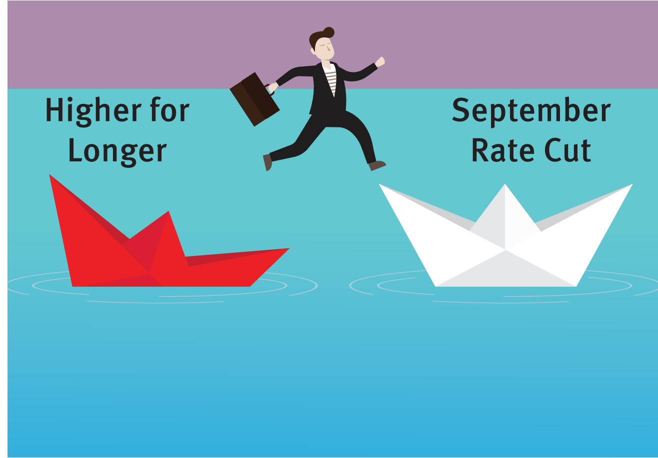
July 29, 2024

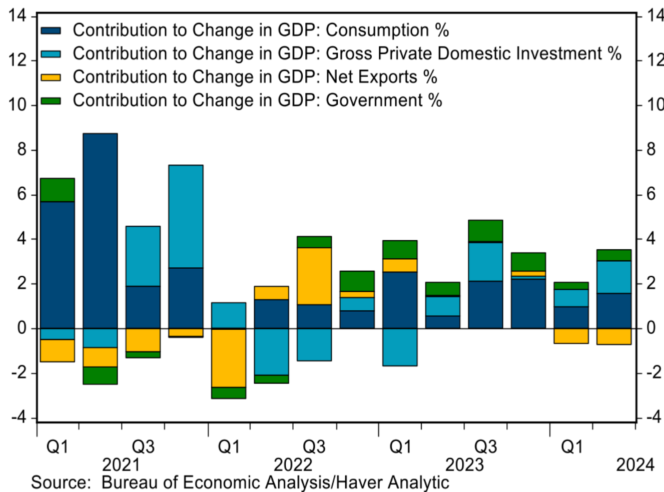
Jumping Ship: A Once Again Lonely Boat of Higher For Longer



In the aftermath of a cooler-than-expected June Consumer Price Index (CPI) report and some cooler labor data in the second quarter, market expectations for a near-term rate reduction surged. In fact, even some of the most steadfast members of the "*higher for longer*" camp have wavered as the pace of disinflation has improved – albeit modestly. Former New York Federal Reserve (Fed) President Bill Dudley, for example, has dramatically adjusted his longstanding insistence that the Fed maintain rates at the current level to now calling for a rate cut as early as next week.

"*The facts have changed, so I've changed my mind,*" Dudley said in a Bloomberg Opinion piece published on July 24.

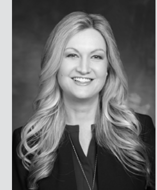
While Dudley argues the risk of recession is on the rise, with little convincing evidence of a sustained disinflationary trend, the bigger danger remains a failure to restore price stability. After all, a downturn or dip into negative territory is an unpleasant but natural part of the business cycle. However, "*Without price stability,*" as Fed Chairman Jerome Powell has underscored many times, "*the economy does not work for anyone.*"



Source: Bureau of Economic Analysis/Haver Analytic

A TURN IN THE ROAD

Dudley insists that for years the "*persistent*" strength of the U.S. economy indicated the Federal Reserve hadn't yet done enough to achieve the desired effect of retarding consumer activity and sufficiently slowing inflation. Now, he argues there are visible indications of a slowdown and a need for a change in policy as inflation pressures are "*abating.*" Aside from a reduction in spending and fewer jobs, a spike in the unemployment rate near the recessionary threshold as indicated by the Sahm Rule, he says is "*most troubling.*"



