Dollars and Sense: Ready... Set... Cut! Cut! Cut!

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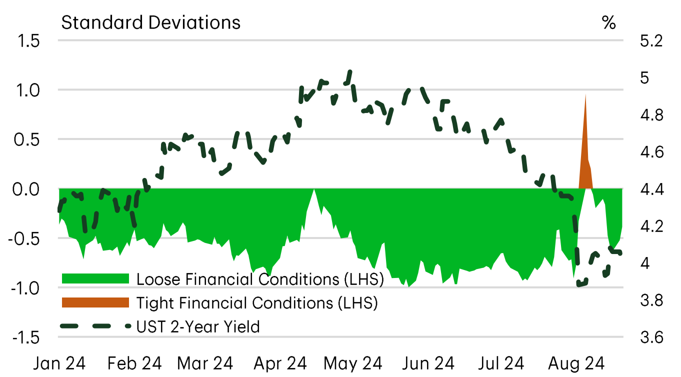
Highlights

- The Fed is finally ready to cut interest rates, but questions remain on the speed and magnitude.
- We penciled in 25 basis points per meeting, with over 250 bps in cuts over this year and next.
- However, now that the Fed is confident that inflation will return to target, it will prioritize a little more of the other side of its dual mandate – developments in the job market – to ultimately determine the speed and size of rate cuts.
- The BoC has moved earlier, established a pace of 25 basis points per meeting, and already gapped 100 basis points to its U.S. counterpart. The economic bar will be higher to deliver on larger cuts than the current pace.

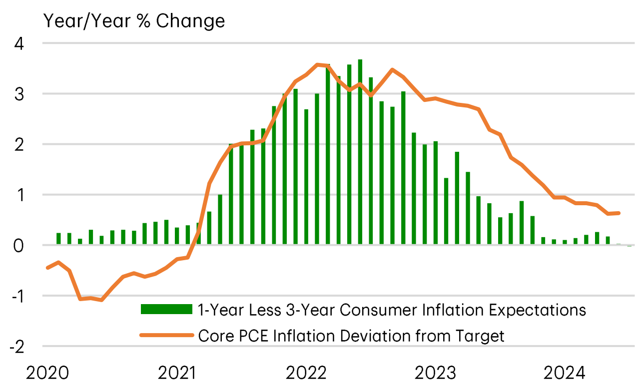
The Federal Reserve is just under three weeks away from delivering its first interest rate cut in four years. While at times it felt like the day would never come, inflation has finally stabilized close to the 2% target alongside a noticeable cooling in the labor market. The Fed's focus has now pivoted away from just fighting inflation, to striking the right balance on its dual mandate to ensure the economic landing remains a soft one. This is the stage where markets typically get nervous on whether the Fed has got the timing right, evidenced by recent bouts of financial volatility (Chart 1). The emphasis will be on downside misses in the data given that the Fed's policy rate is sitting at a lofty level of 5.50%. And with that, we can expect to see pricing jump around between a Fed that needs to act urgently to one that can move in a measured way. But in all circumstances, one prediction will hold firm: the Fed will cut interest rates

Chart 1: Brief Financial Stress Level-Shifts Yields Lower



Source: FRB, TD Economics.

Chart 2: U.S. Inflation Getting Back to Normal



Source: BEA, NYFed, TD Economics.

in September, kicking off a prolonged cycle. This is not a one-and-done deal.

From inflation fears to recession

For much of 2024, Fed members were content maintaining the policy rate at 5.50%, and at one point, a rate cut occurring at any point this year looked elusive. The first quarter reflected reaccelerating inflation and a job market that defied gravity. The Fed steadily pushed out the timing and scope from three cuts before year-end, to a mere single move in their June Summary of Economic Projections. But the tables finally turned. Inflation reversed course over the summer, pushing core PCE inflation to a comforting 2.6% year-on-year (y/y). And the trend is their friend, with the three-month annualized pace holding at the low-2% level. Even near-term consumer expectations for inflation have re-anchored to long-term levels (Chart 2). Cementing this was the July employment report, which not only showed a big drop-off in hiring, but caused the unemployment rate to resurrect the oft-referenced recession predictor, the Sahm Rule.

