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Fed Thoughts: A Drama in Three Acts

Vincent Reinhart | Chief Economist & Macro Strategist

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The narrative arc of the drama surrounding the Federal Reserve (Fed) tidily tracks a classic structure of the theater. As on the stage, we believe the story of 2024 unfolds in three acts:

1. The setup. There is a problem.
2. The confrontation. There is a potential solution proposed.
3. The resolution. The proposed solution may or may not work.

The **problem** is that the Fed needs to balance its dual policy objectives of supporting economic activity, consistent with fostering maximum employment, while engineering further disinflation to reclaim price stability. The Fed's **potential solution** is to gradually lower the nominal policy rate to trim it in real, or inflation-adjusted terms to sustain aggregate demand, but keep the rate high enough to journey along the last mile to price stability.

If the proposed solution works, as we move into the third act the **resolution** may be a happy ending in 2025 where inflation returns to 2% without the economy entering a recession in the interim. In Aristotelian terms, this result is a comedy – not because of any humor, but because the hero triumphs. (However, the joke will be on everyone who doubted.) It may not work in one of two ways. For one, tragedy, if the restrictive real rate tips the economy into contraction. For another, farce, if the Fed rejoins "Team Transitory" as inflation rebounds.

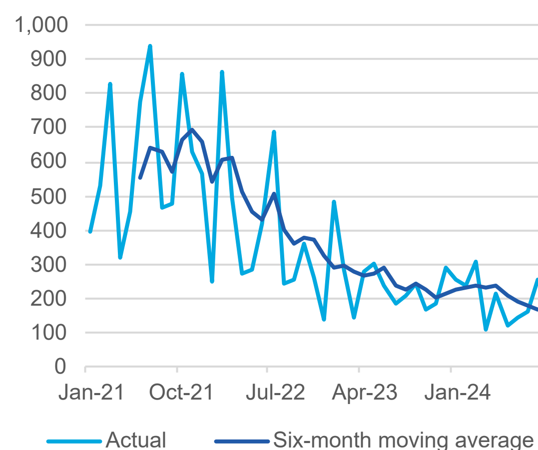
In this note, we will preview the third act by first setting the scene with the economic outlook as perceived (we think) by the Fed. We will then discuss why a happy ending is plausible and why farce is a more likely concern among the two unfortunate outcomes.

Setting the scene

The Fed's policy plan has been laid out in a succession of forecasts in its Summary of Economic Projections (SEP). The forecasts show the nominal funds rate being cut sometime soon, falling gradually thereafter with inflation, and keeping the policy rate restrictive in real terms for a considerable period. In all, the inflation-adjusted policy rate settles from above to the Fed's assessment of its neutral rate only after three or four years.

The economy opened the year with considerable momentum but a troubling undercurrent. About one-quarter million people joined nonfarm payrolls each month, on net, from January through March. Employment had long climbed out of the pandemic crater and appeared to stretch available resources. Except, the unemployment rate increased each month. The history of the business cycle provided the discouraging precedent that an unemployment rate that is rising keeps on rising.

Nonfarm payroll employment
monthly change, thousands



Source: Bureau of Labor Statistics (employment and unemployment) and Federal Reserve Bank of Atlanta (consumer prices), accessed from FRED, 10/24/24. Flexible prices are the 30 percent of the items in the household consumption basket that are deemed to move frequently and sticky prices are the more intertial remainder. Firm analysis.

The Fed, however, appeared to weigh the former strength in employment as more consequential for the outlook than the latter weakness in unemployment. This seems right in retrospect as the strength of the labor market was pulling in new entrants from the domestic sidelines and abroad. The participation rate edged up, and foreign-born members of the labor force increased over 4%.[1]

Inflation disappointed. In 2023, flexible prices within the consumption basket (mostly goods that are sensitive to commodity prices) fell, offsetting the effects on the headline measure of service prices continuing to expand more than 4% per year.[2] The good news under the hood was that sticky-price inflation was declining, albeit gradually. In the first few months of this year, however, flexible prices rose on the back of increases in global commodity prices and difficulties in supply chains.[3] Stubborn inflation did not threaten the Fed's policy plan as it only required delaying the start date of easing—a message conveyed in the June SEP.

