Policy Note

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On Wednesday, September 18, the Fed commenced its easing cycle with a neutral-to-slightly hawkish 50 bps cut to its policy rate (now at 4.75-5.00%), in line with the out-of-consensus forecast of MUFG's rate strategist, George Goncalves. Notably, Governor Michelle Bowman's dissent in favor of a 25 bps cut was the first such dissent by a Fed Governor since 2005.

With consideration to fairly split market expectations, an unusual large rate cut in the context of recent economic data, and Governor Bowman's dissent, **we outline 10 observations behind the Fed's outsized 50 bps rate cut below.**

10 observations behind the Fed's 50 bps rate cut on September 18

1. **Regrets.** With weaker than expected jobless claims just two days after its July meeting, the Fed may have wished it began the easing cycle with 25 bps in July. From that perspective, 50 bps in September perhaps "catches them up" to where they want to be.

2. **"Highly restrictive" policy stance:** The US economy has become notably less rate sensitive compared to both prior decades and other advanced economies today. Nonetheless, the "highly restrictive" nature of "higher for longer" has become increasingly evident in the manufacturing sector, real estate and labor markets.

3. **Dual mandate becoming more singular.** While inflation is the sole focus for many global central banks, the Fed has a dual mandate linked to price stability and full employment. With inflation rapidly declining from 9.2% to 2.5% in two years, the Fed's dual mandate has become more singular in this stage of the cycle as inflation declines and labor markets weaken. Specifically, the FOMC modestly raised its 2024-25 unemployment forecasts, noting the "slowdown" in labor markets and its own commitment to supporting "maximum employment".

4. **"Recalibration":** The Fed emphasized the US economy remains on "solid" ground and changes to US economic forecasts were quite modest. Last week's decision should therefore be viewed as an opportunistic "recalibration" to adjust the course of Fed monetary policy, with a forward expected path that remains "gradual".

5. **Insurance:** The unemployment rate has historically been a "lagging" indicator of the economic cycle. Criticized for commencing the tightening cycle too late, the Fed would prefer to avoid criticism for easing too late. An outsized early cut therefore provides insurance against unexpected deterioration in labor markets.

6. **Skating to where the puck is going to be.** The Fed would prefer to not "chase" the economy. In the words of Chair Powell: "You can take this as a sign of our commitment to not fall behind." Nonetheless, the Fed is a "gradualist" institution and we expect a slower pace of 25 bps cuts in upcoming meetings.

7. **The lag in monetary policy:** Speaking to Congress in 1959, Nobel Prize-winning economist Milton Friedman said that changes to monetary policy are like a "water tap that you turn on now but that only starts to run 6, 9, 12, 16 months from now." History has also not been kind in this regard, with recessions often underway before Fed forecasts have adjusted to the downturn.

