Asset Management One

Registration No.: Director of Kanto Local Finance Bureau
(Financial Instruments Firms) No.324
Commodity Trading Advisor License #(1) No.24, the Minister of Agriculture, Forestry and Fishery & the Minister of Economy, Trade and Industry
Member of Japan Investment Advisers Association
Member of The Investment Trusts Association, Japan

The Federal Reserve is Expected to Implement an Early Rate Cut

5 July 2024

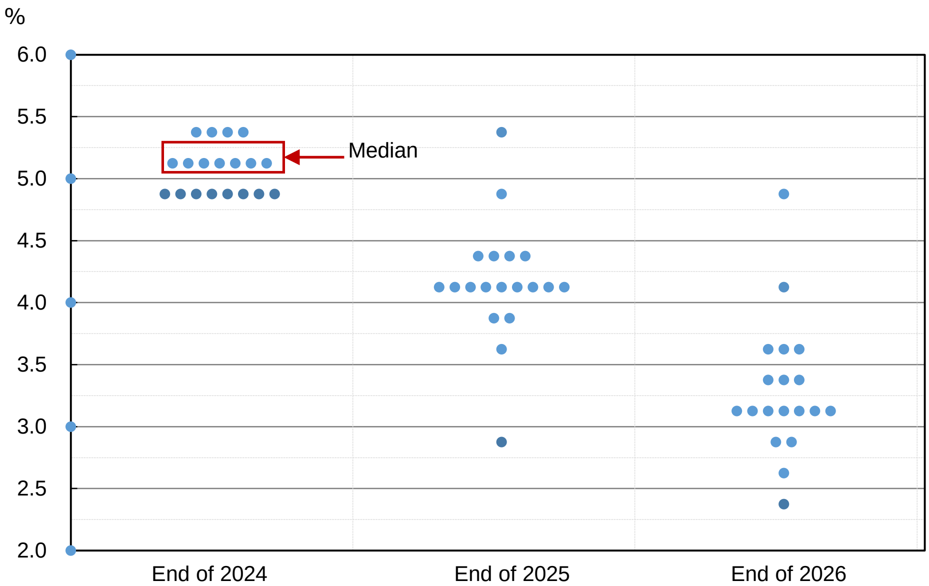
- During the June Federal Open Market Committee (FOMC) meeting, there was a suggestion to postpone the start of rate cuts until the end of the year. However, Chairman Powell acknowledged that the labor market is gradually stabilizing. We believe that a rate cut is being considered to be implemented during the September meeting. Based on the expectation that core inflation will settle at an annual rate of 2-3% after June, we anticipate that the Federal Reserve (FRB) will assess that inflation is returning to the target of 2% by the September meeting.
- Although there has been a significant increase in employment, the supply and demand conditions in the labor market are actually moderating. Given that the unemployment rate is likely to rise in the future, we expect that the FRB will actively explore the possibility of an early rate cut to address the weaker labor market conditions.

Murakami Naoki,
Senior Economist

Will the FRB postpone the start of interest rate cuts until the end of the year?

During the FOMC meeting held on June 11-12, the FRB decided to keep the policy interest rate unchanged at 5.50% (upper limit) as expected. The FOMC participants' projections for the federal funds rate at the end of 2024 in the dot plot were revised upward by 50bps from three months ago, with a median estimate of 5.25% (Figure 1).

Figure 1: FOMC Participants' Projections for the Federal Funds Rate (Meeting in June)



Source: FRB

The caution regarding the persistence of high inflation increased due to the upward surprise in the inflation rate in the first quarter of 2024. This caused some participants to become more cautious, and as a result, the expected timing for rate cuts was pushed back.

According to the consensus view, one rate cut is expected by the end of 2024, with many assuming it will happen by the end of the year. However, there are fewer than half of the members who anticipate two rate cuts of 25 basis points each towards the end of the year. Considering Chairman Powell's remarks after the meeting, we assume that he himself is expecting two rate cuts by the end of the year.

Chairman Powell assessed the recent inflation data as "eased somewhat" and acknowledged the stabilization of inflation indicators since April. He also stated that the labor market had come into better balance and emphasized the importance of considering "the totality of the data" in policy decisions. We believe that Chairman Powell is taking into consideration the impact of the previous interest rate increases on the slowdown in the labor market. Additionally, we believe that the notion of carefully considering both "maximum employment" and "stable prices," which are the two goals the FRB aims for, is becoming even stronger among core members, including Chairman Powell.

