

US FED SLAYS THE RATES BY 50 BPS BUT ADOPTS A CAUTIOUS, NON-LINEAR OUTLOOK...MINT STREET NOT LIKELY TO BREAK THE BANK(S) AS OF NOW WITH NO RATE CUTS IMMINENT IN 2024: LIQUIDITY REMAINS THE CRUCIAL CLOG IN COST OF FUNDS FOR BANKING SECTOR WITH GOVERNMENT CASH BALANCES MOVING OUTSIDE BANKS

Issue No. 14, FY25
Date: 19 Sep 2024

After setting the tone in Jackson hole, FOMC led by Governor Jerome Hayden Powell slashed the Federal funds rate by a rather brave 50 basis points (*a big shot may be, but definitely not a Jumbo cut as painted elsewhere*), **reversing one of the steepest rate tweaking phases set in motion on March'17 2022 though the reading between the lines exposes the fault lines in Fed's playbook.**

The Federal Reserve (voted 11-to-1) to slash the benchmark interest rate by 50 bps to 4.75%-5.0% for the first time in four years. US Fed sees the benchmark interest rate falling by another 50 bps by the end of 2024 (two 25-bps cut each more likely), another full percentage point in 2025, and a final half-point reduction in 2026 to end in a 2.75%-3.0% range going by the latest FOMC dot-plot. In Jun'24, the last time the Fed released quarterly projections, the median U.S. central bank anticipated just one 25 bps reduction in all of 2024. At that time Fed projected median inflation for 2024 at 2.6%. Since then, inflation eased from what had been unexpectedly strong readings early in the year and now in Sep'24 policy it has projected 2.3% median inflation for 2024. The Fed said it decided to cut rates in light of progress toward its inflation goal and with the risks to both its mandates now "roughly in balance."

However, the Fed has increased the unemployment rate projection from 4.0% in June meeting to 4.4% in September meeting for 2024. The interesting part now would be Fed's ability to navigate through the twin mandates; supporting maximum employment and returning inflation to its 2 percent objective. Despite the Fed bravely assuaging the markets'/ investors'/households' psyche through a bolstered interpretation of recent indicators suggesting the economic activity continuing to expand at a solid pace, job gains having slowed, and the unemployment rate having moved up though remaining low as Inflation has made further progress toward the Committee's 2 percent objective the general perception seems to view the bold move as a litmus test by a Central Bank worried down to the hilt by the overall stratospheric hike in prices in the last four years, coupled with higher interest outgo on mortgages and other borrowings (Credit Card outstandings have grown to \$1.14 billion as on June'24, up ~5.8% from a year ago). Coupled with this is the upwardly growing synchronization among joblessness of various ethnic groups (relatively well off Whites and Asians also showing elevation in joblessness along with Hispanics and people of color) and uncertain trajectory of non-core inflation clouding its vision.

While the Fed rates bandwidth have an overarching effect on global sentiments, in particular on investments and capital flows on real time basis, from a purely Indian perspective we believe the action largely remains a minor one for the flows to Equity markets (chiefly due to sharp rise in Buffet indicator, **the current M-cap to GDP ratio of ~141% (93% as on March'23)** which places the Indian markets at a slightly overvalued pedestal. **The bond markets may witness comparatively better inflows due to rate differentials trajectory continuing (and GoI sticking to lower fiscal deficit targets) as the RBI looks more set to depart from the 'Follow the Fed' mentality for good, having created a robust and resilient Indian financial ecosystem, fueled largely by domestic demand-supply metrics. The USD/INR however may undergo some gravitational pull to sustain the country's competitiveness on trade front, despite a weakening Dollar index.**

The aggressive rate cut by Federal Reserve has important bearing on RBIs own decision on interest rates. Although this is not explicit, fall in dollar rates impact the domestic inflation through international prices. The recent minutes of the RBI MPC do indicate discussions on possible Fed rate actions. RBI may disassociate from the interest rate developments in the US and may take independent view on the domestic rates based on evolving conditions. Domestic conditions are paramount and with robust growth higher than potential output, case of pause exists. This is further supported by the fact that impact of weak dollar on international prices and its pass through on Indian economy may evolve in coming days. Additionally, the better liquidity position may provide the cushion to the Central Bank to let the festive season tide over. **As such, we don't anticipate any rate action by RBI in calendar 2024. An early 2025 rate cut (February) looks the best bet as off now. We still believe that liquidity challenges will remain for the banking sector with Government cash balances progressively moving out of the banking system with a move towards JIT mechanism.**

