September 16, 2024

Economic INSIGHT

A Policy Pivot Leaves Unanswered Questions Regarding Size and Pace

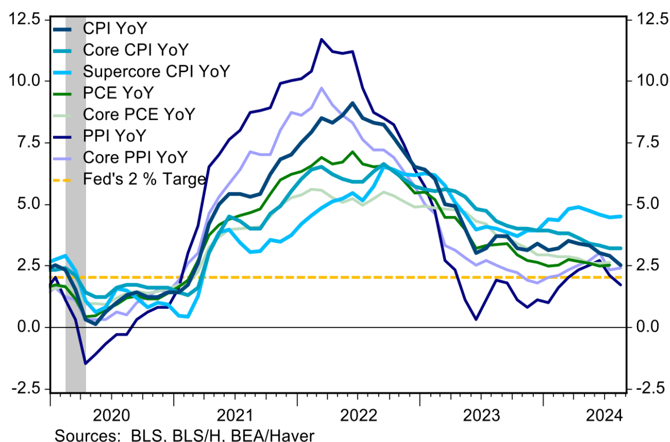
With inflation improving somewhat and indications the labor market is cooling, monetary policy makers have signaled the time is now upon us to begin a reduction in policy firming. Federal Reserve (Fed) Chairman Jerome Powell said as much at the annual Jackson Hole Symposium, declaring "*the time has come for policy to adjust.*"

Of course, while the direction of travel may be clear, Powell said, the specifics of the policy pathway "*will depend on incoming data, the evolving outlook, and the balance of risks.*" Thus, as the market awaits with bated breath for the first policy adjustment since July 2023, the bigger questions are about the size of the initial policy pivot and the communication commitment, if any, to future rate adjustments.

BACKING OFF FROM A MORE AGGRESSIVE FORECAST

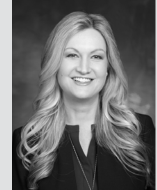
Following a somewhat mixed August employment report, interest rate futures contracts were pricing in a 50 basis point (bps) cut in September at 59%. Since then, those forecasts have narrowed to a 17% probability, or roughly less than a one in four chance. The decline can be attributed to more tempered comments from policy makers and a relatively benign August inflation read.

Speaking after the release of the August employment report, Fed Governor Christopher Waller, for example, indicated he would consider a larger response out of the gate, but only if "warranted" by the data. In other words, he hinted that his base case was a more controlled 25 bps reduction unless there was a material downward revision to the Committee's assessment of the labor market or inflation.



Sources: BLS, BLS/H, BEA/Haver

While the latest payroll increase was disappointing relative to expectations, the broader report continues to support the notion of an ongoing solid labor market. Falling short of the 165,000 increase expected, at 142,000, the August gain marks a three-month high. Additionally, with a 168,000 rise in household employment offsetting a 120,000 gain in the labor force, the unemployment rate ticked down from 4.3% to 4.2% in August, while leaving the participation rate steady at 62.7%. Furthermore, average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hourly earnings rose 0.4% for the month, double the gain in July and increasing from 3.6% to 3.8% on an annual basis.

Inflation, meanwhile, continues its descent back toward 2%, but at a consistently inconsistent pace. The latest read on the Personal Consumption Expenditures (PCE) price index showed no further progress in July, with both the headline and core steady at 2.5% and 2.6%, respectively. And more recently, earlier this week, the latest read on consumer prices was somewhat hotter than expected. The headline Consumer Price Index (CPI) rose 0.2% in August and 2.5% on an annual basis, as expected, down from the 2.9% annual gain in July. Excluding food and energy costs, however, the core CPI rose 0.3% in August, a tenth of a percentage point more than expected and rose 3.2% on an annual basis for the second consecutive month.

