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Varying Federal Reserve Speak Indicates a Lack of Consensus Among Officials Amid Ongoing Uncertainty

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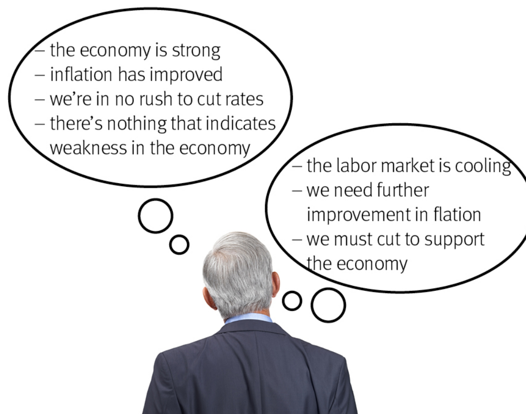
Appeasing market demands, the Federal Reserve (Fed) opted to initiate the latest policy pivot with a sizable 50 basis point (bp) cut – a move Federal Reserve Chairman Jerome Powell called a "*strong start*." With the Fed signaling a willingness to do whatever it takes to support the labor market, and by extension the economy, investors are questioning whether or not a soft landing is on the horizon and if further sizable cuts are on the way. They are also asking if the Fed's willingness to take a more aggressive leap out of the gate signals a heightened level of concern regarding the state of domestic conditions and possibly a recognition of falling behind the curve when it comes to stabilizing the economy.



The wide-ranging perspectives of Fed officials last week indicates there is a clear lack of consensus among them.

NORMALIZING INTEREST RATES

According to Powell, the Committee's need for more aggressive action was not to play catch up from a disadvantaged position, but rather to ensure policy remains at an appropriate level and does not unnecessarily dampen conditions, which could assist in avoiding a meaningful slowdown or outright technical recession. In other words, acknowledging the recent cooling in labor market data, the Fed's latest policy announcement was not an admission of an earlier policy error or tardiness to the policy easing party, but an indication of policymakers' commitment to not fall behind the proverbial policy curve.

As conditions and the risks to employment and inflation move into better balance, the Fed must adjust its policy goals. Rather than keep its foot on the break, the goal now is to "*normalize*" interest rates at a level that neither stimulates nor retards growth.

"*We have made sufficient progress on inflation, and the labor market has exhibited enough cooling, that the time has come to shift the direction of monetary policy to better reflect the more balanced risks to our price stability and maximum employment mandates that have emerged over the course of the year.*"

– Atlanta Fed President Raphael Bostic, Virtual European Economics and Financial Centre event, September 23, 2024

50 BPS IS NOT THE NEW BLACK

The Fed's willingness to cut 50 bps rather than 25 bps in September does not imply an ongoing commitment to outsized rate reductions. Speaking during the Q&A portion of the September press conference, Powell was clear the Committee is in "*no rush*" to

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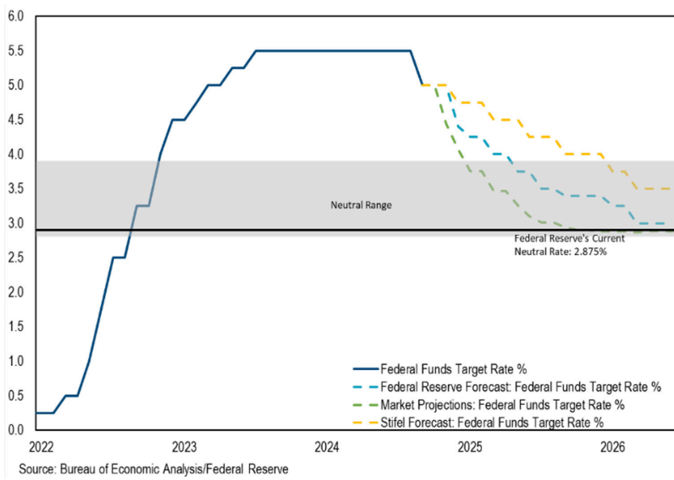


Source: Bureau of Economic Analysis/Federal Reserve

cut rates and insisted that half-point cuts should not be seen as the new pace of policy adjustments. Of course, this potentially leaves the door open to disappoint investors anxious to return to an era of easy money policy. Despite clarification of the Committee's motives, the risk of a 50 bp move was always sending an inappropriate signal of the Fed's intentions to rush back to an accommodative stance to aid an ailing economy as opposed to simply moving towards neutral as conditions normalize.

