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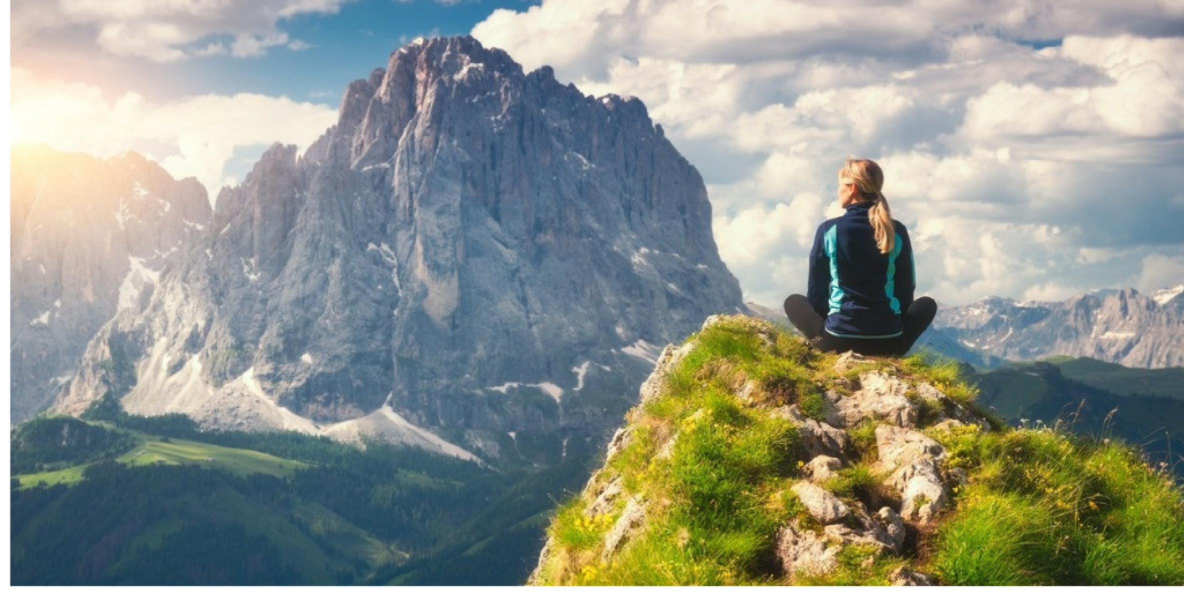


Interest Rate Cut - Can the Fed Engineer a Soft Landing

This week, the much-anticipated US Federal Reserve (Fed) decision resulted in a **0,5% reduction in its key interest rate**, marking the first cut in four years. Central banks across the globe, including South Africa, now seem to be aligned in reducing interest rates.

The Federal Reserve's shift in direction raises questions about the future of the U.S. economy. Can the central bank engineer a so-called **"soft landing"** — easing inflation without triggering a recession? Or is a recession inevitable, beyond the Fed's control? At this stage, the outcome remains uncertain.

The Role of the Central Bank

In financial markets, there is a large emphasis placed on the role of the central bank. The US Federal Reserve operates under a dual mandate: to ensure **price stability** and **maximum employment.** Its responsibilities extend to **stabilising the financial system**, particularly during crises, and supervising and regulating the banking sector.

To achieve these goals, the Federal Reserve uses several key tools:

1) Open Market Operations - This involves the Fed buying and selling securities in the open market. This injects or withdraws liquidity, influencing overall economic activity.

2) Setting Key Interest Rates - The **Federal Funds Rate** is the rate at which banks lend reserves to each other overnight. By lowering rates, the Fed encourages borrowing, investment and spending, stimulating economic growth. Conversely, by raising rates, it can cool down an overheated economy in an attempt to control inflation.

3) Reserve Requirements - The Fed can adjust the amount of reserves that banks must hold, influencing how much money banks can lend out.

4) Quantitative Easing (QE) and Tightening (QT) - Introduced during the 2008 financial crisis, QE involves the Fed expanding its balance sheet by purchasing large amounts of government bonds. This boosts liquidity in the banking system, allowing banks to lend more. In contrast, QT involves the Fed selling or letting its bond holdings mature without reinvesting. This reduces liquidity in the system. The Fed has been engaged in QT for the past two years to cool down inflationary pressures.

In his address this week, Fed Chair Jerome Powell justified the 0.5% rate cut by stating: "*The U.S. economy is in a good place. Inflation is coming down, and while the labour market has cooled, it remains strong.*" He emphasised that this rate cut helps return interest rates to a more **neutral level** after the aggressive rate hikes used to combat post COVID inflation.

The chart below illustrates the trajectory of U.S. interest rates, which peaked in the early 1980s. Post-COVID inflation triggered by a substantial expansion of the Fed's balance sheet, resulted in much higher interest rates.