The Producer Price Index (PPI), furthermore, rose 0.2% in August, a tenth of a percentage point more than expected, albeit cooling from 2.1% to a 1.7% annual pace, the smallest increase since February. Excluding food and energy costs, however, the core PPI rose 0.3%, also a tenth of a percentage point more than expected, and ticked up from 2.3% to 2.4% year-over-year.

THE FED'S INTENTIONS

While the labor market appears less tight relative to the start of the year, there is still a positive pace of hiring and low level of unemployment. These conditions appear to support the notion of an economy simply normalizing as opposed to facing impending weakness. Meanwhile, after three months of ascent, inflation has largely resumed a disinflationary path, or at the very least has not shown any indications of a reversal in trend. Coupled with a topline growth rate of 3.0% in Q2 and expectations for the U.S. economy to continue to expand at a faster pace than the Fed's longer-run projection of 1.8% in the coming years, there is no sense of urgency or immediacy in the data to quickly adjust from the current policy stance. As result, the Fed is less likely to take a more aggressive approach, but rather one of patience as the data continue to evolve, maintaining a base case of 25 bps cuts beginning next week with a *consideration*, but not a commitment, to action at every subsequent meeting.

In fact, if the Fed did make a more sizable policy adjustment in September, the market would likely misread or misinterpret such action as an intention to rush back to an *accommodative* stance as opposed to simply reduce policy firming as price pressures move closer to the target. As San Francisco Fed President Mary Daly, among others, has pointed out, as inflation comes down, "*policy gets more restrictive*." This could be a recipe for "*overtightening and injuring the labor market and growth*." At this point, the Fed is simply trying to remove barriers or restraints on growth, but there is no need to provide artificial stimulus or support.

INVESTORS' OPTIMISM VS. STRUCTURAL REALITY

Heeding the warning of a more cautious approach to unwinding policy firming issued by Committee members, investors have dialed back expectations for a more sizable rate cut in September. However, the market is still anticipating a rate reduction at every meeting in the remaining four months of the year, with at least 100 bps in rate cuts by year-end. Furthermore, market players expect the Fed to consistently and systematically reduce rates, potentially breaching the upper bound of the "*neutral*" range before potentially reaching a low of 2.74% by mid-2026.

Of course, not all metrics are pointing to a more "*supportive*" monetary policy scenario, potentially allowing the Fed to quickly take its foot off the brake. And, certainly not to