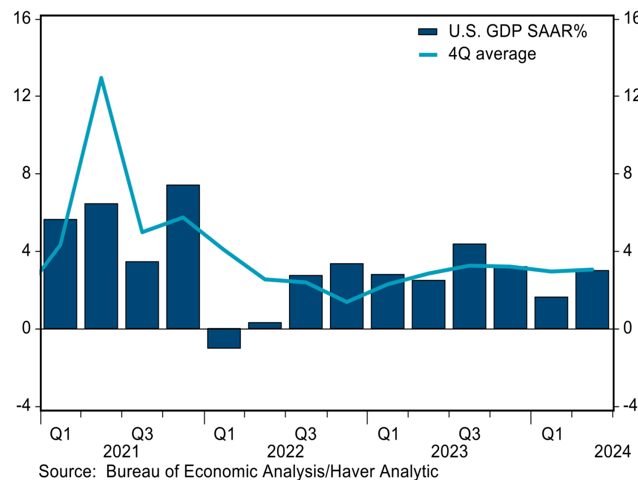
In fact, highlighting the "*healthy*" nature of the economy, solid nature of the consumer and labor market conditions, along with the need for still further improvement in prices and little risk of a downturn, the statement and commentary during the press conference struck a semi-hawkish tone in terms of underscoring the need for a patient stance and approach to policy going forward. While the latest dot plot showed a notably accelerated pathway to neutral relative to an earlier June forecast, with expectations of an additional 50 bps in cuts by year-end, coupled with a further 100 bps in rate reductions next year, the Fed's updated outlook still falls well shy of the market's expectations.

Even after the Fed's first-round cut, policy remains restrictive, or above the neutral level. However, future cuts are likely to be smaller than the one earlier this month, with the base case returning to 25 bps amid consideration but not a commitment to rate cuts at every subsequent meeting, depending on the evolution of the data.

In an essay detailing his support for a 50 bp cut in September, Minneapolis Fed President Neel Kashkari, for example, advocated for further rate cuts this year, albeit at a reduced and more tempered pace. "*I was comfortable taking a larger first step, and then as we go forward, I expect, on balance, we will probably take smaller steps unless the data changes materially,*" Kashkari said.

DATA DEPENDENT

Going forward, the policy pathway will depend on the further improvement, or lack thereof, in the incoming data, particularly the inflation data. The Fed's positive assessment of conditions and expectations for sustained progress towards the Committee's longer-run goal continues to provide support and comfort to investors hopeful of achieving a soft landing. Although only a realized quantification – and hindsight – will provide clear judgment.



Source: Bureau of Economic Analysis/Haver Analytic

GLOSSARY

CPI – Consumer Price Index

FOMC – Federal Open Market Committee

GDP – Gross Domestic Product

PCE – Personal Consumption Expenditures

PPI – Producer Price Index

SAAR – Seasonally Adjusted Average Rate

SEP – Summary of Economic Projections

YoY – Year over Year

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"*I don't see anything in the economy right now that suggests that the likelihood of a downturn is elevated.*"

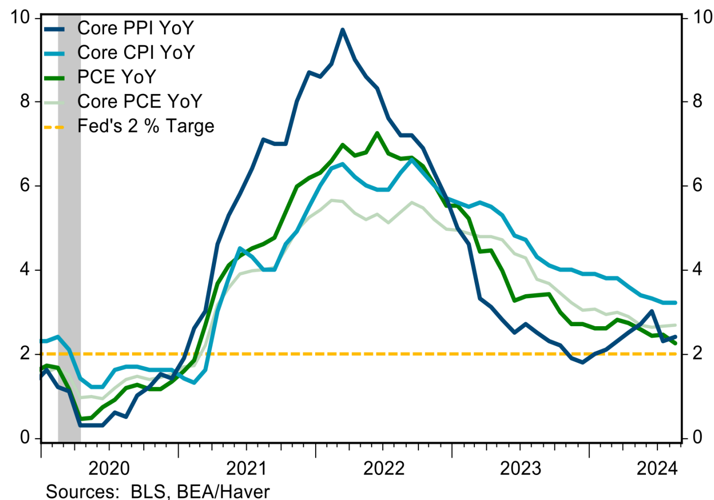
- Federal Reserve Chairman Jerome Powell, September 18 Federal Open Market Committee Press Conference

The latest lookback at Q2 GDP underscores the Committee's current position of contentment. With growth accelerating from 2.8% in the initial Q2 print to a final round print of 3.0% April to June, a two-quarter high, the economy appears well positioned to withstand a slow and tempered pace of policy firming removal. Of course, a more significant slowdown in consumer spending or a more sizable cooling in labor market conditions could undermine growth, quickly prompting a more notable and timely reaction from the Fed, as well as prompting investors to lose confidence in the Fed's ability to cushion the economy from a downturn.

But while the current data give no reason for concern or indication of mounting weaknesses ahead, rather than "*wait until problems show up*," Chicago Fed President Austan Goolsbee says he sees reason to take action sooner than later with many more rate cuts over the next year. Interest rates, Goolsbee explained, need to be lowered "*significantly*" to protect the U.S. labor market and support the U.S. economy as inflation continues to improve.