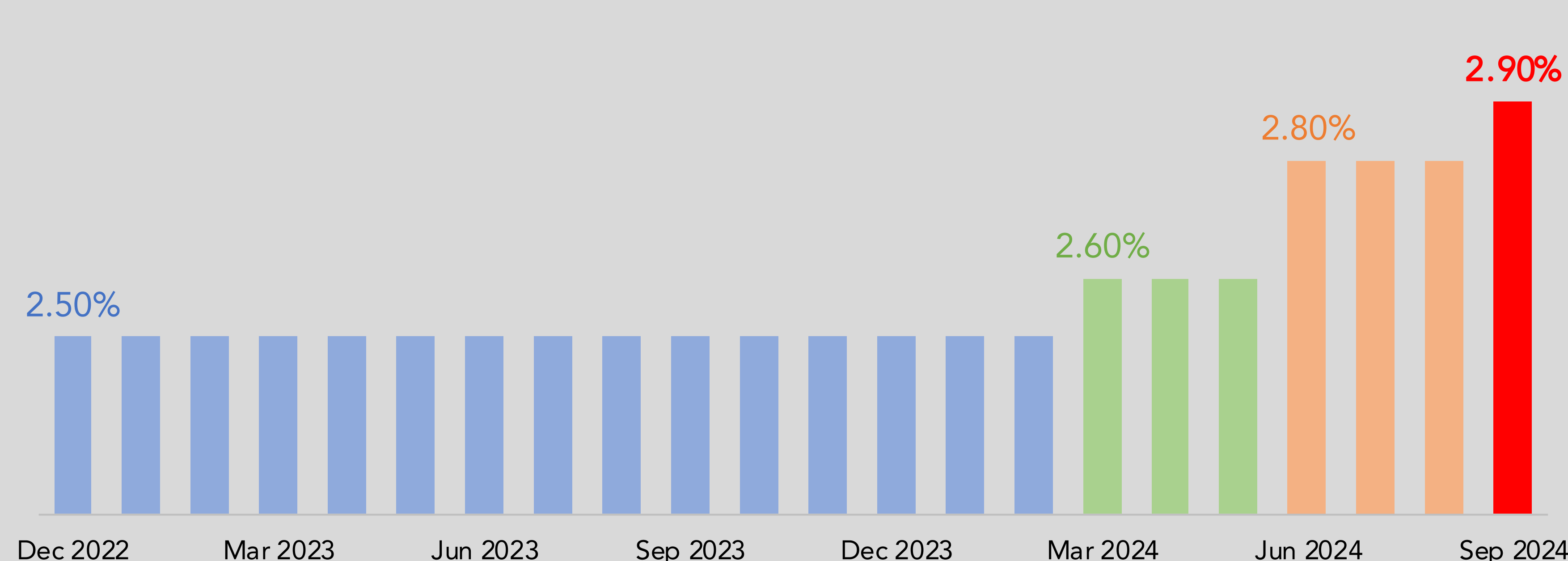
8. **Sticking the landing.** "Soft landings" have been highly elusive in Fed tightening cycles historically, and are actually without precedent when inflation reaches as high as it did during the COVID era. With the benefit of structural tailwinds (less rate sensitive US economy, elevated fiscal stimulus, COVID-related labor shortages), the Fed has thus far made remarkable progress in taming inflation without adversely shocking the economy. With "October" baseball right around the corner, you don't want to lose a game in the late innings.

9. **Keeping up with the neighbors.** Fed policy rates were notably higher than most, and its easing pivot later than most - an unconventional sequencing by historical standards. After 50 bps of easing, Fed policy rates are more aligned with global central bank peer group than previously.

10. **The luxury of dollar dominance.** The Fed has less concern than other Central Banks about the currency implications of its policy moves given: (1) recent USD strength; (2) relatively "closed" US economy (exports only 11% of GDP); (3) less rate sensitive US economy vs global peers; and (4) the USD's reserve currency status.