GLOSSARY

CPI – Consumer Price Index

FOMC – Federal Open Market Committee

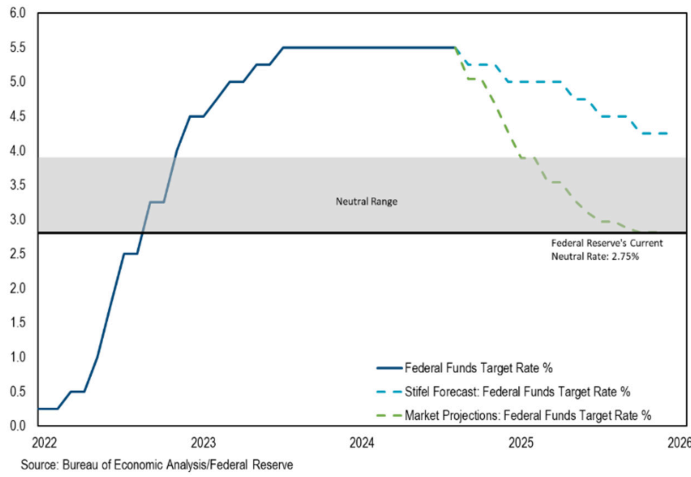
PCE – Personal Consumption Expenditures

PPI – Producer Price Index

SEP – Summary of Economic Projections

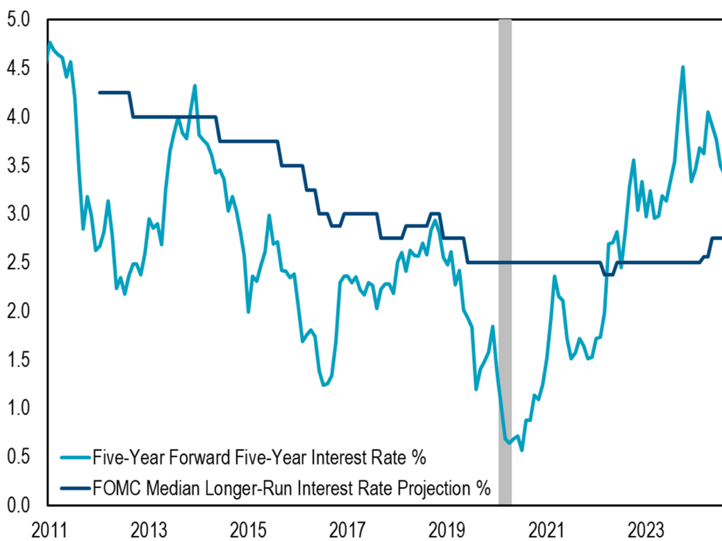
YoY – Year over Year

the tune of 200 bps in rate cuts in the next nine months. In fact, by some measures, the market continues to indicate a potential limitation to the Fed's ability to reduce policy both in the near- and longer-term as the neutral policy rate may be higher than previously indicated even by policy makers themselves.



As a purely theoretical concept, the neutral rate cannot be measured or quantified. It simply represents the ideal or utopic level of policy that neither stimulates nor slows underlying growth. Also known as r*, the neutral rate helps guide policy decisions in terms of how aggressively to adjust rates higher or lower throughout a rate cycle.

At present, the Fed has indicated a "*neutral*" forecast of 2.75%; however, the market has indicated the rate may be substantially above central bank predictions. The five-year forward five-year rate, for example, used as a proxy for the longer-run expectation for rates has stalled around 3.4%. While down notably from a peak of 4.5% in October, it is 120 bps above the 2.2% average for the five years leading up to the pandemic and roughly 65 bps above the Fed's current estimate of 2.75%.



If the market's gauge of r* is correct and it has meaningfully moved higher either because of changed structural factors, such as massive and growing budget deficits or other variables, this limits the downside potential for policy easing as the Fed seeks to remove restrictive policy. After all, if r* proves to be closer to 4%, assuming 25 bps cuts at each meeting, the Committee could potentially reach neutral by second quarter 2025 after around eight cuts. A higher neutral rate also essentially raises the floor for longer-term rates, exacerbating the potential for investors' disappointment and upside movement in yields under the scenario of Wall Street accepting a reality of relatively "*higher for longer*" version 2.0.

ONUS ON THE FED

Despite little meaningful further improvement in inflation over the past six weeks (since the July Federal Open Market Committee meeting), Powell has clearly indicated the time

has come for a new direction of policy. But the clarity stops there. The size and pathway for policy adjustments remains unclear. While the majority of policy makers have indicated the need for a tempered approach to rate reductions given the still-relatively solid nature of conditions in both the labor market and the boarder economy, as well as the fear of falling into a position of cutting rates too quickly then having to "*raise rates again,*" the market remains overzealous in its forecast for a rush to neutral and below.

While the September statement is likely to reiterate a data-dependent stance, an updated Summary of Economic Projections (SEP) including the famed dot plot will likely offer a welcomed quantification of the Committee's expectations, as well as an opportunity for longer term yields to reset – and reprice higher – via investors' expectations for a more expedited sequence of policy firming removal. Previously anticipating one rate cut by year-end, the Fed's expectations for less restrictive policy are unlikely to be materially revised from June with an upside of an additional 50 bps, emphasizing a slow and patient approach to adjustments despite opening the door for a policy pivot.

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"*I don't want us to be in a situation where we cut, and then we have to raise rates again: that would be a very bad,*"
Atlanta Fed President Raphael Bostic said at Stanford event in Atlanta on August 26.

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