Lindsey M. Piegza, Ph.D.
Chief Economist
piegzal@stifel.com

Lauren G. Henderson
Economist
hendersonla@stifel.com

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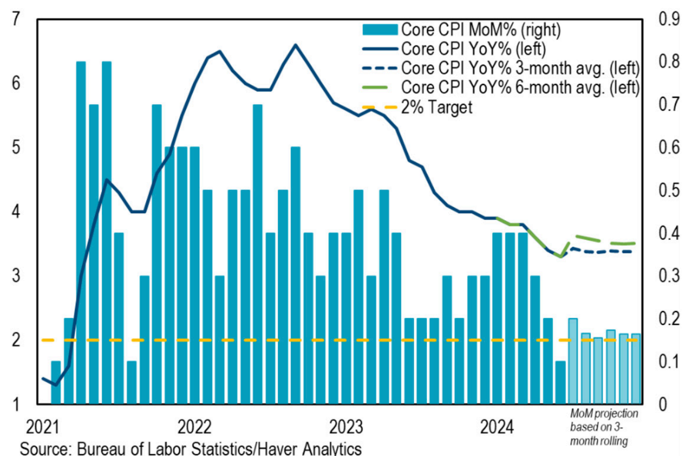
To Dudley's point, the U.S. economy has clearly lost momentum from a more robust average pace of 3.1% in 2023. However, to the contrary, the economy has more recently accelerated, rising from a 1.4% pace at the start of the year to 2.8% in Q2, thanks in good part to a stronger-than-expected 2.3% rise in spending. Underscoring the ongoing resilience of the U.S. consumer and the broader domestic economy, the pickup in momentum lessens rather than strengthens support for a near-term adjustment in policy. Furthermore, while the pace of hiring has also slowed from 251,000 in 2023 to 206,000 as of June, nominally, job creation remains solid amid a lingering and sizable gap between labor demand and labor supply with more than 8 million job vacancies and still near 4% wage growth.

JULY V.S SEPTEMBER

Of course, with Dudley (and others) now convinced of the Fed's need to cut rates – and soon, at the same time he is less convinced the Fed will take action quickly. First, he argues the Fed is hesitant to make a policy adjustment after a series of head fakes in the inflation data at the start of the year. And rightly so! While inflation has made meaningful progress from peak levels, after months of accelerating at the start of the year, price pressures remain elevated, and the rate of improvement continues at a painfully slow pace. Thus, while Dudley may suggest a 2.6% read on the core Personal Consumption Expenditures (PCE), the Fed's preferred measure of inflation, is "*not far from the central bank's 2% objective*," the pathway back to price stability remains bumpy and uneven at best.



Source: Bureau of Labor Statistics/Haver Analytics

The Fed has set the bar relatively high for rate reductions with a focus on further disinflation and a need for "*many*" more months of convincing data. Therefore, with less than half the year left, and the base effects from 2023 increasingly diluted in the second half, price pressures will expectedly remain elevated, or even push higher in coming months, a reality Dudley concedes will make further disinflationary progress "*more difficult*."

There is also a need to build a stronger consensus support for a near-term rate cut among policymakers themselves. Investors are convinced of a September rate reduction, priced in at near certainty. However, after preemptively calling for an end to rate hikes for nearly two years and pricing in rate cuts that have yet to come to fruition, the validity of the overzealous voice of the market has largely been negated.

Fed officials, meanwhile, appear to be less of one mind than market players. The latest Summary of Economic Projections (SEP) showed a sizable reduction in expectations for rate cuts in 2024 amid elevated projections for growth and inflation. According to the June dot plot, Committee members see just one rate cut by year-end with the federal funds rate declining to 5.1%, up from the median forecast of 4.6% indicated in the March release when three rate cuts were expected. Furthermore, there appears to be a growing divide between those members who are hopeful of inflation resuming its previous