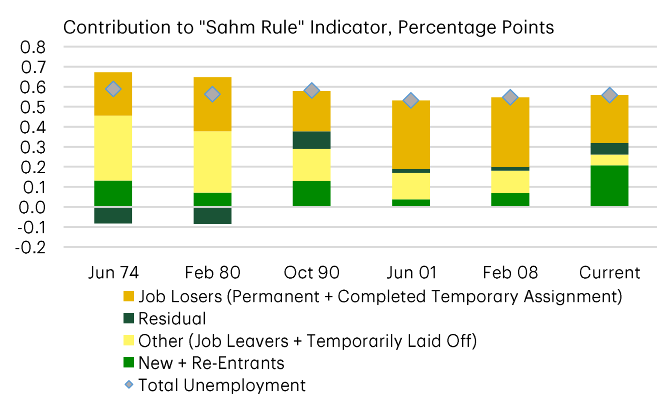
To set the record straight, we are not believers in the Sahm Rule as a hard-and-fast recession predictor, but it's a reminder of the magnitude of the downshift in labor market fundamentals. The data mining exercise is compromised when the economy reflects a surge in population and labor force growth. As Chart 3 captures, the rise in the unemployment rate within this cycle compared to the past is reflective of bulging entrants into the workforce, and not a surge in exits and layoffs. It needs to be coupled with more reliable variables used by the recession dating committee at the NBER that capture the broad status of the U.S. economy (see Table 1). This swath of recession indicators argue that the economy is still in cool-mode and not cratering. In other words, the Fed absolutely needs to start cutting interest rates to start the journey back to a neutral setting, but there's not a compelling argument to act aggressively.

How low should they go?

Once on board with the need for cuts, the next logical question is: how much? Economists apply general rules as guidance, with the updated version of the Taylor Rule being the most cited. This incorporates the state of the labor market and how far inflation is from its 2% target. Taking all this together, we find that monetary policy is between 100 to 200 basis points above where it should be given the state of the economy. The significance of this gap is why market participants react so hard to negative economic data. Any data point that signals the Fed may be behind the curve (like the weak July jobs report) is magnified when considering how much the Fed would need to cut to return to neutral levels.

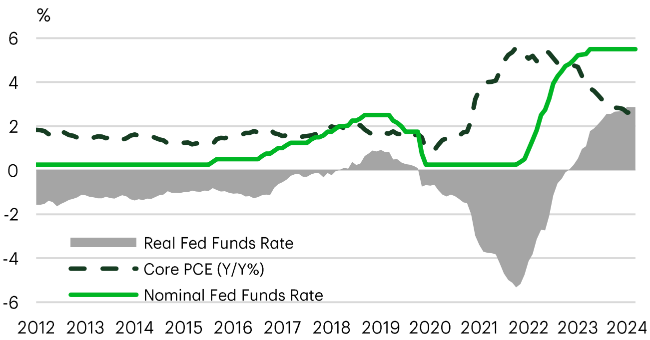
We'd be remiss if we didn't mention that there are many assumptions that go into measuring the appropriate level of the policy rate. We already highlighted the requirement to make assumptions on the state of the jobs market and to take a view of future inflation, but what is arguably hardest to measure is the real neutral

Chart 3: Sahm Rule Driven By U.S. Labor Force Growth



Source: BLS, TD Economics.

Chart 4: Inflation's Decent is Making Fed Policy More Restrictive



Source: FRB, BEA, TD Economics.

interest rate – which is that goldilocks interest rate that keeps the economy in perfect balance of not too hot, and not too cold. This rate is impossible to know in the moment, causing wide-ranging estimates. By some accounts, the dispersion is more than 100 bps. No wonder there is so much debate on just how restrictive interest rates really are!