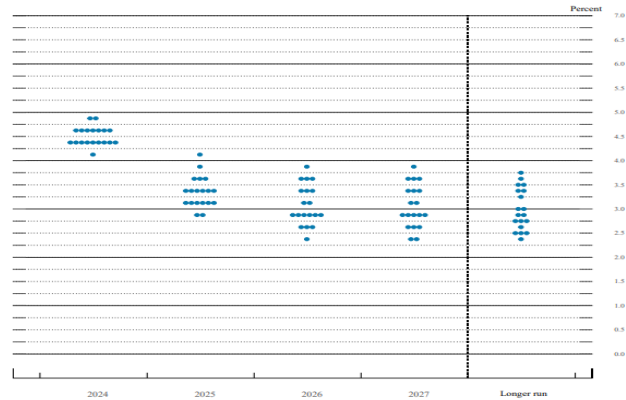
US FED CUTS RATE BY 50 BPS TO 4.75%-5.0%

- ◆ The US Federal Reserve (voted 11-to-1) slashed the benchmark interest rate by 50 bps to 4.75%-5.0% for the first time in four years.
- ◆ US Fed sees the benchmark interest rate falling by another 50 bps by the end of 2024, another full percentage point in 2025, and a final half-point reduction in 2026 to end in a 2.75%-3.0% range going by the latest FOMC dot-plot which assesses the current Midpoint of target range or target level for the federal funds rate (Each shaded circle indicates the value (rounded to the nearest 1/8 percentage point) of an individual participant's judgment of the midpoint of the appropriate target range for the federal funds rate or the appropriate target level for the federal funds rate at the end of the specified calendar year or over the longer run).
- ◆ Hence for this cycle (2024-2026), US Fed has projected to cut interest rates by 250 bps, though the cuts are not so aggressive as compared to the hikes that took place during 2022-2024 (by a whopping 525 bps, with 300 bps rise coming between mid-June and early Nov'22 alone). Even during the period of great recession US Fed had slashed rates by 250 bps. The uncertain, non-linear forward guidance on rate cuts reveals the mountain of challenges before the Fed, even though stock markets have largely written off the announcement while benchmark 10Y yields are hovering around 3.70%.
- ◆ In Jun'24, the last time the Fed released quarterly projections, the median U.S. central banker anticipated just one 25 bps reduction in all of 2024. at that time Fed projected median inflation for 2024 at 2.6%. Since then, inflation eased from what had been unexpectedly strong readings early in the year and now in Sep'24 policy it projected 2.3% median inflation for 2024. The Fed said it decided to cut rates in light of progress toward its inflation goal and with the risks to both its mandates now "roughly in balance."
- ◆ However, the Fed has increased the unemployment rate projection from 4.0% in June meeting to 4.4% in September meeting for 2024.
- ◆ The interesting part would be Fed's ability to navigate through the twin mandates; supporting maximum employment and returning inflation to its 2 percent objective.

Economic projections of Fed (%)						
	Meeting	2024	2025	2026	2027	Longer run
Change in real GDP	Sep-24	2.0	2.0	2.0	2.0	1.8
	Jun-24	2.1	2.0	2.0	-	1.8
Unemployment rate	Sep-24	4.4	4.4	4.3	4.2	4.2
	Jun-24	4.0	4.2	4.1	-	4.2
PCE inflation	Sep-24	2.3	2.1	2.0	2.0	2.0
	Jun-24	2.6	2.3	2.0	-	2.0
Core PCE inflation	Sep-24	2.6	2.2	2.0	2.0	-
	Jun-24	2.8	2.3	2.0	-	-