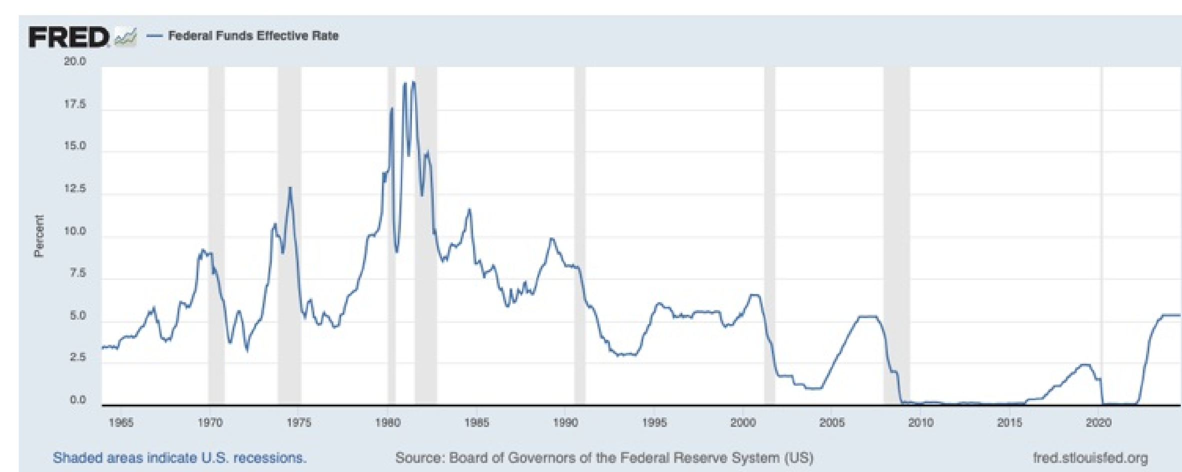
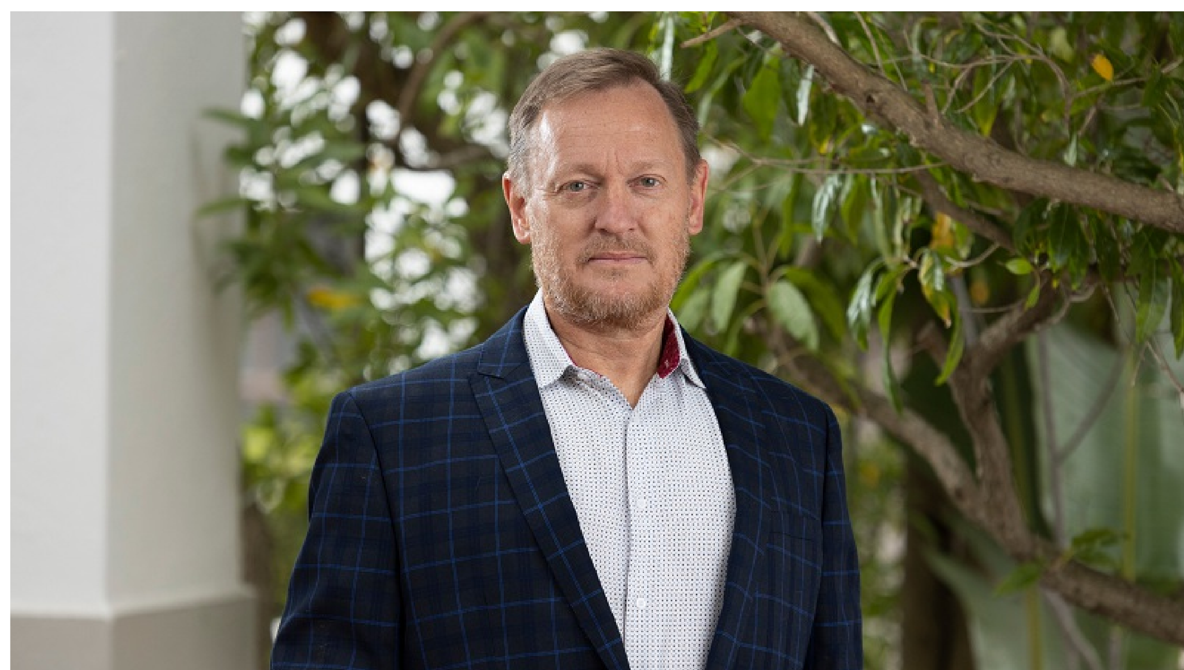


Chart Source/s: Board of Governors of the Federal Reserve System (US)

Conclusion

Setting short-term interest rates is just one of the many tools central banks use to manage economic activity. In a world built on debt, **governments often prefer to stimulate the economy** rather than restrain it, explaining their tolerance for lower interest rates and moderate inflation. Investors should always consider this when making **asset allocation** decisions.



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If you have any questions, Ian and our team would love to hear from you on global@seedinvestments.co.za.

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