Fed – mission accomplished?

The Fed will probably stay put at next week's meeting and leave the federal funds target range at 5.25%-5.50%. This is because inflation and the labor market are moving into the right direction from the Fed's perspective, which is why further rate hikes are unnecessary. Rather, rate cuts are likely to be on the agenda in the not too distant future.

Bernd Weidensteiner

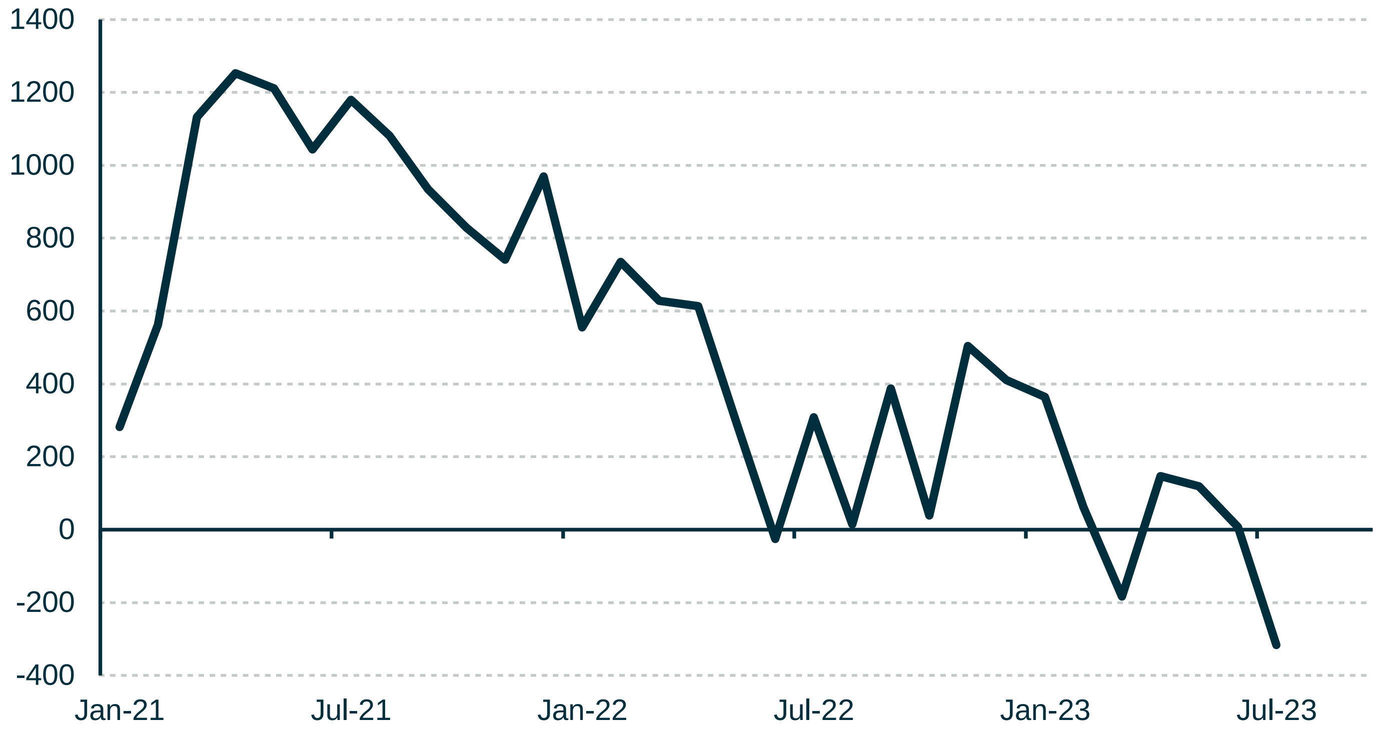
Not only a pause, but the end of rate hikes