"Increased caution on high inflation led to delayed rate cuts"

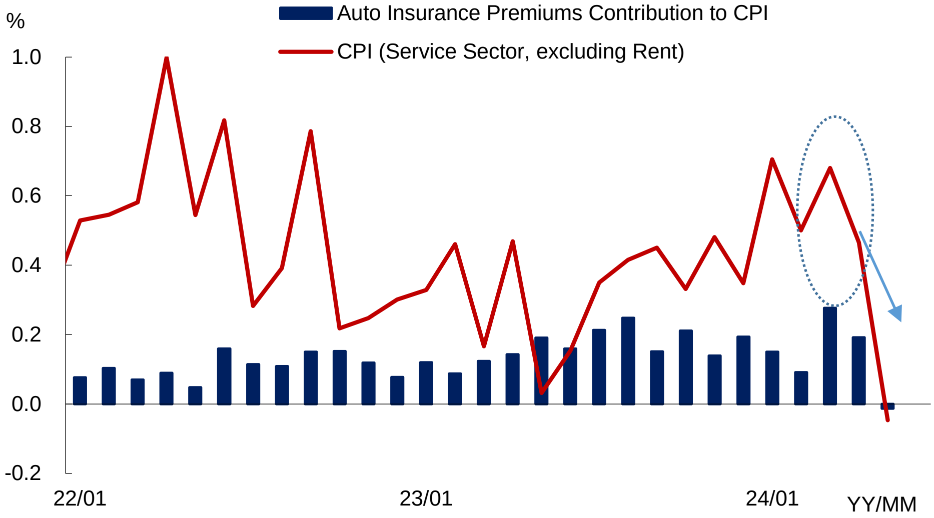
Mitigation of inflation in the service sector becomes evident

Chairman Powell and other members are believed to have a more positive stance towards an interest rate cut compared to some other members who are somewhat cautious. However, the decision to proceed with a rate cut or not depends on whether future economic indicators show progress towards returning to a 2% inflation rate.

If the year-on-year movement of the core inflation rate, excluding energy and others, continues to stay in the range of 2%-3% after June, the likelihood of the FRB implementing a rate cut will increase in the September meeting.

The upward surprise in core inflation in the January-March quarter of 2024 was largely influenced by price increases in certain items such as auto insurance premiums (Figure 2), which can be considered as "noise".

Figure 2: CPI (service sector, excluding rent) and Auto Insurance Premiums (MoM)



Source: LSEG Data & Analytics
Note: Monthly data from January 2022 to May 2024

Auto insurance premiums declined in May, indicating that the high inflation in the first quarter was a temporary movement. Considering the easing labor market supply and demand conditions and the sluggishness of wages, we anticipate that service sector inflation, excluding rent, will settle below an annual pace of 3% in the future.

<u>While the labor market may appear to be strong at first glance...</u>

In the May US employment statistics, the nonfarm payrolls saw a substantial increase of 272,000 jobs from the previous month, continuing the robust employment growth seen in the past few years. The monthly increase of nearly 300,000 jobs exceeds the cruising speed of employment expansion and can be seen as an overheating labor market, which could give the FRB a reason to hesitate on rate cuts.

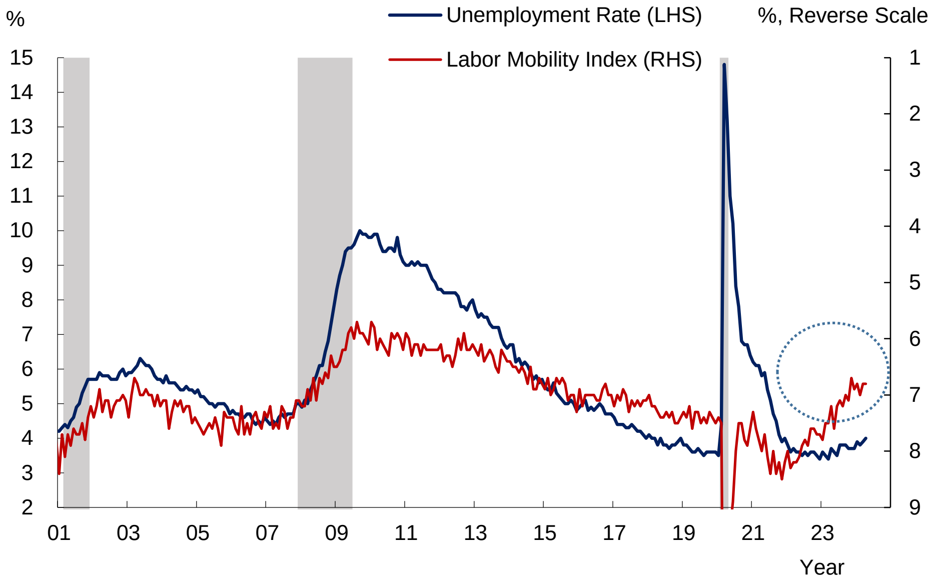
However, in the current US context, the increase in labor supply from immigrants since 2022 has contributed to the temporary acceleration of employment expansion. The FRB is aware of this factor, and as a result, many FOMC participants do not express strong concerns about the speeding-up employment expansion that normally would be seen as exceeding the speed limit.

