MARKETS & ECONOMY

July inflation reading trims the odds of a big September rate cut

PCE price index shows inflation continued to cool in July, but at a gentle enough pace that Fed policymakers are now seen as likely to only bring rates down by a hair in September



Image by: Canva

BY MATT CARTER
August 30, 2024

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Mortgage rates were trending up Friday after the latest reading of the Federal Reserve's preferred gauge of inflation showed the economy continued to cool in July — but at a gentle enough pace that Fed policymakers are now seen as likely to be content to only bring rates down by a hair in September.

The personal consumption expenditures (PCE) price index showed prices of goods and services were up 2.5 percent in July from a year ago — just half a percentage above the Fed's 2 percent target, the Commerce Department's Bureau of Economic Analysis reported.

While that's no better than June, the year-over-year measurement is getting harder to budge because of the sharp deceleration in inflation seen in the second half of 2023, KPMG U.S. Chief Economist Diane Swonk said in a bulletin.

"Federal Reserve Chairman Jay Powell has warned that those 'base effects,' as they are called, will buoy year-over-year measures of inflation through year-end," Swonk said. "Those base effects drop out of the data at the start of 2025, which is why we don't need a big improvement in inflation on a monthly basis from here to get much closer to the Fed's 2 percent target in early 2025."





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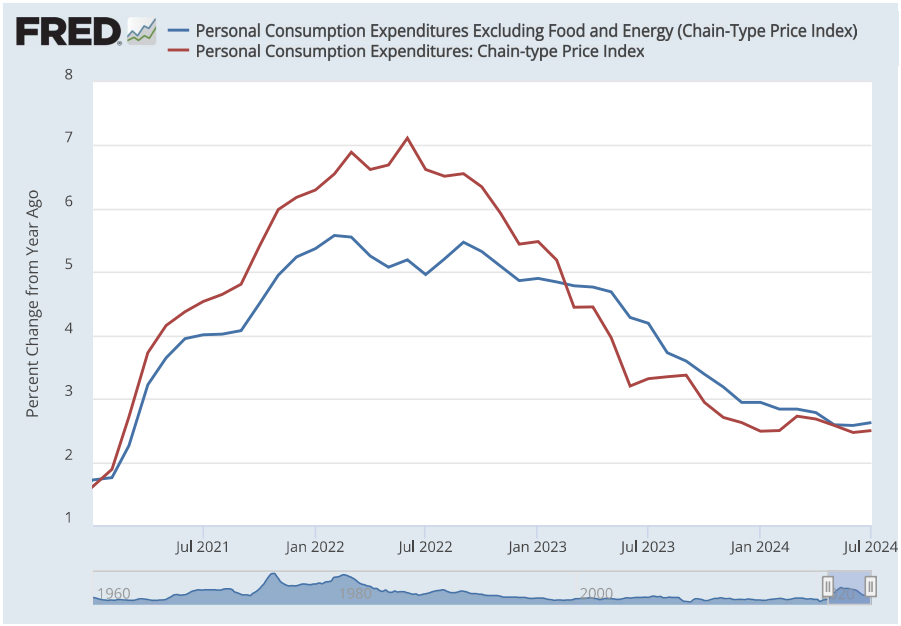


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Inflation nearing Fed's 2 percent target



Source: U.S. Bureau of Economic Analysis

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Housing and utilities were the biggest contributors to the increased cost of services, while cars, auto parts, food and beverages were the biggest drivers of higher costs for goods.

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Core PCE, which excludes the cost of food and energy and can be a more reliable indicator of underlying inflation trends, rose 2.62 percent from a year ago, compared to a revised 2.58 percent in June.

The 0.16 percent increase in core PCE from June to July was in line with forecasts tallied by *The Wall Street Journal*, Pantheon Macroeconomics Chief Economist Ian Shepherdson said in a note to clients.



Ian Shepherdson

"Consumers' spending growth has been running well ahead of real income growth for some time, which has only been possible due to a drop in the personal saving rate to a very low level," Shepherdson noted.

