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CREDIT RATING AGENCY

Mr. Vipin Malik,  
(Chairman, Infomerics Ratings)

Mr. Sankhanath Bandyopadhyay  
(Economist)

## THE FED HAS FINALLY STARTED THE RATE CUTTING CYCLE

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The Fed has finally initiated the reduction in the policy interest rate by half-percentage point on 18<sup>th</sup> September 2024,<sup>1</sup> based on the growing confidence that the labour market will exhibit moderate growth, and inflation would move sustainably down to the target rate of two percent. The US FOMC has finally brought the rate cut cycle from 5.25-5.75% to 4.75-5.00% after a prolonged four years, where at the initial years, inflation started increasing and stayed high for a variety of reasons. The financial market was in a buzz about the quantum of the rate cut.<sup>2</sup> The Fed has also decided to continue to reduce their securities holdings.

The recent macroeconomic indicators show reasonable pace of progress, for instance, GDP rose at an annual rate of 2.2 percent in the first half of the year, and available data point to a roughly similar pace of growth this quarter. The growth of the consumer spending remains resilient. According to the Fed's Summary of Economic Projections, the GDP growth is likely to increase with a reasonable faster pace, with a median projection of 2 percent over the next few years.



<sup>1</sup> Despite one dissent on the Board of Governors. Fed governor Michelle Bowman voted in favor of the smaller 25 basis point cut option.

<sup>2</sup> According to the CME's FedWatch Tool, the probability of a 50-basis point rate cut this week is about 65%, and the probability of a 25-basis point cut this week is about 35%.

In the labour market, payroll job gains averaged 116 thousand per month over the past three months, a significant decline from the pace seen earlier in the year. The unemployment rate has increased but remains low at 4.2 percent. Nominal wage growth has improved over the past year and the jobs-to-workers gap has contracted. Overall, a broad set of indicators suggests that conditions in the labour market are now relatively more flexible in line with the policy rate manoeuvring.

Though the rate of inflation remains above the long-term target rate of two per cent, it has eased considerably. The Private Consumption Expenditure (PCE) prices increased 2.2 percent over the twelve months ending in Aug'24. Excluding the volatile food and energy categories, core PCE prices rose 2.7 percent. According to the Fed Governor J. Powell's speech, the longer-term inflation expectations seem to be well anchored, reflected in a broad range of surveys of households, businesses, and forecasters, as well as measures from financial markets.

The Fed has highlighted that while the upside risks to inflation have faded, the downside risks to employment have increased. Hence, the Central Bank is attentive to the risks to both sides of their dual mandate.

US 30-year mortgage rate falls to two-year low of 6.15%, and are likely to be around near 6%, that has been skyrocketed earlier. As highlighted by *Yahoo Finance*,<sup>3</sup> interest rates on personal loans have increased from 8.73% at the beginning of the Fed rate hikes in 2022 to 11.92% in May 2024. Such interest rates are expected to be reduced, because of the Fed's policy rate softening.

### **Impact on the Indian Economy:**

The 10-year Indian government bond yield declined to 6.76% from the previous 6.78%. It is expected to soften further. Regarding the foreign inflows, the perception is mixed, as the equity market seems to be overvalued, whereas the debt market is likely to attract more inflows due to stable rupee. The economic conditions of the US economy could have a bigger impact on other markets, especially the emerging markets (EMs). The latest data shows that the applications for unemployment benefits have reduced, thus indicating possibly the labour market is slowing and if this trend continues a soft landing can be expected. However, the private sector borrowings and US debt level is very high, hence we need to be watchful about the aggregate demand conditions. The Bank of Japan (BoJ)'s hawkishness is also altering the trend of yen carry trade, which could have impact on EM countries. Though, on 20<sup>th</sup> Sept'24, the Bank of Japan (BOJ) maintained its short-term rate target stable between 0.15%-0.25%. The economic condition of China would also be crucial.