What we do know is that the longer the Fed waits, the more restrictive the policy rate becomes. This is because inflation has continued to ease. It has been over a year since the Fed policy rate hit the current level of 5.50% and, over that time, inflation has fallen by 1.6 percentage points. Even though the Fed hasn't made any further adjustments, the real rate of interest (adjusted for inflation) keeps increasing (Chart 4). This is one of the strongest arguments for the Fed to commence the rate cut cycle and proceed in a well-telegraphed, steady pattern thereafter. Otherwise, it risks having to move in larger, more disruptive, steps of 50 basis points or more if domestic demand finally capitulates under the weight.

We anticipate the policy rate to reach 4.75% by year-end and 3.00% by the end of next year. Importantly, this path will require a change of position from the Fed, which had only penciled in one rate cut this year and four 25 bps cuts in 2025. That is more than 100 bps above our current thinking.

However, the Fed hasn't tipped its hand yet on this pivotal piece that will ultimately guide market expectations over the course of the rate-cut cycle. That will come on September 18th, at the FOMC meeting that will produce the famous "dot plot". So far, we only know from Chair Powell's speech at Jackson Hole that there's a clear intent to cut, and that the pace will be set by the data. Basically, he signaled full optionality to speed-up the pace of cuts should economic fundamentals deteriorate more than they anticipate.

BoC has cleared the path for lower rates

Less ambiguity exists with the Bank of Canada. Having already cut in June and July, the pattern of a 25 basis points per meeting has been established. The BoC came off the sideline earlier than its U.S. counterpart with a domestic economy providing convincing evidence of building slack as it narrowly avoided a technical recession in 2023. This created a more imminent risk amidst a highly leveraged Canadian. Around 50% of borrowers are still going to experience sticker shock when they renew their mortgages over the next two years, even with the central bank expected to eventually get to a neutral rate of 2.25%. That's because mortgages initiated in 2020 and 2021 benefited from historically low lending rates that are unlikely to materialize again in the absence of a severe recession.

On inflation, we have been arguing that the fundamentals of inflation were calling for interest rate cuts since the beginning of 2024. Our initial preference was for the easing cycle to commence in April, so in some respects, Canada is in catch-up mode. The degree of economic slack is evident in the inflation excluding shelter metric, which is running at 1.2% y/y (i.e. the bottom end of the BoC's target range). As the year rolls forward, the population impulse to consumer spending will wane as the government tries to wrap its arms around a run-away policy through stronger entry caps and guidance. This speaks to the clear path for the rate cut cycle to proceed uninterrupted, even amidst the usual bumps and wiggles of inflation. We estimate that the current policy rate is 125 bps to 225 bps above what we think the economy warrants. This means that the BoC, like the Fed, is slated to keep cutting at every meeting, bringing the policy rate to 3.75% by year-end and 2.50% by end-2025.

Table 1: Recession Indicators				
	Current Reading	Trend	Recessions Captured	False Warnings***
Household Survey	0.0%	↓	100%	2
Payroll Survey	1.6%	↓	100%	0
Personal Income*	1.8%	-	78%	2
Industrial Production	-0.2%	-	100%	7
Manufacturing Sales**	1.9%	↑	100%	2

Source: TD Economics. *Real income less transfers. **Real sales. ***Occurances where the indicator went negative without a corresponding recession

