The US goes large

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Yesterday, the US Federal Reserve (Fed) cut rates for the first time in over four years. The benchmark rate was lowered by 0.5% to a range of 4.75% to 5.00%. One committee member, Michelle Bowman, voted for only a 0.25% reduction and became the first governor since 2005 to dissent. The Fed's updated economic projections, represented by the famous dot-plot, show that they expect to cut rates by another 0.5% before the end of 2024 and by a further 1% by the end of 2025. This signals sharper cuts than those signalled by the Fed in June but moves closer to what was already expected by financial markets.

The timing of this cut is no surprise - it comes after inflation has declined from above 9% in June 2022 to 2.5% in July 2024 and after many other central banks (including the Bank of England and the European Central Bank) have started reducing rates. However, in recent weeks there has been intense debate on the size of this first cut. Initial rate cuts of 0.25% are more typical and, with economic data still pointing towards a healthy outlook, it can be argued that only modest changes in the policy rate are needed. However, given interest rates increased at the fastest pace on record over 2022-23, this cycle is, arguably, not typical.

Although inflation is still a little above target, the sharp decline means that real rates (i.e. after being adjusted for inflation) have increased rapidly, even while policy rates have been on hold. When inflation was elevated, businesses and consumers could pass on costs to customers and employers and, at least partially, offset the adverse impact of higher borrowing costs. However, with inflation lower, the impact of elevated borrowing rates becomes more challenging to offset and provides rationale for significant cuts. Additionally, there has been some softening in the labour market. There was a huge surge in demand for workers following lockdowns, greatly exceeding supply, which has dissipated as jobs have been filled. Alongside this, increased immigration has pushed up the supply of workers and put upward pressure on the unemployment rate which, although still low in a historical context, has risen from 3.4% last year to 4.2%. Although layoffs remain low, this has catalysed attention.

Fed Chair Powell referred to the cut as a recalibration and a commitment from the Fed to not get behind the curve. He also reiterated his view that the economy is in a good place. The prior uncertainty around the size of the cut led to some initial volatility across asset markets. However, at the time of writing, the cut as well as Powell's reassuring message is pushing stocks higher.

Bottom line

The Fed's action is, all else equal, supportive for asset markets. Accommodative monetary policy helps to reduce borrowing costs for businesses and consumers; therefore, encouraging confidence, investment and spending. The upcoming US election on 5th November has the potential to trigger some near-term volatility in asset prices but the long-term outlook for earnings is robust.

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