Mixed US indicators still point to 2% growth

Recent US economic data have been mixed but don’t make an overwhelming case for lower rates at this stage. Q2 growth is looking solid—we continue to track a 2.2% annualized increase, down from 3.1% in Q1 but with a healthier composition. The US consumer’s slow start to the year is proving to be a temporary blip with spending growth likely getting back to a 3.5% pace in the latest quarter. Housing activity, after softening for more than a year as the Fed raised rates, has shown signs of life thanks to an easing in financial conditions more recently. And business investment is poised to increase in Q2, albeit at a relatively slow rate. There is little to be concerned about in the labour market. Job growth rebounded nicely in June and the average pace of hiring this year, while down from 2018, has been enough to put downward pressure on the unemployment rate. Wages continue to rise at a healthy (but not inflationary) rate.

There are soft spots, though. The US industrial sector is losing momentum and manufacturing sentiment is slipping (two themes that are being observed globally). Even the latest ISM non-manufacturing report featured complaints about trade uncertainty or tariff-related cost increases (though overall sentiment remained close to its long-run average). And while business investment will add to growth in Q2, capex orders point to less momentum going forward. At the same time (and to no surprise) tariffs have done little to rein in the US trade deficit. A surge in imports in May suggests net trade was a drag on growth in Q2, and we see little prospect of the trade balance improving in a slower global growth environment. We don’t think these data signal the beginning of the end for the current economic expansion, which is now the longest in US history. But it looks like they’ve been enough to convince the Fed that a bit of accommodation is needed.

Inflation making the case for cuts?

The case for lower rates has also been built on “muted” inflation pressures. The PCE deflator, the Fed’s preferred measure, held below 2% for a seventh consecutive month in May and core inflation remained stuck at 1.6%. Chair Powell was somewhat dismissive of low inflation readings after the Fed’s May meeting—saying the recent slowdown should be transitory—but has been less emphatic on that point recently. It’s hard to see what has changed. Core inflation actually appears to have a bit more momentum, running at a 2% annualized rate in the last three months. And the Dallas Fed’s trimmed inflation measure, which Powell pointed to back in May, remains at 2%.

It could be that policymakers are growing impatient with their inability to get inflation back to target on a sustained basis. Core PCE has been 2% or higher for just six months in the last decade. This persistent undershoot might be weighing on inflation expectations. Market-based inflation compensation remains low (five-year breakevens around 1.5-1.6%) and survey-based measures of expected inflation (also over the next five years) are at record lows. That has some of the FOMC thinking a period of above-2% inflation might be needed to push inflation expectations higher.

Markets prepped for a Powell put

The Fed has done little to push back against growing expectations for cuts. The central bank’s June meeting was more dovish than expected, with the dot plot showing roughly half of committee members think two rates cuts will be appropriate by the end of the year. Even those not calling for a move thought the case for easing had strengthened. The post-meeting statement—dropping reference to being “patient” and instead saying the committee would “act as appropriate” to sustain the expansion—was seen as an indication that rates could be lowered as soon as July. With a relatively positive G-20 outcome and strong payroll report doing little to change Powell’s view, we now expect a 25 basis point cut in July and a follow-up move in September. We don’t think this is the start of a full-on easing cycle; rather, these cuts are about providing a bit more accommodation to offset trade headwinds. 50 basis points of easing (in total) would fall short of what markets are currently pricing in over the next year, but should be enough to placate investors that are concerned monetary policy has become a bit too restrictive.