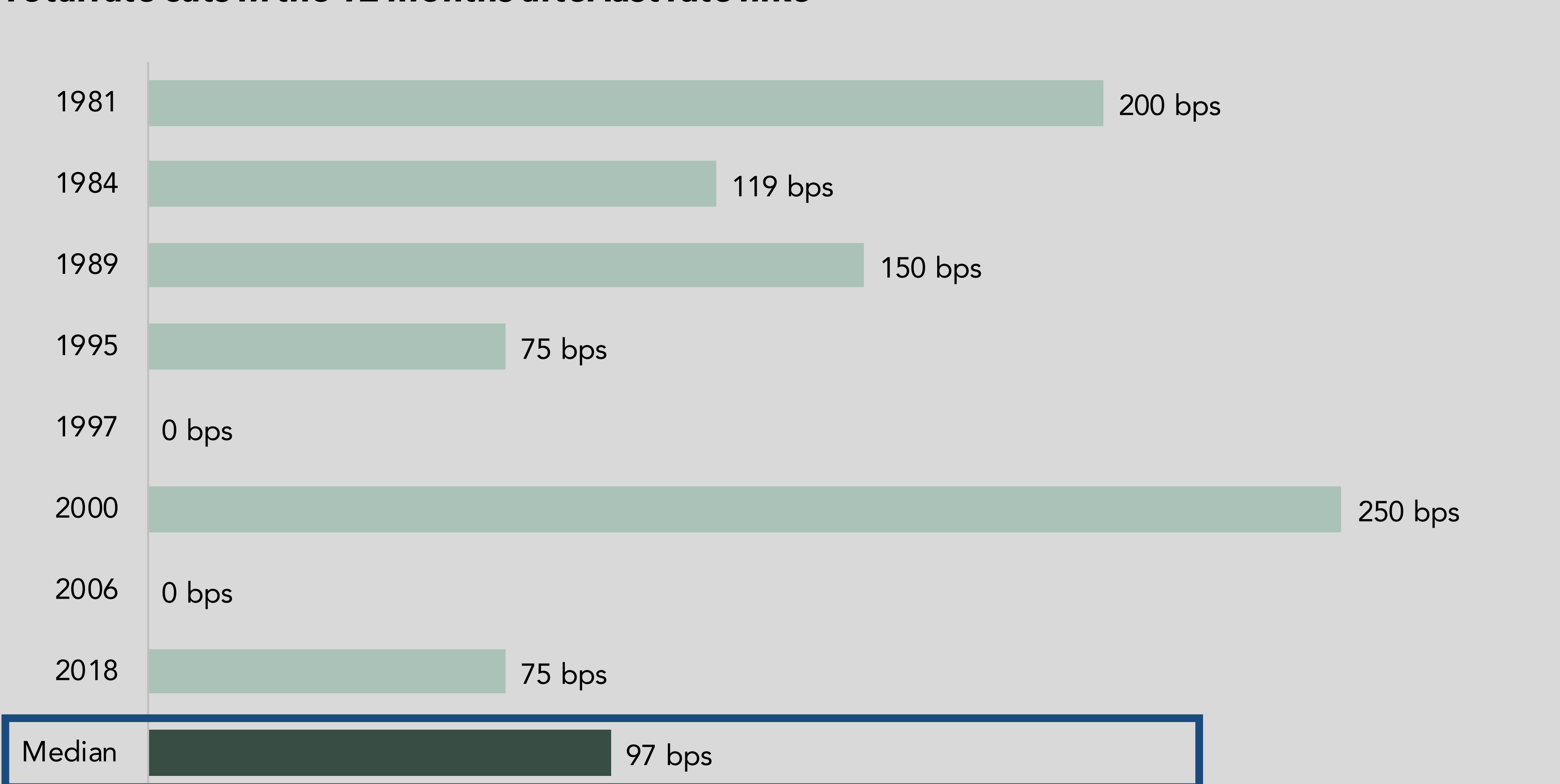
The Fed's projection of the neutral rate at which policy is neither stimulating nor dragging growth is not easily observed but has been rising over the post-pandemic period.