GLOSSARY

CPI – Consumer Price Index

FOMC – Federal Open Market Committee

GDP – Gross Domestic Product

PCE – Personal Consumption Expenditures

PPI – Producer Price Index

SEP – Summary of Economic Projections

UST – U.S. Treasury

YoY – Year over Year

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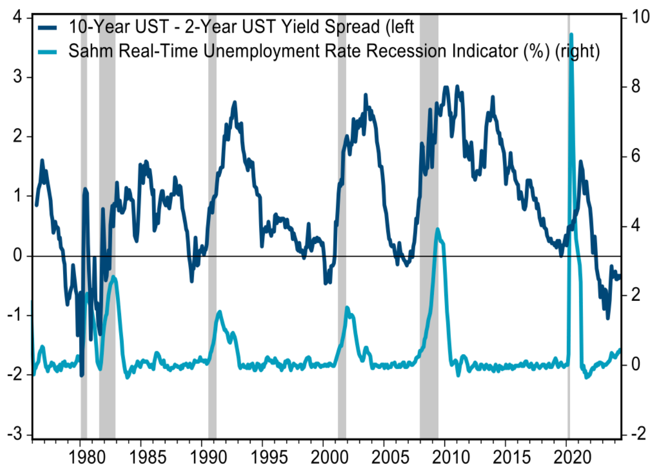
disinflationary path and those underscoring the rising risks – upside risks – to price pressures. Four Fed officials, in fact, see no rate cuts in 2024, while eight see as many as two rate reductions.

Finally, Dudley underscores the varying assessments and levels of concern regarding how the health of the labor market could complicate the Fed's willingness to reduce policy firming. While Powell noted earlier this month that the "*labor market has cooled off,*" and as such, the Fed's dual mandates are in "*better balance,*" Dudley isn't convinced Fed officials are "*particularly troubled,*" by the risk that the unemployment rate could soon breach the Sahm Rule threshold. At 0.43, Dudley argues, this is "*very close*" to the 0.50 recessionary break point.

The Sahm Rule, devised by Economist Claudia Sahm in 2019, suggests that as labor force conditions deteriorate, or when jobs become harder to find, a self-reinforcing feedback loop occurs compounding a reduction in spending. As this cycle of layoffs continues, resulting in a further pullback in expenditures, the economy weakens, eventually into recession. According to the rule, which accurately predicted recessions in the 1970s retroactively, the early stages of recession are signaled when the three-month average unemployment rate moves above the lowest three-month moving average unemployment rate over the last 12 months by half a percentage point or more.

Of course, like other recessionary indicators such as curve inversion, such "*rules*" should be seen as guidelines or barometers of economic functionality rather than hard lines drawn in the economic sand. Recall, the yield curve, for example, has seen an inverted 2-10 spread (the difference between the 10-year Treasury yield and two-year Treasury yield) since July 2022, the longest period on record, indicating imminent recessionary conditions (most often within 12 to 24 months of inverting). Of course, given the perversion of market fundamentals by both monetary and fiscal policy, the ongoing predictive nature of the yield curve comes into question. Similarly, there is uncertainty surrounding the ability of the Sahm Rule to indicate deteriorating economic conditions in today's post-Covid environment should the rise in the unemployment rate be primarily a reflection of unaccounted growth in the labor force – particularly due to a sizable flow of immigration – as well as a growing trend towards gig and part-time employment, as opposed to layoffs.



Source: Haver Analytic

THE END GAME

Market predictions aside, it may be "too late to fend off a recession" at this point with a near-term reduction in rates. Nevertheless, Dudley argues maintaining this (relatively) elevated level in Fed funds, given the improvement in price pressures and weakening in employment, greatly and "unnecessarily" increases the risk of a downturn.

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While conceding inflation has made great progress from earlier highs and the labor market appears notably less tight than at the start of the year, price stability is far from a forgone conclusion. The last 50 to 100 basis points is always the most difficult, suggesting now is far from the ideal time for the Committee to lose focus on achieving further disinflation. Of course, while some may question whether it's still an appropriate target, for now, the Fed maintains a commitment to 2% inflation and cannot move the goal post in the middle of the game without the risk of un-anchoring inflation expectations.

While recession is an unfavorable scenario, often resulting in elevated levels of job loss and wealth destruction, by far the bigger risk at this point is a period of prolonged elevated inflation continuing to erode the purchasing power and savings of American households. The Fed recognizes the possible harm caused by easing too late, but equally understands the risks of easing too much or too soon, potentially allowing inflation to come back or become further embedded into the U.S. economy.

Lindsey Piegza
Ph.D., Chief Economist
piegzal@stifel.com

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