Source: US Fed; SBI Research

Dot Plot: FOMC participants' assessments of appropriate monetary policy



Source: FOMC, SBI Research

US Fed Major Rate Cycles since 1998			
Starting Year/Period	Event	Total Magnitude in bps	
		Hike	Cut
1998	Global Currency Crisis	-	-75
1999-2000	The Dot-Com Boom	175	-
2001	The Dot-Com Bust and 9/11	-	-475
2002-2003	Flagging Recovery, Low Inflation	-	-75
2005-2006	The Housing Market Boom	425	-
2007-2008	The Housing Market Crash	-	-325
2008	The Great Recession	-	-200
2015-2018	Returning to Normalcy	225	-
2019	Mid-Cycle Adjustment	-	-75
2020	Coping with Covid-19	-	-150
2022-2024	Taming Inflation	525	-
2024-2026 (P)	Normalcy, Low Inflation	-	-250

Source: US Fed; SBI Research; P: Projection

THE STATE OF US ECONOMY

- ◆ Despite the Fed bravely assuaging the market/investors'/household's psyche through a bolstered interpretation of recent indicators suggesting the economic activity continuing to expand at a solid pace, Job gains having slowed, and the unemployment rate having moved up though remaining low as Inflation has made further progress toward the Committee's 2 percent objective (but remaining somewhat elevated), the general perception seems to view the bold move as a litmus test by a cornered Fed worried down to the hilt by the overall stratospheric hike in prices in the last four years coupled with higher interest outgo on mortgages and other borrowings (CC outstandings have grown to \$1.14 billion as on June'24, up ~5.8% from a year ago). Coupled with this, the upwardly growing synchronization among joblessness of various ethnic groups (relatively well off Whites and Asians also showing elevation in joblessness along with Hispanics and people of color) and uncertain trajectory of non-core inflation clouding its vision.
- ◆ While the Fed rates bandwidth have an overarching effect on global sentiments, in particular on investments and capital flows on real time basis, from a purely Indian perspective we believe the action largely remains a minor one for the flows to Equity markets (chiefly due to enhanced Buffet indicator, the M-cap to GDP ratio of ~141% which place the Indian markets at a slightly overvalued pedestal forcing the large active investors to scout for relatively inexpensive markets globally. The bond markets may witness better inflows due to rate differentials trajectory continuing as the **RBI looks more set to depart from the 'Follow the Fed' mentality for good, having created a robust and resilient Indian financial ecosystem, fueled largely by domestic demand-supply metrics. The USD/INR however may undergo some gravitational pull to sustain the country's competitiveness on trade front.**

RBI RESPONSE FUNCTION TO FED RATE CUT

- ◆ The aggressive rate cut by Federal Reserve has important bearing on RBIs own decision on interest rates. Although this not explicit, fall in dollar rates impact the domestic inflation through international prices.
- ◆ The recent minutes of the RBI MPC do indicate discussions on possible Fed rate actions. The reference to Fed action is explicit in June 5 to 7, 2024 minutes and August 6 to 8, 2024 minutes. Further only on member has considered Federal Reserves action into its assessment for domestic rates.

The Buffet Indicator: Can India remain competitively attractive to FPIs



Source: FOMC, SBI Research

MPC Minutes statement	Possible clue for future
<p><i>Third, is the belief, widespread in financial markets that India cannot cut before the US Fed. <u>But the US has its own special problems that do not apply elsewhere. Many other central banks are cutting rates. The fall in India's current account deficit, index inclusion and ratings upgrade add to the many reasons that make interest differentials with the US less important. India's inflation differential with the US is also narrowing again.</u></i> [June 5 to 7, 2024]</p>	<p>RBI may disassociate from the interest rate developments in the US and may take independent view on the domestic rates based on evolving conditions.</p>
<p><i>The Fed in indicating a cut in its September meeting, pointed out that since monetary policy acts with a lag they can't afford to wait until they reach their inflation target before cutting. That lag may be responsible for the sharply adverse August jobs report that has stoked recession fears and created market volatility.</i> [August 6 to 8, 2024]</p>	<p>Domestic conditions are paramount and with robust growth higher than potential output, case of pause exists. This is further supported by the fact that impact of weak dollar on international prices and its pass through on Indian economy may evolve in coming days.</p>

