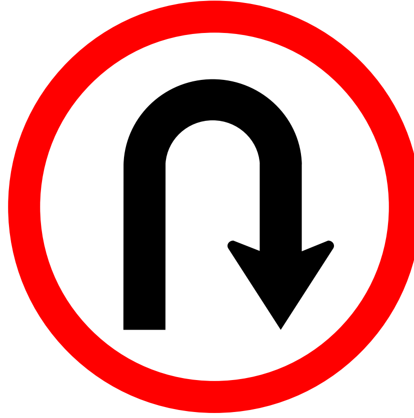
October 28, 2024

After a "Strong Start," What's Next?



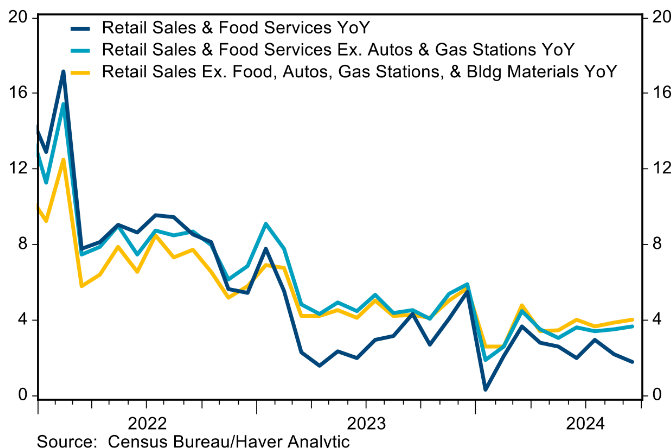
Driven by the fear of impending weakness in the labor market, the Federal Reserve (Fed) opted to cut interest rates by a larger-than-expected 50 basis points (bps) at last month's meeting. Since that policy pivot, however, the data has come in surprisingly strong, calling into question not only the rationale for the Fed's decision, but also the need for additional cuts in the near term.

Fed officials have subsequently amended their policy message to market participants, insisting they are in "*no rush*" to reduce rates and that 50 bps should not be seen as the new "*normal*" pace for reductions going forward. Investors, meanwhile, are also recalibrating their expectations, now anticipating fewer rate cuts and a less expeditious pathway towards neutral policy.

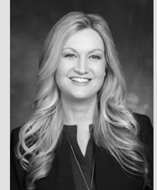
STRENGTH IN THE NUMBERS

Since the September 18 policy pivot, the latest data is hardly indicative of an ailing economy in need of monetary support. In fact, the latest economic reports suggest ongoing consumer resilience, a strong pace of job creation and, by some metrics, reaccelerating price pressures.

- **Consumer Spending:** Retail sales rose 0.4% in September, a tenth of a percentage point more than expected and the strongest monthly gain since July. Year-over-year, retail sales increased 1.7% in September, the smallest annual gain since January. Excluding autos and gasoline sales, however, core sales rose 0.7% at the end of Q2 and increased 3.7% year-over-year, a six-month high. Furthermore, excluding food, autos, building materials, and gasoline station sales, control group sales – which feed directly into the GDP calculation – rose 0.7% in September, more than double expectations, and gained 4.0% on an annual basis, the largest annual rise since June.



Source: Census Bureau/Haver Analytic



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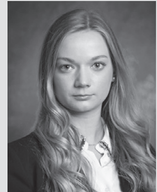