In reality, the unemployment rate based on household surveys has gradually increased to 4.0% as of May, rising from the bottom in the first half of 2023. This indicator reflects a loosening labor market supply and demand balance, and its importance in the FRB's policy decisions looks to be increasing.

"Unemployment increased but Labor Market Indicators declining, caution in market"

The employment rate, turnover rate, and dismissal rate are also being closely watched as statistics on the labor market. If the labor market is robust, the "Labor Mobility Index," which is the sum of these indicators, will increase. However, it has continued to decline even in 2024, peaking around the end of 2022 (Figure 3, reverse scale). As economic activity settles down, companies have become cautious in their hiring practices, and the labor market conditions, as seen in the number of hires, have already returned to pre-pandemic levels.

Figure 3: Unemployment Rate and Labor Mobility Index



Source: LSEG Data & Analytics

Note: 1. Monthly data From January 2001 to May 2024

2. Labor Mobility Index = employment rate + turnover rate + dismissal rate, calculated till April 2024

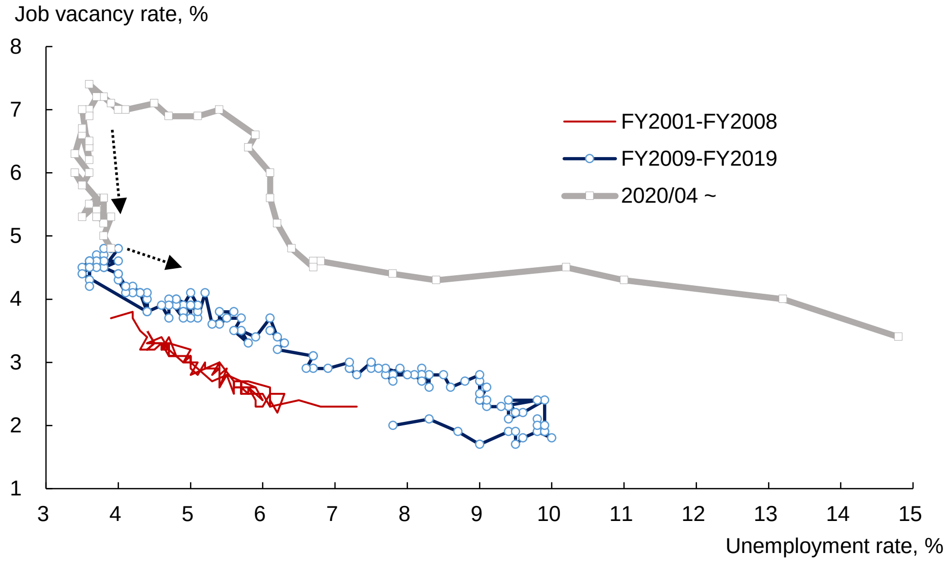
3. Shadow refers to the economic recession phase

Considering the gradual increase in the unemployment rate mentioned earlier, we would assert that the labor market is undergoing a gentle adjustment, and the supply and demand conditions are easing.

There is a possibility that the unemployment rate will further increase in the future

Looking at the relationship between the unemployment rate and the job vacancy rate (the number of job vacancies divided by the labor force), it has been observed that while the job vacancy rate has been significantly decreasing since 2022, the increase in the unemployment rate has been limited. In the past, the easing of labor market supply and demand has mainly been reflected in the decrease in job vacancies and has not resulted in a significant increase in the number of unemployed individuals (Figure 4).

