1	3.1	2.8
Dec. projections	*4.6*	*3.9*	*3.1*	*2.6*

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