The Fed initiated the normalization of its monetary policy very late in the day with a first rate hike in March 2022 and therefore had to brutally jack up its key rates (see title chart). After rate hikes totaling 525 basis points, the key rate is now probably roughly there where the Fed's top brass believes it should be. It's now just a matter of fine-tuning. With a pause at the June meeting and a 25 basis point hike at the last meeting in July, the Fed has already slowed the pace considerably. Market participants (and we as well) expect the Fed to pause again at next week's FOMC meeting and leave the fed funds target range at 5.25%-5.50%. This is also supported by the latest data:

- The **labor market** has cooled noticeably. Employment growth in the three months to August was only 150 thousand [1]. At the beginning of 2022, more than 500 thousand new jobs were still being created each month. At the same time, the number of job vacancies has fallen significantly. In July, the last available data, 8.8 million jobs were still unfilled. This is noticeably below the high of 12 million reached in March 2022. Thus, the sum of employment and vacancies, which shows the demand for labor, fell by a monthly average of 300 thousand between May and July (Chart 1). This is also reflected in a weakening of wage growth.

Chart 1 - Demand for labor is cooling

Labor demand (nonfarm payrolls + job openings), average 3-month change in thousands



Source: BLS, S&P Global, Commerzbank Research

- **Inflationary pressure** continues to decrease. The core rate of inflation, based on the consumer price index excluding food and energy, fell further to 4.3% in August. Looking at the shorter term, things look even better: Over the past three months, the core index increased by only 2.4% when annualized. The headline inflation rate did rise somewhat in August, but this was solely due to higher gasoline prices and should therefore not detract from the easing of underlying inflation.

If there is no reversal of these trends in the short term – and we do not expect this to happen – there are unlikely to be any further interest rate hikes in the coming meetings. This is because there would no longer be any reason for the Fed to resume rate hiking after the probable pause next week.

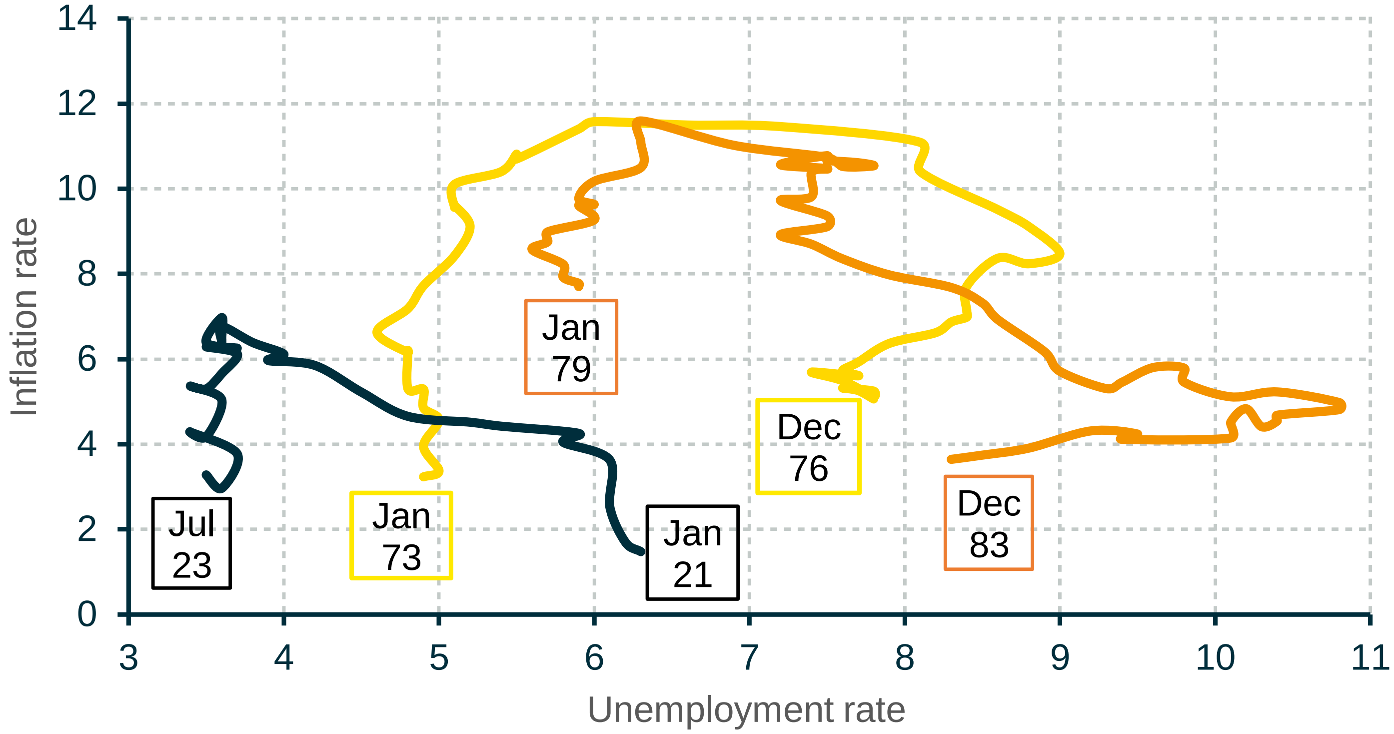
Up to now, surprisingly painless disinflation