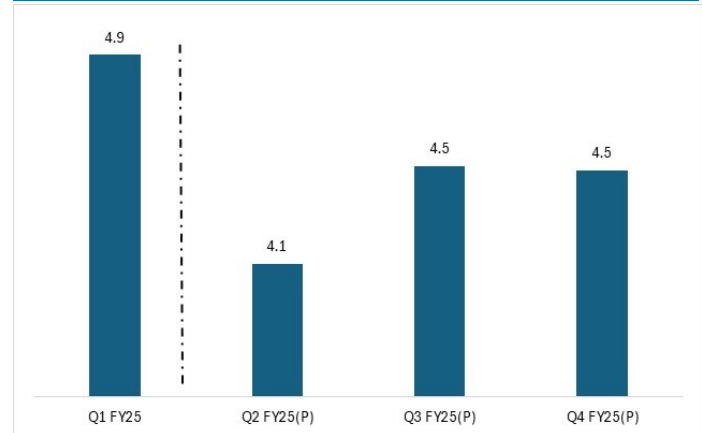
RBI and Fed rate actions (in bps)				
Event	How Fed React		How RBI React	
Housing crisis/ Recession	09.2007 to 12.2008	-525	10.2008-04.2009	-425
Returning to Normalcy	12.2015 to 12.2018	225	08.2017 to 08.2018	50
Mid-Cycle Adjustment	08.2019 to 10.2019	-75	02.2019 to 10.2019	-135
Covid-19	03.2020 to 03.2020	-150	03.2020 to 05.2020	-115
Taming Inflation	03.2022 to 07.2023	525	05.2022 to 02.2023	250
Returning to Normalcy	9.2024	-50	-	-

Source: US Fed; SBI Research

We expect, RBI will cut rates earliest in Feb 2025 due to the following reasons:

- ◆ India's CPI inflation has eased to almost 5-year low of 3.65% YoY in August, and is expected to remain below or close to 5.0% in the remaining months, except for Sep'24 and Oct'24. However, for the full year FY25, CPI inflation is likely to average to 4.6%-4.7% and will remain in the RBI's targeted range of 4-6%.
- ◆ With monsoon progressing satisfactorily with 7% surplus till date and Kharif sowing has reached 109.7 million hectares this season, surpassing the average of the last five years. As of September 17, the area sown for Kharif crops was 0.1% above the typical acreage and 2.2% more than last year's figures. Specifically, paddy sowing saw a 2.1% increase, reaching 41 million hectares compared to the five-year average. However, the area dedicated to pulses was 6.1% lower, totaling 12.8 million hectares
- ◆ Additionally, RBI is also maintaining tight liquidity to control inflation. Government surplus cash balances averages to Rs 2.8 lakh crore. Durable/core liquidity surplus has gone up to Rs 3.19 lakh crore as on 18 Sep with an average of Rs 3.9 lakh crore post last policy.

India's CPI Inflation Trajectory



Source: FOMC, SBI Research

Average Liquidity Position (Rs lakh crore)

	FY25 Average	Post policy average	18.09.2024
Repo Outstanding	0.71	0.03	0.83
Reverse Repo Total	0.38	0.69	0.17
SDF	0.83	0.90	0.96
MSF	0.07	0.05	0.05
Net LAF (-absorption)	-0.34	-1.37	0.05
Government Cash Balance (net LAF-core liquidity)	2.88	2.58	4.30
Core Liquidity (-Surplus) system liquidity adjusted with GOI Balances	-3.19	-3.93	-4.06

Disclaimer: The Ecowrap is not a priced publication of the Bank. The opinion expressed is of Research Team and not necessarily reflect those of the Bank or its subsidiaries. The contents can be reproduced with proper acknowledgement. The write-up on Economic & Financial Developments is based on information & data procured from various sources and no responsibility is accepted for the accuracy of facts and figures. The Bank or the Research Team assumes no liability if any person or entity relies on views, opinion or facts & figures finding in Ecowrap.

Contact Details:

Dr. Soumya Kanti Ghosh
Group Chief Economic Adviser
State Bank of India, Corporate Centre
M C Road, Nariman Point, Mumbai - 400021
Email: soumya.ghosh@sbi.co.in,
gcea.erd@sbi.co.in
Phone:022-22742440
 : kantisoumya