GENERALI INSURANCE ASSET MANAGEMENT

MARKET COMMENTARY

The Fed is about to cut, as the labour market gets more attention.

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- **The first rate cut is only postponed, most likely to September. The Fed appears happy with the Q2 inflation progress and is shifting attention to the labour market outlook.**
- **The FOMC sees the economy as broadly rebalancing amid solid demand growth, and a significant downturn of the labour market appears a tail risk. But the string of good inflation prints was not yet long enough for a July cut.**
- **Fed's mild dovishness contrasts with the hawkish tilt of the BoJ Japan, which raised the policy rate to 0.25% earlier than expected and despite mixed evidence on inflation. Further monetary tightening will come from the widely expected start in the reduction of asset purchases.**

Improvements in inflation and higher potential risks for the labour market are eventually leading the Fed to cut rates. Barring any very nasty surprises in the July and August price data releases, the September cut, which is already priced in by the market, is an almost done deal. The tone of the press releases clearly indicates the change in outlook and the shift in policy priorities (see below), with the unemployment mandate increasing in importance.

Recent indicators suggest that economic activity has continued to expand at a solid pace. Job gains have moderated, and the unemployment rate has moved up but remains low. Inflation has eased over the past year but remains somewhat elevated. In recent months, there has been some further progress toward the Committee's 2 percent inflation objective.

The Committee seeks to achieve maximum employment and inflation at the rate of 2 percent over the longer run. The Committee judges that the risks to achieving its employment and inflation goals continue to move into better balance. The economic outlook is uncertain, and the Committee is attentive to the risks to both sides of its dual mandate.

In the press conference, Chair Powell repeatedly declined to commit to a date for the first rate cut. Yet he hinted several times that this could happen at the next meeting if the current trend of disinflation, coupled with steady demand growth and a gradually rebalancing labour market, continues over the summer. He also painted a rosy view of the US economy, pointing out that final demand keeps expanding at a very high level (2.6% annually in Q2). The recent labour market data align with the Fed's objectives, indicating further rebalancing that tames wage inflation and reduces upside risks for consumer price growth. Data released this afternoon showed that the Employment Compensation Index (ECI) increased by 0.91% quarter-over-quarter in Q2, with the annual growth rate edging down to 4.1% from 4.2%. Even more encouragingly, ECI private wages and salaries—likely to have a stronger impact on price inflation—increased by a 4-year low of only 0.84% quarter-over-quarter (or 3.4% annualized), and the annual growth rate slowed to 4.0% from 4.3%. Assuming a trend of 1.5% productivity growth, wage growth has returned close to the level consistent with 2% inflation.

The Fed is very carefully assessing whether the cooling of the labor market can go too far and result in a downturn; this is clearly the highest risk. Chair Powell played down the fact that anecdotal evidence from surveys and the Beige Book is less upbeat than hard aggregate indicators, which remain strong and greatly reduce the risk of a hard landing.

On a year-on-year basis, inflation remains higher than the target (the core PCE rate stood at 2.6% in June), but the situation looks much better than a year ago, not just in terms of headline numbers but also in the 'quality' of deflation. Back in 2023, it was entirely driven by goods; now it appears much more broad-based. In surveys and earnings calls, corporations signal low demand and reduced pricing power, which should contribute to reduced wage pressures and a stronger dollar, further driving down inflation. Yet the cumulative evidence was not enough for a rate cut at the current meeting, and the entire FOMC agreed on that. The rebalancing between demand and supply has brought back into focus the unemployment mandate, tilting the stance from hawkish to broadly neutral. Q2 data instilled confidence in the possibility of a cut, but Powell signaled that this trend must continue for the Fed to cut rates in September.

Today's meeting was the last before the November election. Unsurprisingly, Powell stressed that the electoral cycle does not affect FOMC decisions, and the economic projection does not consider the candidates' programs, although he conceded that scenarios based on different policy settings help inform decisions.

Needless to say, we stick to our scenario of two rate cuts this year. For 2025, we pencil in four cuts, but risks are tilted toward a slower pace of accommodation, especially if the Republican party maintains its lead in the polls and successfully implements its economic agenda. A larger deficit, slower immigration, and tariffs would clearly pose an upside risk to inflation.

Bond yields ticked marginally down as the meeting confirmed the markets' view. The S&P rose 1.7% after the communiqué was released, with the interest rate-sensitive tech sector posting the best performance.