Unlike in most previous cycles, the Fed could well manage a "soft landing" of the U.S. economy after a phase of very high inflation, i.e., a return of inflation to the target range without the economy slipping into recession. Many observers, including former U.S. Treasury Secretary Larry Summers in particular, did not actually think this was possible. They were unmistakably mindful of the experience with the two waves of inflation in the 1970s and early 1980s. These could only be broken at the price of a drastic increase in the unemployment rate.

The contrast with the current situation is well illustrated by the development of inflation and the unemployment rate during these periods of high inflation:

- Between the beginning of 1973 and the end of 1974, inflation (measured by the Fed's preferred measure, the deflator of consumer spending) rose from 3% to over 11%. By the end of 1976, inflation had been brought back down to 5%, but the unemployment rate rose sharply to 9% and the economy slid into a severe recession. In chart 2, this is a clockwise movement on the yellow line.
- The situation was similar after 1979: inflation rose sharply once again, starting from an already high level. The Fed's monetary policy response caused another deep recession, with unemployment at a high of almost 11%.
- In contrast, the post-2021 trend was the other way around. The movement on the black line between early 2021 and July 2023 was counterclockwise. From mid-2022, the inflation rate fell significantly from around 7% to just over 3%, with the unemployment rate remaining below 4% with minor fluctuations. Inflation thus declined without the unemployment rate having to rise noticeably to facilitate this, at least so far.

Chart 2 - Disinflation - this time, almost painless
Annual rat eof inflation (PCE deflator) and unemployment rate, monthly data in %