Interest Rate Outlook

Interest Rates	Spot Rate	2023				2024				2025			
	Aug-23	Q1	Q2	Q3	Q4	Q1	Q2	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
CANADA													
Overnight Target Rate	4.50	4.50	4.75	5.00	5.00	5.00	4.75	4.25	3.75	3.25	3.00	2.75	2.50
3-mth T-Bill Rate	4.23	4.34	4.90	5.07	5.04	4.99	4.64	4.00	3.50	3.13	2.88	2.63	2.38
2-yr Govt. Bond Yield	3.29	3.74	4.58	4.87	3.88	4.17	3.99	3.30	3.00	2.70	2.40	2.40	2.35
5-yr Govt. Bond Yield	2.97	3.02	3.68	4.25	3.17	3.51	3.51	3.00	2.90	2.75	2.65	2.65	2.60
10-yr Govt. Bond Yield	3.06	2.90	3.26	4.03	3.10	3.45	3.50	3.05	3.00	2.90	2.90	2.85	2.85
30-yr Govt. Bond Yield	3.14	3.00	3.08	3.81	3.02	3.37	3.37	3.15	3.15	3.15	3.15	3.15	3.15
10-yr-2-yr Govt Spread	-0.23	-0.84	-1.32	-0.84	-0.78	-0.72	-0.49	-0.25	0.00	0.20	0.50	0.45	0.50
U.S.													
Fed Funds Target Rate	5.50	5.00	5.25	5.50	5.50	5.50	5.50	5.25	4.75	4.25	3.75	3.50	3.25
3-mth T-Bill Rate	5.02	4.68	5.17	5.32	5.20	5.23	5.22	5.05	4.40	3.90	3.55	3.30	3.00
2-yr Govt. Bond Yield	4.01	4.06	4.87	5.03	4.23	4.59	4.71	4.05	3.75	3.45	3.15	3.05	3.00
5-yr Govt. Bond Yield	3.71	3.60	4.13	4.60	3.84	4.21	4.33	3.75	3.60	3.40	3.25	3.20	3.20
10-yr Govt. Bond Yield	3.84	3.48	3.81	4.59	3.88	4.20	4.36	3.85	3.75	3.60	3.50	3.45	3.45
30-yr Govt. Bond Yield	4.12	3.67	3.85	4.73	4.03	4.34	4.51	4.10	4.05	3.90	3.80	3.75	3.75
10-yr-2-yr Govt Spread	-0.17	-0.58	-1.06	-0.44	-0.35	-0.39	-0.35	-0.20	0.00	0.15	0.35	0.40	0.45
CANADA - U.S SPREADS													
Can - U.S. T-Bill Spread	-0.79	-0.34	-0.27	-0.25	-0.16	-0.24	-0.58	-1.05	-0.90	-0.77	-0.67	-0.67	-0.62
Can - U.S. 10-Year Bond Spread	-0.79	-0.58	-0.55	-0.56	-0.78	-0.75	-0.86	-0.80	-0.75	-0.70	-0.60	-0.60	-0.60

F: Forecast by TD Economics, August 2024; Forecasts are end-of-period.
Source: Bloomberg, Bank of Canada, Federal Reserve.