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<sup>3</sup> "The Fed rate cut: What it means for bank accounts, CDs, loans, and credit cards" (19<sup>th</sup> September 2024) Yahoo Finance.

The Indian rupee remains stable with a marginal decline to 83.61 on 19<sup>th</sup> Sep'24 compared to 83.83 on 17<sup>th</sup> Sept'24. In the commodity market, gold prices gained strong momentum, it continues to increase incessantly in the range of 0.38%~0.45% on 20<sup>th</sup> Sep'24, which is likely to increase further. It has increased by 317 bps on 20<sup>th</sup> Sept'24 in the range of ₹73457~ ₹73769/10 gm. The stock market remains buoyant. On 20<sup>th</sup> Sept'24, the BSE SENSEX remains at 83,607.79, increased by 0.51%. The banking stocks remain gainers, with the Nifty Bank index records a high at around 53,711 on 20<sup>th</sup> Sept'24.

On the 19 Sept'24, the BSE Sensex ended above 83,000. Nonetheless, the overall net gains in the index remained subdued due to profit-booking. The FMCG index rallied over one per cent. The volatility index (VIX) remains range-bound, though it increased by six per cent ahead of the Fed decision. On 20<sup>th</sup> Sept'24, the Nifty VIX has gained 1.42% to reach at 12.65.

In this context, let's explore whether RBI will also follow the rate cutting cycle or not. The RBI Governor has repeatedly emphasised that the RBI is looking for a sustained decline of the CPI towards the target rate of the 4%. The CPI remains at the 3.65% during Aug'24, whereas for the entire financial year 2024-25 (FY25), average inflation is likely to be in the range of 4.6%~4.7%. However, the major concern is about the future trend of the food inflation that remains extremely erratic. A positive factor is that the monsoon remains with a seven per cent surplus with favourable kharif sowing. Hence, for repo rate softening, the food inflation will play a much crucial role.

Going forward, there is a further 25 bps rate cut expected by the end of this year. The terminal rate is expected to be in the range 3.75%-4.00%. As per the July'24 data,<sup>4</sup> there was a panic about a possible recession, following the "Sahm Rule" indicating that when the 3-month moving average of the US unemployment rate is 0.5 percentage points or more above its prior 12 month low then it's a signal of recession.

However, the Bureau of Labor Statistics (BLS) reported that the U.S. economy added 142,000 jobs in August 2024, 28,000 more than in July'24, thus indicating a relatively strong labour market that is aligned with the Fed's another objective of attaining the maximum employment. The recent 50 bps cut is likely having some favourable impact on the mortgage and other sectors (though in a lag), thus avoiding a possible 'hard landing'. Nonetheless, the future trend of the labour market is quite crucial in this regard, based on that a much larger cut in the policy rate can be expected further.

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<sup>4</sup> The July non-farm payrolls data got the market worried about a US downturn because the unemployment rate increased to 4.3%, a jump from 4.1% in the prior month and the highest level since late 2021.

## Annexure:

### US GDP growth projections (%YOY)

	2024	2025	2026
Sep'24	2.0	2.0	2.0
Jun'24	2.1	2.0	2.0
Mar'24	2.1	2.0	2.0
Dec'23	1.4	1.8	1.9
Sep'23	1.5	1.8	1.8

### US Unemployment rate (%)

	2024	2025	2026
Sep'24	4.4	4.4	4.3
Jun'24	4.0	4.2	4.1
Mar'24	4.0	4.1	4.0
Dec'23	4.1	4.1	4.1
Sep'23	4.1	4.1	4.0

### PCE Inflation (YOY%)

	2024	2025	2026
Sep'24	2.3	2.1	2.0
Jun'24	2.6	2.3	2.0
Mar'24	2.4	2.2	2.1
Dec'23	2.4	2.1	2.0
Sep'23	2.5	2.2	2.0

Source: Federal Open Market Committee (FOMC) projections.