November 25, 2024

MARKET SIGHT LINES

Tariffs, Inflation, and Federal Reserve Policy: Slow and Steady

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People are feeling the pinch of higher prices and higher interest rates. Higher prices are the result of elevated inflation in recent years, with higher interest rates influenced by the Federal Reserve's (Fed's) restrictive monetary policy to fight that inflation. While investors cheered the September Fed rate cut with the anticipation of more, inflation remains sticky, which will slow the pace of further cuts. In this Sight|Lines, we review the state of inflation, the direction of Fed policy, and the potential impact of any tariffs imposed by the incoming Trump administration.

THE TAKEAWAY: STICKY INFLATION MEANS HIGHER RATES FOR *EVEN* LONGER

Inflation has remained sticky, not quite reaching the Fed's 2% target. So, the Fed will slow its rate cuts, especially given the uncertainty of tariffs and other Trump policies. In summary:

- Higher prices are here to stay … the Fed is fighting to keep prices from going higher.
- Three popular inflation measures show inflation is still above the Fed's 2% target.
- Market participants expect inflation above the Fed's target over the next year and longer.
- Fed officials remain data dependent but are signaling slower rate cuts, their ability to do so influenced by our economy being strong, despite higher rates.
- The Fed's slowdown is the result of the persistent inflation as well as uncertainty around policies of the incoming administration, especially the strong likelihood of tariffs.
- A tariff can result in a one-time jump in prices, followed by a one-time price cut once the tariff is removed.
- Fed funds futures are forecasting a possible, but not certain, quarter-point cut in December, and a total of 0.5% in cuts in 2025.
- While influenced by other factors, market interest rates also remain elevated and are expected to remain higher going forward.
- This all means a higher cost of debt for individuals, businesses, and our government.

IN-DEPTH: RECENT STICKY INFLATION AND UNCERTAINTY AROUND TARIFFS AND OTHER POLICIES MEAN INTEREST RATES WILL BE HIGHER FOR *EVEN* LONGER

Inflation has remained sticky recently, not yet reaching the Fed's 2% target. The Fed is signaling a slowdown, certainly informed by this sticky inflation as well as uncertainties around the policies of the incoming Trump administration, especially around tariffs. Going deeper:

- While subtle, the recent higher inflation means prices are higher from here, even as the Fed fights to keep prices from going even higher:
    - The Fed is seeking disinflation, or a reduction in the positive inflation rate driving prices higher.
    - We shouldn't expect deflation, or the decline of prices overall.
- Three popular measures show inflation remains sticky, above the Fed's 2% target:
    - The core consumer price index averaged an annualized rate of 2.6% over the last six months.
    - The core producer price index averaged an annualized rate of 3.1% over that period.
    - For the same period, the core personal consumption expenditures price index averaged 2.3%.
- The break-even rates, which reflect market expectations for average inflation, have increased:
    - In mid-September, the one-year and five-year break-even rates were 0.4% and 1.9%.
    - Currently, these rates have risen to 2.7% and 2.5%, respectively.
- Fed officials are more cautious about rate cuts. Fed Chair Jerome Powell recently said:
    - "The economy is not sending any signals that we need to be in a hurry to lower rates."
- There has been a lot of talk that tariffs proposed by President Trump will increase inflation:
    - A tariff results in a one-time jump in prices.
    - Some have estimated, based on Trump's proposals, a 0.75%-1% one-time price increase overall.
    - We expect the administration to use tariffs as a negotiation tool, with a good chance of lowering or reducing them later, which would then result in a one-time price decline.
    - While tariffs would be a meaningful event that may have broader economic consequences, they would not have a sustained negative effect on inflation.
- Fed funds futures are forecasting a slower pace and fewer rate cuts:
    - Currently, there's a 59% probability of a 0.25% cut in December and a 41% chance of no cut.
    - Fed funds futures now forecast 0.50% in 2025 cuts, down from 1.5% in September.

CONCLUSION

People are really feeling the pinch of higher prices and higher interest rates, with the Fed's restrictive monetary policy likely to remain in place even longer to fight inflation and better understand the policies of incoming administration. This all means a higher cost of debt for individuals, businesses, and our government. These topics will remain in keen focus as we head into 2025.

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