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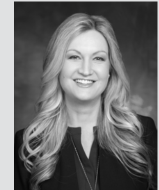
Gauging Appropriate Policy Amid Potential Upside Risks to Inflation and a Higher Neutral Rate



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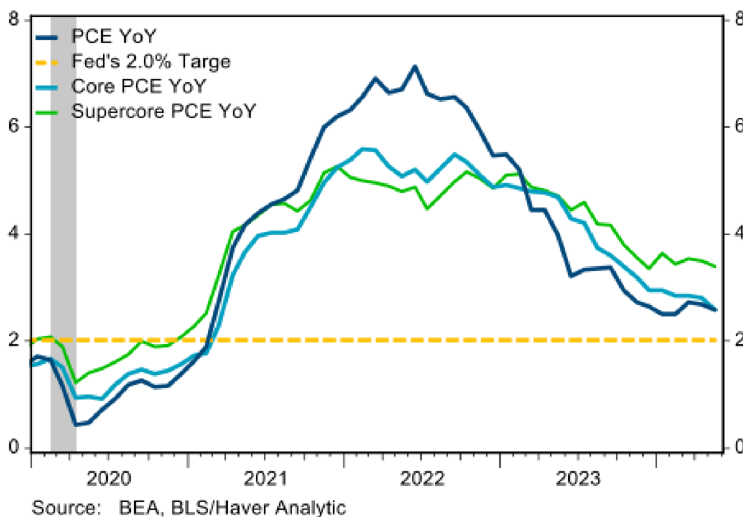
While arguably rebalancing at a gradual pace in the aftermath of the fastest backup in rates in four decades, the expected slowdown in demand and overall impact on the U.S. labor market remains muted. Momentum is slowing in many key categories of economic activity, however, the readjustment remains less than anticipated. This is calling into question not just the Committee's ability to lower rates in the near term, but the truly restrictive nature of policy. Is policy as restrictive as previously indicated? Has policy reached a sufficiently restrictive level? For investors anxiously awaiting rate cuts, a lack of affirmation could mean a further delay in relief.

"ABOUT RIGHT"

According to the Federal Reserve Chairman Jerome Powell, the restive nature of policy is *"about right."* Furthermore, given the additional *"progress towards the price stability goal,"* while the Committee is in no rush and prepared to adjust *"as appropriate,"* he indicated lingering optimism the Federal Reserve (Fed) could have the needed confidence to cut rates by year end. Such sentiment has buoyed investors' expectations for a nearer-term rally in the bond market, already on the brink of erasing losses for the year with rates down 38 basis points (bps) from a peak of 4.71% in April.



In fact, as inflation seemingly resumes its previous disinflationary pathway after a number of head fakes at the start of the year, at least some investors are making sizable bets in favor of *"many"* rate cuts sooner than later. According to Bloomberg data, there has been a substantial jump in bets that rates will decline to 2.25% or lower by March 2025. That would mean roughly 300 bps in cuts over six meetings' time.

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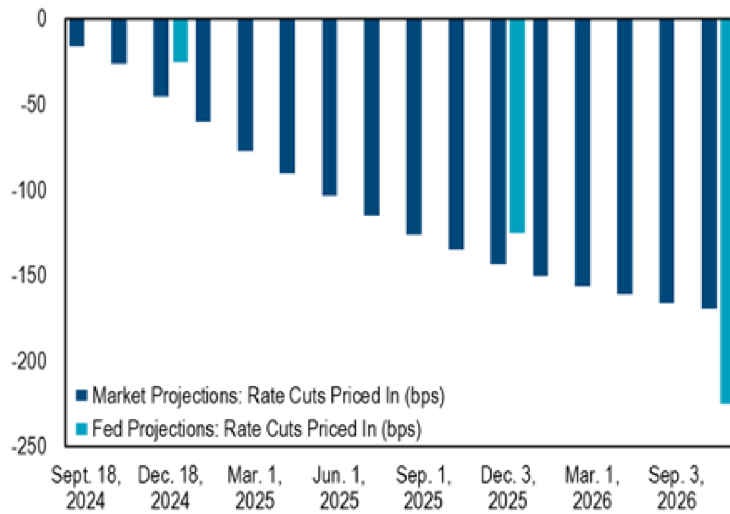
After all, following modest improvement in April, May offered further reprieve in inflation with consumer and producer price measures falling to a three- and two-month low, respectively. Additionally, the latest read on the Personal Consumption Expenditures (PCE) Index, the Fed's preferred measure of inflation, was flat in May, following a more sizable 0.3% in April. This is the first time the headline has been flat since October and November of last year. Year-over-year, headline inflation increased 2.6%, down from a 2.7% annual increase in April, and the lowest reading since February.

While welcome steps towards the Fed's 2% target, the headline remains above an earlier low of 2.5% in February with the core still elevated at 2.6% from this time last year.

A HIGHER NEUTRAL RATE?