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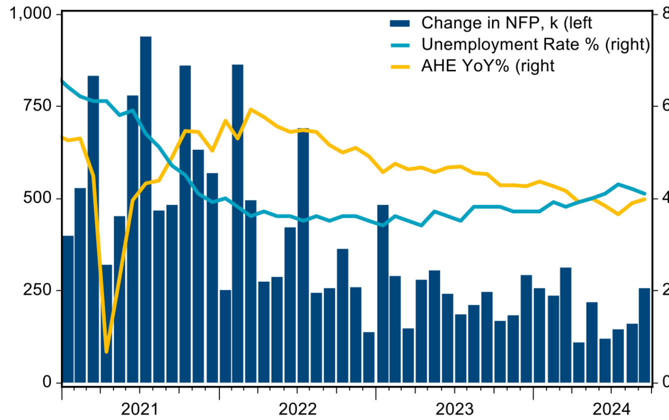
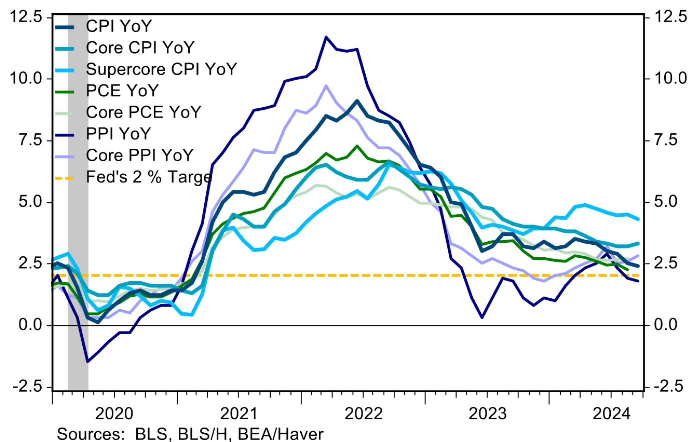
- **Hiring:** With widespread gains in everything from education and health to leisure and hospitality, nonfarm payrolls surged by 254,000 in September, well surpassing the 150,000 gain expected and marking the largest increase in six months. The unemployment rate also indicated further strength, ticking down from 4.2% to 4.1% in September, a three-month low and still well below what the Fed considers full employment. Additionally, average hourly earnings rose 0.4% in September and increased 4.0% on an annual basis, up from a 3.9% pace in August and marking the largest annual gain in four months.



- **Inflation:** The Consumer Price Index (CPI) rose 0.2% in September, a tenth of a percentage point more than anticipated and increased 2.4% on an annual basis, also a tenth of a percentage point above exceptions. Excluding food and energy costs, the core CPI rose 0.3% in September for a second consecutive month and gained 3.3% year-over-year, the largest annual gain in three months. On the producer side, while the headline slowed from 1.9% to a 1.8% pace in September, the core Producer Price Index (PPI) rose 2.8% year-over-year, up from a 2.6% pace in August, and marking a three-month high. Finally, the headline Personal Consumption Expenditures (PCE) increased 2.2% in August, a tenth of a percentage point below expectations and a decline from the 2.5% annual increase in July. However, excluding food and energy, the core PCE – the Fed's most preferred measure of inflation – gained 2.7% over the past 12 months, rising from the 2.6% annual pace in July and marking a three-month high.



GLOSSARY

CPI – Consumer Price Index

FOMC – Federal Open Market Committee

PCE – Personal Consumption Expenditures

PPI – Producer Price Index

YoY – Year over Year

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MIXED MESSAGING FROM THE FED

Immediately following last month's rate announcement, Fed officials began back peddling, straining to rein in market expectations for a more rapid descent in policy back to, and potentially below, neutral by instead underscoring the healthy and solid nature of domestic activity. As we've noted before, there was always a risk that a 50 bp cut would send an inappropriate signal of the Fed's intentions to provide accommodation to a weakening domestic environment as opposed to simply unwinding policy firming back toward neutral as the data normalizes. That messaging has been further complicated by the opposing commentary from Fed officials, some warning of upside inflationary risks and the need for less policy action going forward versus those in favor of an ongoing aggressive approach to rolling back the current elevated level of rates for fear of budding weakness in the U.S. labor market.

- **September Federal Open Marke Committee (FOMC) Statement:** In a somewhat surprising twist, the Fed opted to take a sizable jump to begin its easing cycle, but it also tempered the move with a semi-hawkish statement. The Committee cut rates by 50 bps, lowering the upper bound of the target range from 5.50% to 5.00%. In the details of the statement, however, the Committee offered a positive assessment of conditions, noting growth continues to expand at a "*solid*" pace, amid a "*low*" unemployment rate and still "*elevated*" inflation.