"*As we've gained confidence that we are on the path back to 2%, it's appropriate to increase our focus on the other side of the Fed's mandate — to think about risks to employment*," Goolsbee said.

Of course, a controlled and orderly retreat in price pressures is far from a foregone conclusion. While the Fed's target remains in sight, the goal of 2% has not yet been met. As such, even those policy makers in favor of a more expeditious pathway to neutral recognize the "*job is not yet done;*" reengaging in a welcomed pathway of disinflation since the spring, policy makers acknowledge the ongoing struggle with still-elevated price pressures and uneven progress. The Fed's outlook for inflation was somewhat improved in the latest Summary of Economic Projections (SEP), with the pathway back to the target level less steep. Although, the Committee still maintains a longstanding forecast that price stability at 2% will not be met until 2026, some two years from now.



The latest look at inflation provided even more uncertainty against the broad-based expectations for an orderly reduction in prices back to 2%. In August, for example, the core Consumer Price Index (CPI) remained steady relative to the prior month's pace, with the core Producer Price Index (PPI) ticking higher from 2.3% to 2.4% in August and positing no further improvement since June. This week, the latest read on Personal Consumption Expenditures (PCE) was mixed with the headline rising a muted 0.1% in August and 2.2% on an annual basis, down from

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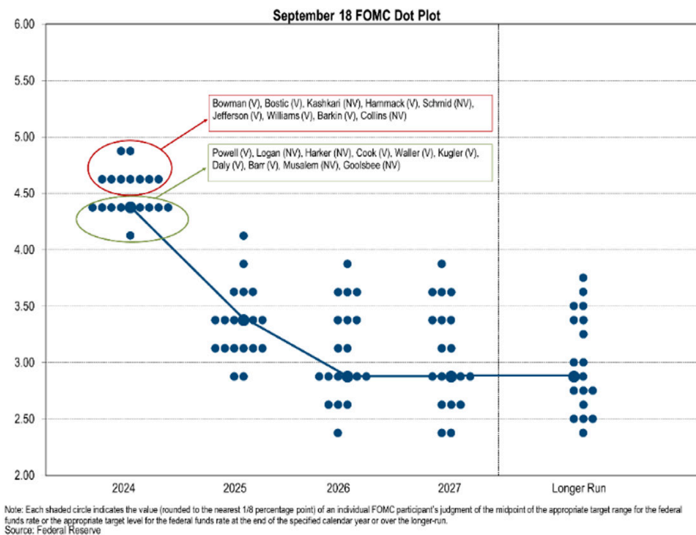
a 2.5% increase the month prior and reaching the slowest pace of ascent since February 2021. The core PCE, however, after moving sideways the prior month, rose 2.7% annually, rising from the 2.6% annual gain in July, perpetuating fears of not only an ongoing battle with inflation but the dreaded scenario of stagflation. After all, falling inflation and rising unemployment clearly warrants a supportive Fed. But the pathway of policy becomes less clear amid the conundrum of slowing growth and still elevated prices.

Joining Stifel earlier this week at a Kentucky Bankers Association event, Fed Governor Michelle Bowman noted lingering concerns that upside risks to inflation remain. "*Turning to the risks to achieving our dual mandate, I continue to see greater risks to price stability, especially while the labor market continues to be near estimates of full employment,*" Bowman said. Bowman was the sole dissent at the September meeting, casting favor of a smaller 25 bp reduction. Supporting her decision last week, Bowman noted that in her view, "*beginning the rate-cutting cycle with a quarter percentage point move would have better reinforced the strength in economic conditions, while also confidently recognizing progress toward our goals.*"

CONCLUSION

Market participants appear increasingly divided over the size of the Fed's next policy adjustment. While the latest decline in consumer confidence data has upped expectations for a second-round 50 bp cut in November, a backup in inflation expectations, as well as a solid reading on Q3 GDP and a lack of meaningful improvement in inflation for the past two months, have others betting on a smaller quarter-point reduction, or even floating the notion of a potential pause. Mixed messaging from Fed officials is further muddying the waters, underscoring the uncertainty in the pathway forward, as each move remains "*data-dependent.*"



Note: Each shaded circle indicates the value (rounded to the nearest 1/8 percentage point) of an individual FOMC 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.
Source: Federal Reserve

While investors remain broadly optimistic for further action with more than 70 bps of additional cuts priced in by year-end, Fed officials appear relatively more reserved in their predictions. The more dovish members of the Committee anticipate 50 bps (nine officials) or up to 75bps (one official). On the other hand, seven of the more hawkish leaning members anticipate just one additional 25 bp rate cut by year-end, with two expecting no further adjustment in policy in 2024. The division in expectations, not just between the market and the Fed, but among policymakers themselves is indeed notable, suggesting 1) the decision between a 25-bp and 50-bp cut last week likely was a very close call and 2) going forward, each subsequent decision is likely to be met with a robust debate.

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