Source: BEA, BLS, S&P Global, Commerzbank Research

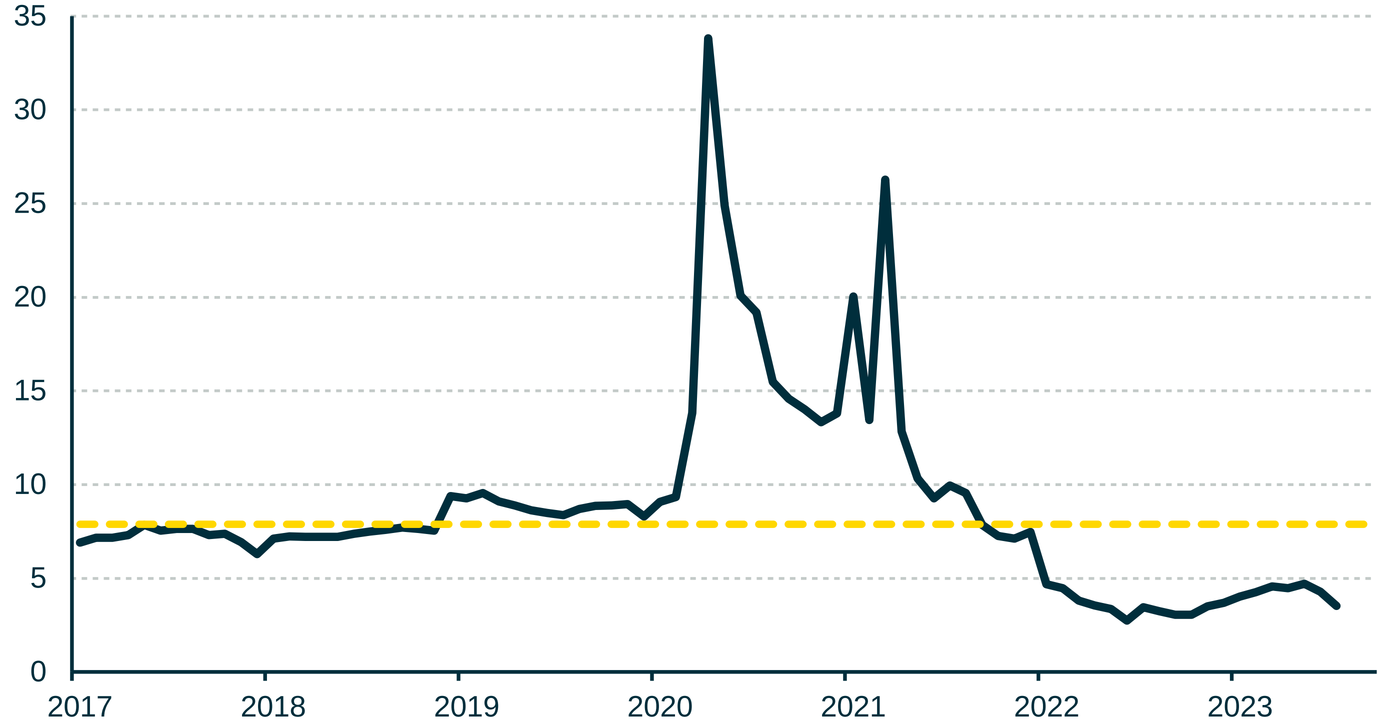
An important reason for the surprising development in the current cycle is probably the substantial differences in inflation expectations. These have remained relatively stable in recent years, as measured by surveys of consumers, forecasters or based on market expectations. The Fed was apparently trusted to bring inflation back under control in the foreseeable future. As a result, businesses raised prices less and workers demanded lower wage increases than they would have if they had feared persistently very high inflation. Because of these stable inflation expectations, the Fed has not had to resort to monetary policy "overkill" to break inflation. This can also be interpreted as a return on the Fed's credibility, built up over many years, which was obviously not undermined by the overdose of expansionary measures in the pandemic and the too-late introduction of interest rate hikes.

The Fed really defeated inflation without causing a recession?

However, we should be wary of prematurely proclaiming "mission accomplished" [2]. There are some warning signs that the economy is facing more difficult times in the medium term. This applies not least to private consumption, which has been so strong so far and has been an important pillar of the economy in recent years. However, Americans currently seem to be living somewhat beyond their means: The excessive savings of the Corona era have probably been partly used up, and the savings rate, at just 3.5%, was well below its pre-crisis level most recently (chart 3). Even though savings data are often noticeably revised, they make it likely that Americans will soon start saving more again, especially as wage increases are no longer quite as lush as before. As a result, the boost from consumption is likely to wane.

Chart 3 - Americans pushed down savings rate

Private households' savings in & of disposable income, monthy data. Dashed lined: 2017-19 average



Source: BEA, S&P Global, Commerzbank Research

The government is also likely to have to tighten its belt somewhat in the coming quarters. The federal government's deficit is expected to rise to $1.7 trillion (6.5% of GDP) in fiscal year 2023 which lasts from October 2022 to September 2023, noticeably higher than last year's shortfall (5.5% of GDP). This is an unusually high deficit for an economy at full employment. Increasingly, rising interest expenditures are also having an impact. Consolidation pressure on the budget is thus increasing, and no further widening of the deficit is to be expected in 2024. This means that certain fiscal headwinds for the economy is to be expected.