- **September Press Conference:** During the press conference, Fed Chairman Jerome Powell insisted the Fed is in "*no rush*" to cut rates and that half-point cuts should not be seen as the new normal pace of policy adjustments going forward, potentially leaving room to further disappoint investors anxious for a return to easier money policy.

- **Atlanta Fed President Raphael Bostic:** Bostic underscored the motivation for the September 50 bp cut as a meaningful move towards neutral as the risks between employment and inflation come into better balance. He went on to warn that policy is not on a predetermined pathway, and policy makers should not commit to a particular cadence of moves going forward as uncertainty remains in the evolution of the data as well as over where the so-called neutral rate truly is. "*My residual concern about inflation might have led me to settle on a relatively small first move last week—say, 25 basis points. But such a move would belie growing uncertainty about the trajectory of the labor market,*" Bostic said.

- **Minneapolis Fed President Neel Kashkari:** Echoing Bostic's call for a slower, more tempered pace of rate cuts, Minneapolis' Kashkari said he expects to lower rates by smaller, 25 bp increments going forward, unless of course the data changes materially. "*After 50 basis points, we're still in a net tight position so I was comfortable taking a larger first step. As we go forward, I expect, on balance, we will probably take smaller steps unless the data changes materially,*" Kashkari said.

- **Fed Governor Michelle Bowman:** Governor Bowman, meanwhile, has been clear that upside risks to inflation remain. Bowman also commented on her dissenting vote in September, noting that in her view a smaller cut would have better identified the strength in economic conditions while still making progress in a policy adjustment. "*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.

- **Cleveland Fed President Beth Hammack:** Adding to the mix, Cleveland Fed President Beth Hammack said she was not ready to drop the mission-accomplished banner.

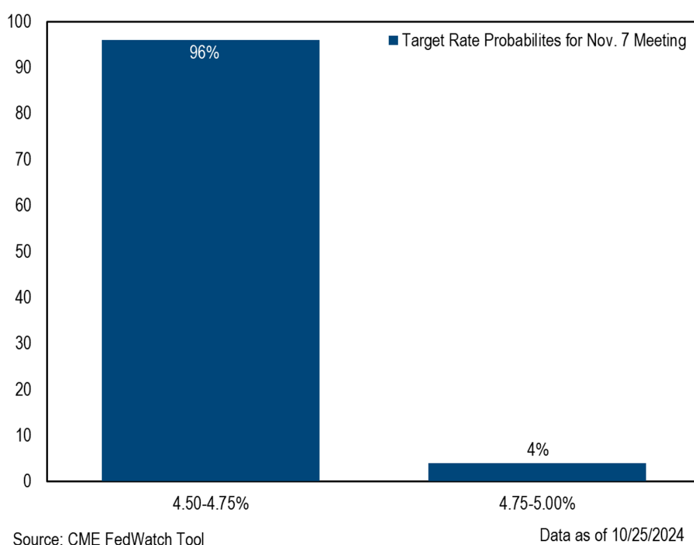
Speaking at a conference held by the Cleveland Fed, Hammack said, "*We have made good progress, but inflation is still running above the FOMC's 2% objective*."

- **Chicago Fed President Austan Goolsbee:** Taking a more aggressive and notably dovish position, Goolsbee championed the Fed's latest outsized cut and said further aggressive action is warranted. In fact, Goolsbee said he sees many more rate cuts over the next year, as interest rates need to be lowered "*significantly*" to protect the U.S. labor market and support the U.S. economy. "*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.