Figure 4: Unemployment Rate and Job Vacancy Rate (Beverage curve)



Source: LSEG Data & Analytics
Note: Monthly data from January 2001 to April 2024

However, as of April 2024, the job vacancy rate has dropped to the 4% range. If we assume a return to the relationship between the job vacancy rate and the unemployment rate observed during the period from 2009 to 2019, the unemployment rate could rise more noticeably in conjunction with the decrease in job seekers.

With the increased likelihood of labor market adjustments occurring along with an increase in unemployment, FOMC participants on the dovish side will likely make policy decisions cautiously in preparation for labor market adjustments.

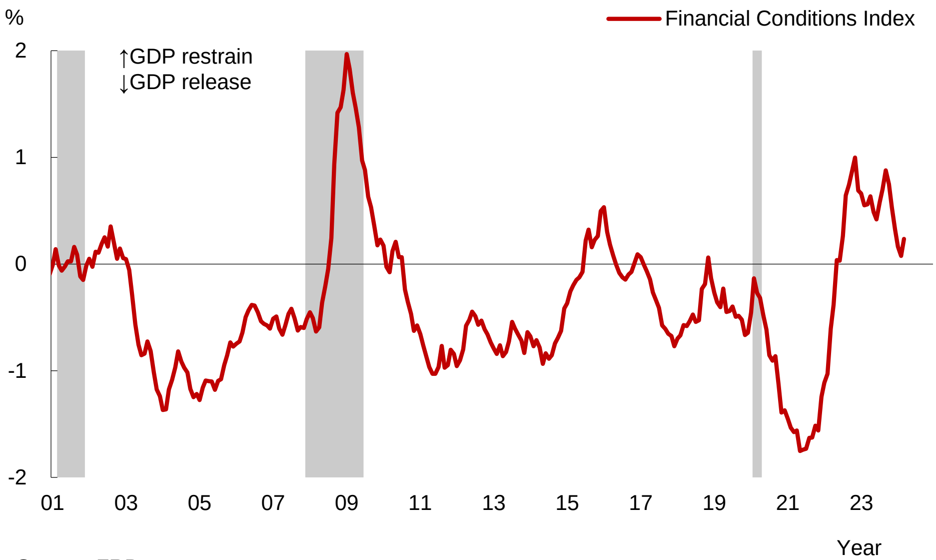
Therefore, Chairman Powell is expected to proceed with rate cuts as soon as it is determined that inflation is returning to the 2% range. This timing could potentially occur as early as the September FOMC meeting.

There will be no sharp slowdown in economic activity

We consider that the US economy is slowing down due to the negative impact of higher interest rates. However, this will not lead to a "sharp slowdown in economic activity" accompanied by significant job cuts.

Although long-term interest rates in the US have remained in the 4% range, financial conditions index including stock prices and credit spreads are at nearly neutral levels relative to growth rates, indicating that the situation is not significantly restraining economic activity (Figure 5).

Figure 5: Financial Conditions Index



Source: FRB

Note: 1. Monthly data from January 2001 to April 2024

2. Shadow refers to the economic recession phase,

3. The Financial Conditions Index indicates the extent to which the current financial environment will affect the economy in three years' time

Even if labor market adjustments continue moving forward, the situation can be described as a process of returning from an overheated state to a pre-pandemic norm. Additionally, the gradual increase in corporate investment, particularly in the AI-related field, is expected to support US economic growth.

We anticipate that with the US economy not experiencing a sharp slowdown, as the FRB starts to lower interest rates, the pace of rate cuts will be gradual.

Disclaimer

For this Presentation Material

- This documentation was prepared by Asset Management One Co., Ltd.
- This documentation is required to be used only by the investor to whom it is distributed.
- This documentation is only for the purpose of providing information and is not intended to be used to solicit investments.
- This documentation was prepared using data that Asset Management One Co., Ltd. has judged to be reliable including data from third-party sources. However, Asset Management One Co., Ltd. does not guarantee its completeness or accuracy. Additionally, the published data is only indicative of past performance and does not provide a guarantee of future performance.
- The contents included in this documentation are only current as of the date this documentation was prepared (July 5, 2024) and are subject to change without notice.
- The intellectual property and all other rights pertaining to the data published in this documentation including benchmark indices shall remain the property of the publisher and licensor.