Finally, the investment boost triggered by the high subsidies, for example in the semiconductor sector, which boosted industrial construction in particular, is also likely to weaken. At the same time, the further rise in mortgage rates is likely to prevent residential construction, which has stabilized recently, from becoming a growth driver.

First rate cut only around mid-2024

Growth is therefore likely to slow noticeably by the turn of the year at the latest, which would suggest a turnaround in monetary policy. Initially, the inflation rate will remain to be too high. The Fed could react if the forecasts indicate a further decline in inflation and a possible recession. However, the Fed has had bad experiences with inflation forecasts in recent years, because the models did not indicate the massive rise in inflation in time. Against this background, the Fed will probably base its monetary policy on the actual figures by necessity. This suggests that the Fed will not lower its key rates at least in the first half of 2024. For the second half of the year, however, we expect the key rate to be reduced by a total of 100 basis points.

[1] Employment data can fluctuate greatly from month to month, for example due to weather influences. It is therefore advisable to look at an average over several months. (back to text)

[2] In May 2003, six weeks after launching an invasion of Iraq, US president George W. Bush stated "mission accomplished" in a speech held on an aircraft carrier. US combat troops, however, left Iraq only in December 2011. (back to text)

Research contacts (E-Mail: firstname.surname@commerzbank.com)

Chief Economist
Dr Jörg Krämer
+49 69 136 23650

Economic Research

Dr Jörg Krämer (Head)
+49 69 136 23650

Dr Ralph Solveen (Deputy Head; Germany)
+49 69 136 22322

Dr Christoph Balz (USA. Fed)
+49 69 136 24889

Dr Marco Wagner (ECB, Germany, Italy)
+49 69 136 84335

Bernd Weidensteiner (USA, Fed)
+49 69 136 24527

Christoph Weil (Euro area, France, Switzerland)
+49 69 136 24041

Tung On Tommy Wu (China)
+65 6311 0166

Interest Rate & Credit Research

Christoph Rieger (Head)
+49 69 136 87664

Michael Leister (Head Rates)
+49 69 136 21264

Rainer Guntermann
+49 69 136 87506

Hauke Siemßen
+49 69 136 49496

Ted Packmohr
(Head Covered Bonds and Financials)
+49 69 136 87571

Marco Stoeckle
(Head Corporate Credit)
+49 69 136 82114

FX & Commodities Research

Ulrich Leuchtmann (Head)
+49 69 136 23393

Antje Praefcke (FX)
+49 69 136 43834

Elisabeth Andreae (FX)
+49 69 136 24052

Tatha Ghose (FX)
+44 20 7475 8399

Charlie Lay (FX)
+65 63 110111

You-Na Park (FX)
+49 69 136 42155

Esther Reichelt (FX)
+49 69 136 41505

Thu-Lan Nguyen (FX, Commodities)
+49 69 136 82878

Carsten Fritsch (Commodities)
+49 69 136 21006

Barbara Lambrecht (Commodities)
+49 69 136 22295

Tung On Tommy Wu (China)
+65 6311 0166

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Analysts

Dr. Jörg Krämer
Chief Economist
+49 69 136 23650
joerg.kraemer@commerzbank.com

Bernd Weidensteiner
Senior Economist
+49 69 9353 45625
bernd.weidensteiner@commerzbank.com

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Commerzbank Offices

Frankfurt	**London**	**New York**	**Singapore**
Commerzbank AG	Commerzbank AG	Commerz Markets LLC	Commerzbank AG
DLZ - Gebäude 2, Händlerhaus	PO BOX 52715	225 Liberty Street, 32nd floor,	71, Robinson Road, #12-01
Mainzer Landstraße 153	30 Gresham Street	New York,	Singapore 068895
60327 Frankfurt	London, EC2P 2XY	NY 10281-1050	
Tel: + 49 69 136 21200	Tel: + 44 207 623 8000	Tel: + 1 212 703 4000	Tel: +65 631 10000