At 2.9 percent in July, the savings rate is "unsustainably low" compared to just over 6 percent before the pandemic, Shepherdson said.

Pantheon economists predict that ongoing softening in the labor market will lead to more precautionary saving that should dampen growth in consumption "significantly over the next few quarters."

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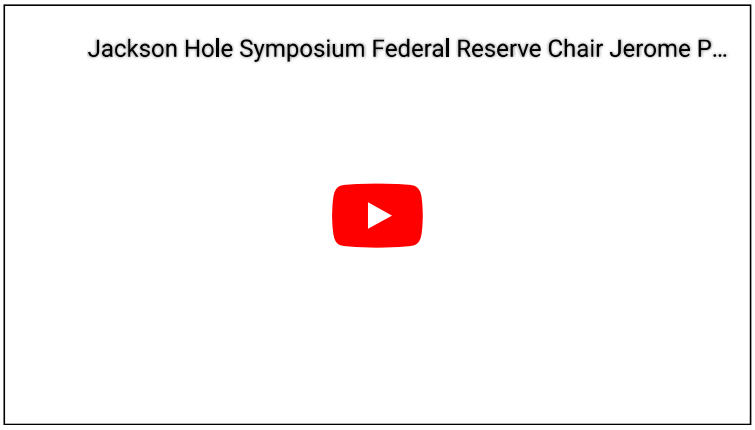
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The release of two weak jobs reports at the beginning of August triggered a recession warning indicator known as the Sahm Rule, named for economist Claudia Sahm. As part of their "dual mandate," Fed policymakers are trying to bring down inflation without triggering widespread layoffs.

Federal Reserve Chair Jerome Powell last week telegraphed the Fed's intention to cut rates when it meets next on Sept. 18, but said the timing and pace of rate cuts "will depend on incoming data, the evolving outlook, and the balance of risks."

Powell's Jackson Hole speech

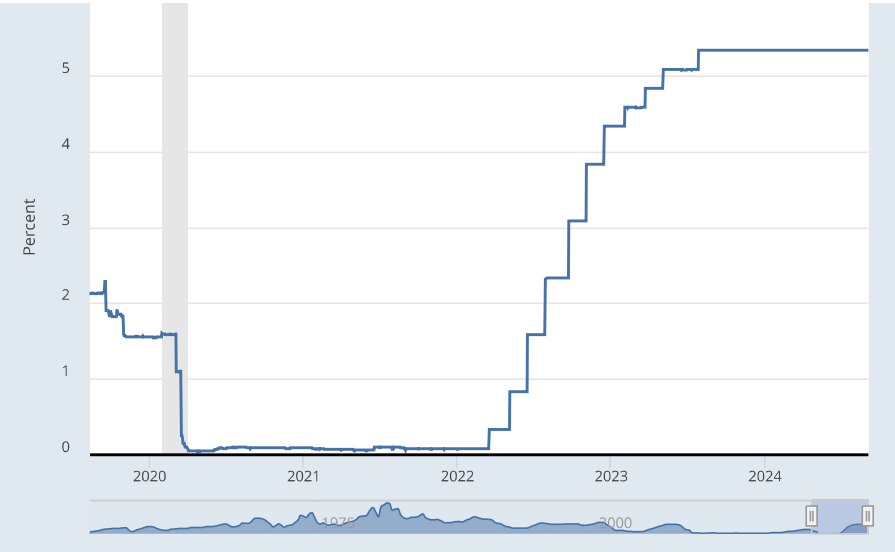


"Our objective has been to restore price stability while maintaining a strong labor market, avoiding the sharp increases in unemployment that characterized earlier disinflationary episodes when inflation expectations were less well anchored," Powell told bankers attending the Jackson Hole economic symposium on Aug. 23.

Futures markets tracked by the CME FedWatch tool show that while investors are certain the Fed will cut rates, the probability that policymakers will start out with a dramatic 50-basis point reduction dropped to 30 percent Friday, down from 36 percent a week ago.