Foreign Exchange Outlook

Currency	Exchange Rate	Spot Price	2023				2024				2025			
		Aug-23	Q1	Q2	Q3	Q4	Q1	Q2	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
Exchange rate to U.S. dollar														
Chinese Yuan	CNY per USD	7.14	6.87	7.25	7.30	7.10	7.22	7.27	7.15	7.30	7.25	7.20	7.15	7.10
Japanese yen	JPY per USD	146	133	144	149	141	151	161	144	143	142	141	139	138
Euro	USD per EUR	1.11	1.09	1.09	1.06	1.11	1.08	1.07	1.10	1.05	1.07	1.09	1.11	1.14
U.K. pound	USD per GBP	1.31	1.24	1.27	1.22	1.27	1.26	1.26	1.29	1.23	1.26	1.28	1.31	1.30
Canadian dollar	CAD per USD	1.36	1.35	1.32	1.35	1.32	1.35	1.37	1.37	1.38	1.37	1.35	1.35	1.34
Australian dollar	USD per AUD	0.67	0.67	0.67	0.65	0.68	0.65	0.67	0.69	0.66	0.67	0.68	0.70	0.71
NZ dollar	USD per NZD	0.62	0.63	0.61	0.60	0.63	0.60	0.61	0.63	0.60	0.61	0.62	0.63	0.65
Exchange rate to Euro														
U.S. dollar	USD per EUR	1.11	1.09	1.09	1.06	1.11	1.08	1.07	1.10	1.05	1.07	1.09	1.11	1.14
Japanese yen	JPY per EUR	163	144	158	158	156	163	172	158	150	152	154	155	157
U.K. pound	GBP per EUR	0.85	0.88	0.86	0.87	0.87	0.85	0.85	0.85	0.85	0.85	0.85	0.85	0.87
Canadian dollar	CAD per EUR	1.51	1.47	1.45	1.43	1.46	1.46	1.47	1.51	1.45	1.46	1.48	1.50	1.52
Australian dollar	AUD per EUR	1.65	1.62	1.64	1.64	1.62	1.65	1.60	1.60	1.60	1.60	1.60	1.60	1.60
NZ dollar	NZD per EUR	1.81	1.73	1.78	1.76	1.75	1.80	1.76	1.76	1.76	1.76	1.76	1.76	1.76
Exchange rate to Japanese yen														
U.S. dollar	JPY per USD	146	133	144	149	141	151	161	144	143	142	141	139	138
Euro	JPY per EUR	163	144	158	158	156	163	172	158	150	152	154	155	157
U.K. pound	JPY per GBP	192	164	184	183	180	191	203	186	176	178	180	182	179
Canadian dollar	JPY per CAD	107.8	98.2	109.2	110.4	106.7	111.7	117.6	105.1	103.6	103.9	103.9	103.1	102.8
Australian dollar	JPY per AUD	98.4	89.0	96.3	96.4	96.2	98.7	107.4	98.7	93.6	94.8	95.7	96.7	97.6
NZ dollar	JPY per NZD	90.1	83.2	88.6	89.9	89.3	90.5	98.1	90.2	85.5	86.6	87.4	88.3	89.1
Exchange rate to Canadian dollar														
U.S. dollar	USD per CAD	0.74	0.74	0.76	0.74	0.76	0.74	0.73	0.73	0.73	0.73	0.74	0.74	0.75
Japanese yen	JPY per CAD	107.8	98.2	109.2	110.4	106.7	111.7	117.6	105.1	103.6	103.9	103.9	103.1	102.8
Euro	CAD per EUR	1.51	1.47	1.45	1.43	1.46	1.46	1.47	1.51	1.45	1.46	1.48	1.50	1.52
U.K. pound	CAD per GBP	1.78	1.67	1.68	1.65	1.68	1.71	1.73	1.77	1.70	1.72	1.73	1.76	1.74
Australian dollar	AUD per CAD	1.10	1.10	1.13	1.15	1.11	1.13	1.09	1.06	1.11	1.10	1.09	1.07	1.05
NZ dollar	NZD per CAD	1.20	1.18	1.23	1.23	1.19	1.23	1.20	1.17	1.21	1.20	1.19	1.17	1.15

F: Forecast by TD Economics, August 2024; Forecasts are end-of-period.
Source: Federal Reserve, Bloomberg.

Global Stock Markets					
Major Market Indexes	Price Aug-23	30-Day % Chg.	YTD % Chg.	52-Week High	52-Week Low
S&P 500	5,605	0.9	17.5	5,667	4,117
S&P/TSX Composite	23,177	1.6	10.6	23,177	18,737
DAX	18,579	0.1	10.9	18,869	14,687
FTSE 100	8,315	1.8	7.5	8,446	7,291
Nikkei	38,364	-3.1	14.6	42,224	30,527
MSCI AC World Index*	823	0.8	13.2	831	629

*Weighted equity index including both developed and emerging markets.
Source: Bloomberg, TD Economics.