- **San Francisco Fed President Mary Daly:** Speaking at The Wall Street Journal's TechLive conference in Laguna Beach, California earlier this week, San Francisco Fed President Mary Daly said she supports further interest rate cuts in an effort to stave off further weakness in the labor market. "*So far, I haven't seen any information that would suggest we wouldn't continue to reduce the interest rate*," Daly said. "*This is a very tight interest rate for an economy that already is on a path to 2% inflation, and I don't want to see the labor market go further.*"

WHAT TO EXPECT GOING FORWARD

The growing positivity in the data from a robust employment report to hotter-than-expected spending to elevated core prices suggests the September decision to cut 50 bps may have been excessive and is furthermore muddying the outlook for future policy adjustments. Going forward, any additional indications of underlying strength amid sticky inflation will increase calls for a lesser 25 bp cut next month or even allow the Fed to bypass November altogether, before turning to December, the final meeting of the year. According to market metrics, investors have taken a second-round 50 bp cut off the table, pricing in a smaller 25 bp reduction at 96%.



Reasons to Bypass November

- The latest data suggests the economy is not only on solid footing but upside risks to inflation remain and could intensify amid a declining level of policy restriction. While the Fed has a clear dual mandate of stable prices and full employment, with the latter seemingly satisfied for the moment, the former has clearly not yet been achieved. In considering additional adjustments to the federal funds target range, the Committee will "*carefully assess incoming data, the evolving outlook, and the balance of risks.*"

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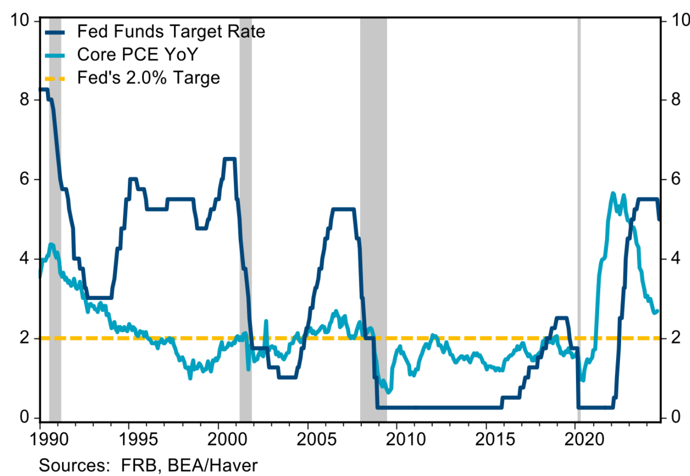
- Allowing inflation to remain above the target level for a prolonged period of time risks undermining the prospects of a soft landing and potentially sending the economy into a scenario of stagflation. Additionally, tolerating a sustained elevated level of price pressures could allow inflation to gain further momentum, eventually forcing the Committee to reengage in policy firming beyond what would have been necessary had they dealt with inflation the first time around. Keep in mind, historically, the Fed is required to raise rates above the peak in inflation to assure a return of price stability. Thus, with core PCE peaking at 5.6%, a federal funds rate of 5.5% was the bare minimum that should have been expected in terms of policy action, particularly given the unprecedented growth in the money supply and fiscal stimulus pumped into the market amid the COVID-19 pandemic.

- Given the close proximity of the November FOMC meeting and next month's presidential election, amid uneven data at best, forcing through a second-round policy adjustment with market metrics already questioning the initial September rate decision, could be viewed as politically motivated.



Reasons to Stay the Course with an Additional 25 bp Cut

- Fears of mounting weakness in the labor market could convince some policy makers further rate cuts are warranted. While job creation remains solid and the unemployment rate is still well below the full employment range, the recent uptick in jobless claims, while mostly explained away by temporary disruptions due to the hurricanes, could also in part reflect furloughs at auto makers and the spillover effect of the Boeing strikes as well as increasing weakness in areas such as housing and manufacturing.

- Given the decision for an outsized rate cut last month, bypassing November could be interpreted as an omission of an earlier policy error. Thus, even if the strength in the latest rounds of data warrant a pause near-term, the Fed may be more willing to follow through with an additional – albeit smaller– 25 bp cut to maintain credibility among market players, while still preserving the optionality for bypassing December as needed.

- Holding rates steady in November could perpetuate claims the Fed's decision to act in September was purely political. Given the close proximity of the policy pivot to the presidential election, as well as the large size of the initial cut, a pause one month later could insinuate it was factors other than the data motivating the outsized first-round rate reduction.

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