Shepherdson said Pantheon forecasters are sticking to their view that the Fed will bring the federal funds rate — the rate banks charge each other for overnight loans — down by 25 basis points in September, followed by bigger cuts of 50 basis points in November and December.

A basis point is one-hundredth of a percentage point, so Pantheon's forecast is that the Fed will bring short-term interest rates down by 1.25 percentage points by the end of the year, and by another 1.5 percentage points next year.



Source: Board of Governors of the Federal Reserve System (US)

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Fed policymakers approved 11 increases in the federal funds rate from March 2022 through June 2023, bringing the target for the short-term rate to between 5.25 and 5.5 percent — the highest level since 2001.

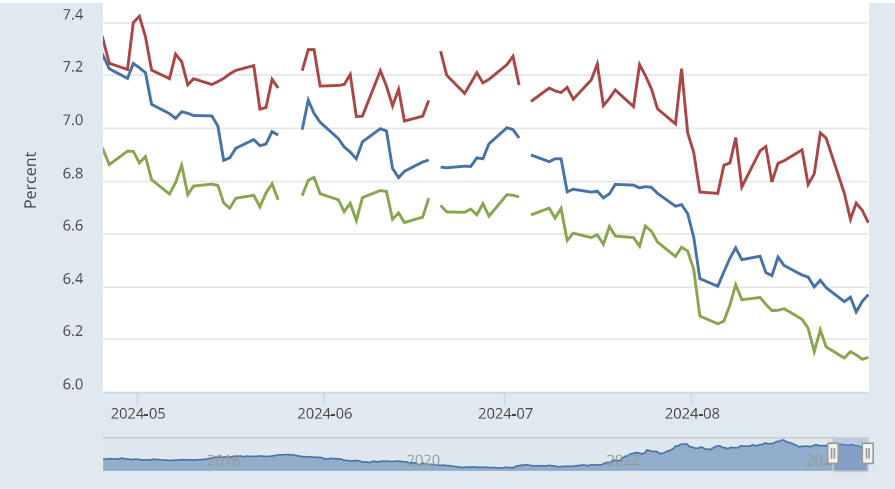
Swonk said KPMG forecasters still expect a 50-basis rate cut in September, with an eye to the potential for layoffs driven by price cuts on items like clothing and big-ticket durable goods, which fell for the fourth month in a row in July.

"Consumers continued to spend in response to discounting in July. They dipped into their savings to do so," Swonk said. "The Fed welcomes growth on the heels of discounting but wants to cut rates before that discounting triggers a surge in layoffs. Those shifts have already prompted Federal Reserve Chairman Jay Powell to shift the risks the Fed is hedging from inflation to a weaker labor market."

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home loans are already accepting lower returns in anticipation of future rate cuts.

Mortgage rates falling



Source: Optimal Blue

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Since hitting a 2024 high of 7.27 percent on April 25, Optimal Blue data shows rates on 30-year fixed-rate conforming mortgages have come down by nearly a full percentage point, hitting a new low for the year of 6.30 percent on Wednesday.

Rates rebounded Thursday following the release of a relatively benign jobs report showing initial unemployment claims fell by 2,000 during the week ending Aug. 24, to 231,000.

Rates were on the rise again Friday following the release of the PCE price index showing inflation cooling no more than expected.

Yields on 10-year Treasury notes — a barometer for mortgage rates — climbed 4 basis points. A *Mortgage News Daily* lender survey showed rates on 30-year fixed-rate loans were up 2 basis points Friday.

One side effect of the recent decline in mortgage rates has been reduction in the "spread" between mortgage rates and 10-year Treasury yields.

Before the pandemic, the "30-10 spread" was only 2 percentage points, but widened to 3 percentage points last year, alarming housing and lending industry groups like the National Association of Realtors and the Mortgage Bankers Association.

As interest rates climbed, investors in mortgage backed securities (MBS) demanded higher returns to compensate them for "prepayment risk," or the chance homeowners will refinance if rates come down.

With mortgage rates now down 1.5 percentage points from the post-pandemic high of 7.83 percent registered in October 2023, the prepayment risk on loans taken out today has diminished.

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