Early this morning, the Bank of Japan (BoJ) proved to be more hawkish than expected and, possibly, warranted by economic data. It raised the policy rate to 0.25% despite mixed evidence of wage-driven inflation. While the Consumer Price Index (CPI) has remained above 2%, the core-core CPI (which excludes energy and fresh foods) has shown signs of easing. Still, the BoJ remains confident in meeting the 2% inflation target. It highlighted that wage increases are becoming more widespread across regions, industries, and company sizes. The median forecast for the core-core CPI remains steady at 1.9% for FY2024 and FY2025, expected to rise slightly to 2.1% for FY2026. Given the aggressive stance, another smaller (10bps) hike is possible before the end of the year, but a steady path of rate increases would require a very stable macroeconomic situation. Expectations were met regarding the plan to reduce monthly JGB purchases by ¥0.4 trillion every quarter, from the current ¥6 trillion to ¥3 trillion by Q1 2026, and therefore bond yields barely reacted to the news. This reduction will decrease the BoJ's JGB holdings by 7% and lower its footprint in the JGB market to 45% from 48% by the end of FY2025.

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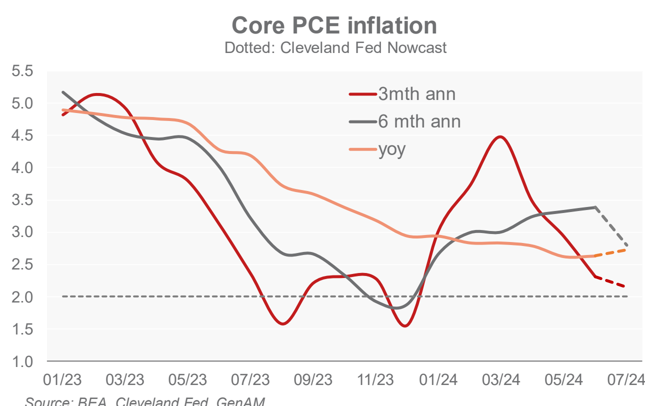
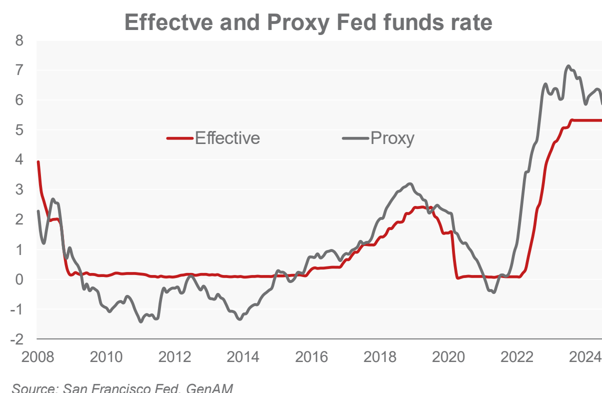
Variable	Prev. FOMC meeting	Latest	Chg.
Real Activity			
Weekly activity index (yoy GDP)	1.5	2.4	0.9
ISM - Manuf	48.7	48.5	-0.2
ISM - Services	53.8	48.8	-5.0
Macro Surprises	24.6	-25.5	-50.1
Labor Market			
Payroll growth (3 mth. MA)	218	177	-41
Unemp. Rate	4.0	4.1	0.1
Unemp. Rate (broad)	7.4	7.4	0.0
Hourly wages, % yoy (3 m. MA)	4.1	4.0	-0.1
Prices			
Core CPI	3.4	3.3	-0.1
Core PCE	2.8	2.6	-0.2
Trimmed PCE	2.9	2.8	-0.1
U. Mich 5 yr exp.	3.0	3.0	0.0
NY Fed 3 Y exp.	2.8	2.9	0.2
5Y5Y fwd exp.	2.2	2.4	0.1
Financial Conditions			
Chicago Fed index*	-0.5	-0.6	-0.1
10 yr. Treasury	4.3	4.1	-0.1
- Risk neutral Component	4.4	4.2	-0.2
- Term Premium	-0.2	-0.1	0.1
Yield curve (10Y - 3M)	-1.1	-1.1	0.0
S&P 500	5225	5436	4.1%
Trade Wighted Dollar	130.9	134.3	2.5%
WTI Crude Oil	82.8	76.2	-8.0%

** Decrease: looser conditions*



Source: BEA, Cleveland Fed, GenAM



Source: San Francisco Fed, GenAM

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