Of course, not all metrics are pointing to a more upbeat scenario, potentially allowing the Fed to take its foot off the brake. And, certainly not to the tune of 300 bps in rate cuts in the next nine months, which short of a significant fallout in the economy appears far-fetched. It's an aggressive position nominally given the ongoing resilience in the economy, but also relative to market participants' expectations for a more muted 75 bps of easing through Q1 2025, as well as the Fed's updated projections for 125 bps of rate reductions by the end of 2025.



In fact, by other measures, the market continues to indicate a potential limitation to the Fed's ability to reduce policy both in the near and longer term. According to market projections, the Fed's neutral policy rate may be higher than previously indicated by policy makers themselves, suggesting a more elevated bar to justify future potential easing.

Of course, like the elusive Yeti or Abominable Snowman, the actual neutral rate of policy cannot be seen. 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.

When the Federal Reserve began publishing estimates of the neutral rate in 2012, the median forecast was 4.25%. Fluctuating over the years, the projection fell to 2.5% in 2019[1], only to dip further to 2.375% in March 2022. By June 2022, the neutral rate projection rose to 2.5%, where it stood until this March before slowly rising to 2.75% in June.

[1] Equation for neutral rate of interest: $x_t - \eta x_{t-1} = E_t(x_{t+1} - \eta x_t) + \varsigma(r_t^n - r_t)$, where xt is consumption and rt is the short-term real interest rate.

GLOSSARY

FOMC – Federal Open Market Committee

PCE – Personal Consumption Expenditures

YoY – Year over Year

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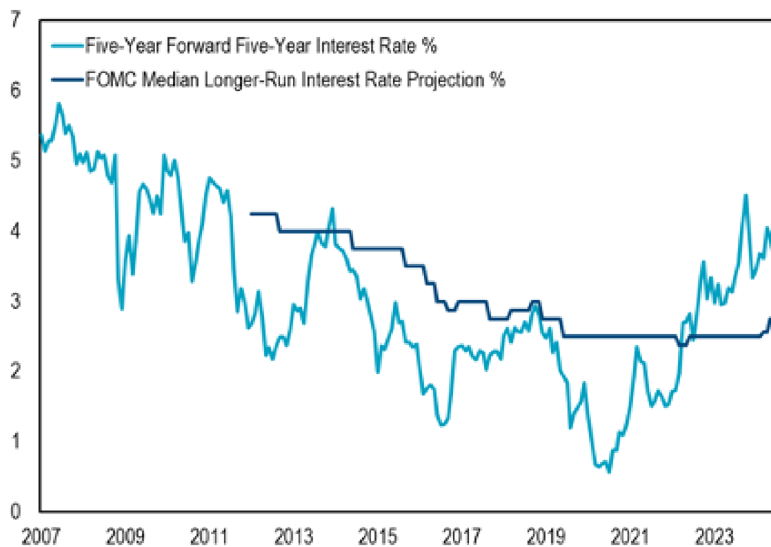

Source: Bloomberg

At present, the market has indicated the neutral 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 3.6%. While down notably from a peak of 4.5% in October, it is 140 bps above the 2.2% average for the five years leading up to the pandemic and roughly 88 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 essentially raises the floor for longer-term rates. A higher neutral rate also limits the downside potential for policy easing as the Fed seeks to remove restrictive measures without slipping into an accommodative stance. In turn, this would also undermine upside potential for bond market returns.

A significantly higher neutral rate also calls into question the Fed's terminal rate decision at 5.5%, suggesting the current level of policy may not be as restrictive as previously indicated. It also suggests the Fed's current policy stance may be shy of the sufficiently restrictive level needed to rein in price pressures and ensure a return to price stability. It would, however, offer an explanation for ongoing strength in the domestic economy despite a rapid ascension in rates to a 23-year high.

READJUSTING EXPECTATIONS

Given the lack of a sizable downturn in economic activity, with business investment still solid and consumer spending specifically rebounding in May, many Fed officials have relocated into the camp of a relatively higher neutral rate. Additionally, perpetuating a message of patience and ongoing focus on inflationary pressures, some members, such as Governor Michelle Bowman, continue to warn of upside inflationary risks.

> *"We are still not yet at the point where it is appropriate to lower the policy rate … Given the risks and uncertainties regarding my economic outlook, I will remain cautious in my approach to considering future changes in the stance of policy."*
>
> – Federal Reserve Governor Michelle Bowman, Event in London, June 25, 2024

More recently, Chairman Powell downplayed the importance of neutral rates. *"I want to remember to point out that long run neutral rate of interest is a long run concept. It really is a theoretical concept, can't be directly observed,"* he said at the June Federal Open Market Committee press conference. And while as San Francisco Fed President Mary Daly recently argued a rate as high as 5% may not be the new neutral level, as

her fellow Fed official Neel Kashkari has highlighted numerous times, the ongoing resilience of the economy raises legitimate questions about *"whether policy makers are misperceiving neutral."*

At the very least, with a wide range of neutral rate forecasts among Committee members varying from 2.40% to 3.75%, more than anything, the discrepancy in r* projections underscores the uncertainty and difficulties in determining the appropriate policy pathway during such uneven and challenging times. But with undeniable shifts in structural forces such as massive and growing fiscal deficits, the momentum in neutral policy is clearly to the upside.

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