Fed neutral rate projection

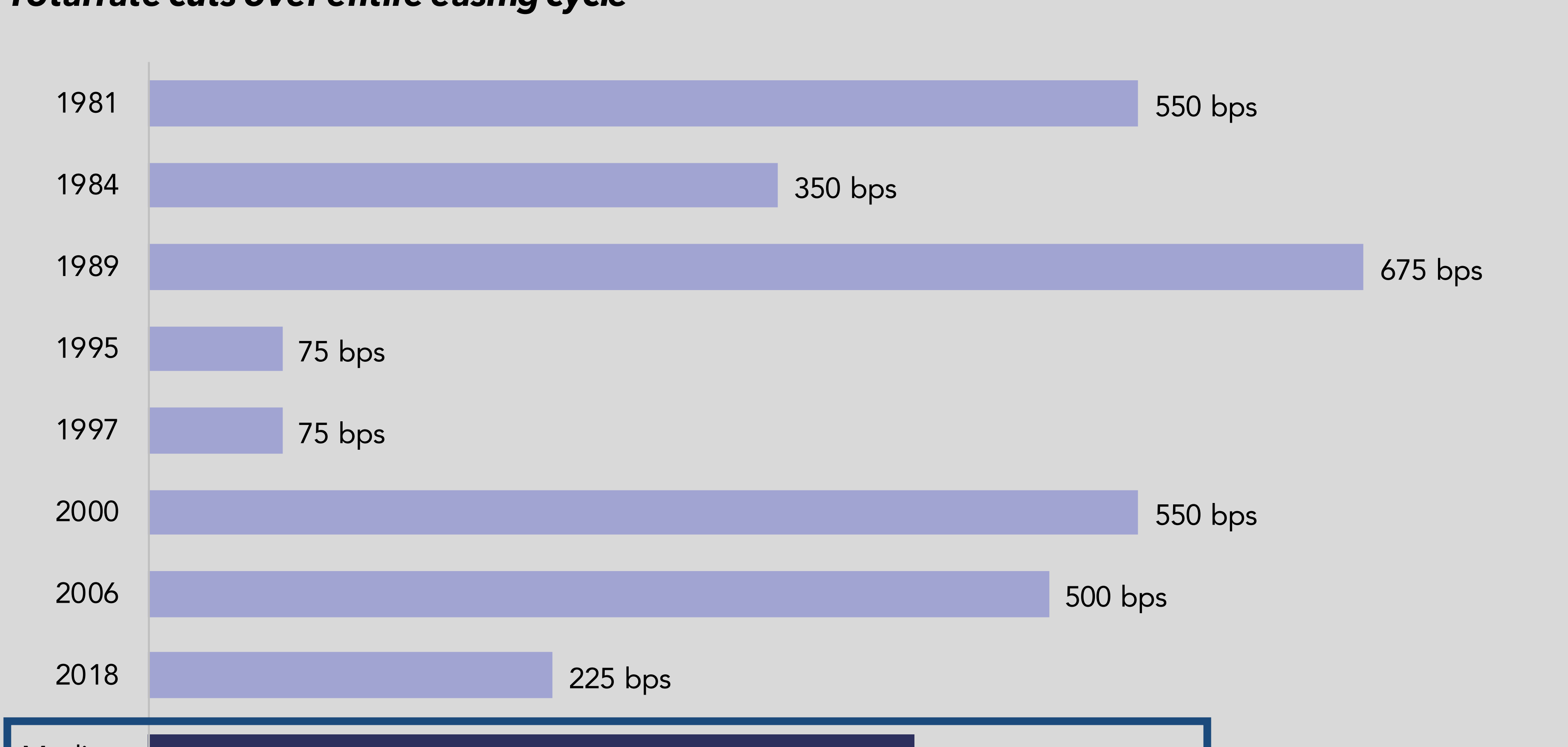


Looking at eight easing cycles since 1980, the Fed has typically cut rates by about 100 bps in the first 12 months of an easing cycle and by more than 4% over the entirety of the easing cycle, with a fair amount of variability around that range.

Total rate cuts in the 12 months after last rate hike



Total rate cuts over entire easing cycle



Source: (1-3) Bloomberg. FOMC Summary of Economic Projections.. Fred Economic Data St. Louis Fed. Note: Discount rate used before 1988. Fed Fund based on upper bound.

Global Corporate & Investment Banking
Capital Markets Strategy Team

Tom Joyce
Managing Director
Tom.Joyce@mufgsecurities.com
(212) 405-7472

Hailey Orr
Managing Director
Hailey.Orr@mufgsecurities.com
(212) 405-7429

Stephanie Kendal
Vice President
Stephanie.Kendal@mufgsecurities.com
(212) 405-7443

Angela Sun
Analyst
Angela.Sun@mufgsecurities.com
(212) 405 – 6952

"Macro stability isn't everything, but without it, you have nothing."