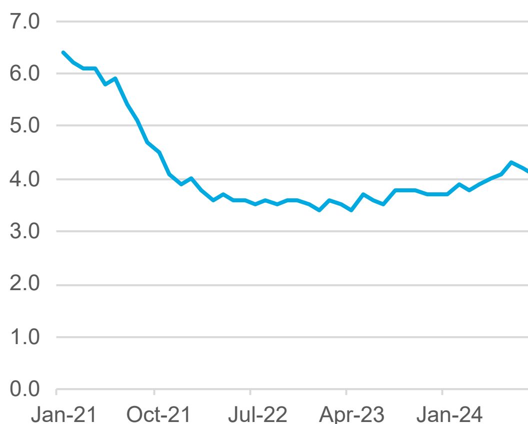
Employment growth slowed subsequently, to about 125,000 new jobs each month. The unemployment rate moved higher, again pushed up by new entrants. However, inflation fell as flexible prices declined and sticky-price inflation continued to notch monthly one-tenth percentage point declines.

The employment situation was the Rorschach test for views on the economic outlook and the consequences for monetary policy, leading to a handwringing second act.[4] Many investors connected the dots to extrapolate economic weakness. The Fed, however, seemed to take the slowdown in employment gains as settling to a more sustainable pace and the rise in unemployment as resulting from the lure of a healing labor market.

The policy problem was how to support that sustained expansion while continuing to encourage further disinflation. The proposed solution was put in motion on September 18. The Federal Open Market Committee (FOMC) concluded that the economic outlook had changed sufficiently during the 420 days that the fed funds policy target had been held at 5.25% to 5.5% to warrant action. The 50-basis-point cut in the target was more substantial than expected as the Fed's proposed solution moved forward recalibrating the nominal policy rate with a jump start.

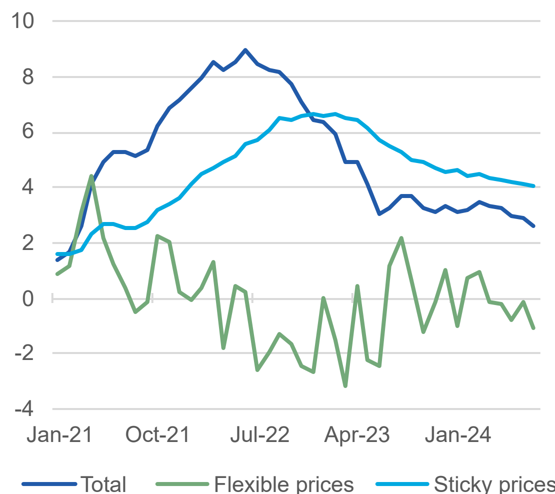
Unemployment rate

Unemployed as a share of the civilian labor force, percent



Consumer prices

Twelve-month change, percent



Source: Bureau of Labor Statistics (employment and unemployment) and Federal Reserve Bank of Atlanta (consumer prices), accessed from FRED, 10/24/24. Flexible prices are the 30 percent of the items in the household consumption basket that are deemed to move frequently and sticky prices are the more intertial remainder. Firm analysis.

The third act

A happy ending is possible if Fed officials are correct that economic activity retains sufficient momentum to withstand lingering policy restraint and inflation retreats to goal. On the first score, we think spending will likely continue to grow near trend for four reasons.

- *Fiscal policy, directly*. As opposed to other advanced economies, the US has not scaled back its discretionary fiscal stimulus (the fisc) in a material way in the past few years, as highlighted by the Inflation Reduction Act of 2022. The federal budget deficit for the fiscal year that just ended was the largest since the pandemic response. The lack of concern about the budget trajectory is bipartisan, so election notwithstanding, the fisc will support the level of aggregate demand and likely will not impede growth, as in most other major economies.

- *Fiscal policy, indirectly*. Households and states and localities saved a considerable portion of the enormous government transfers of 2020 and 2021. The cushion built as they exited the pandemic has kept them cyclically resilient and their balance sheets healthy.

- *Business profits*. Non-financial firms continue to expand their profits, and their financial condition remains relatively strong, in our view. With capital markets still receptive to risk and the Fed lowering the base rate, this sector may have little reason to pull back spending.

- *The irrelevance of a worldwide drag*. Headwinds are emanating from abroad as global trade remains subdued. The world is a risky place. Barriers to trade have risen after nations chose sides in the grueling European war, and the second largest economy in the world struggles to support its expansion. However, this problem looms more seriously for our trading partners because the US is the most closed to trade among the large economies. This difference helps explain why Fed easing lags its peers.

The resolution

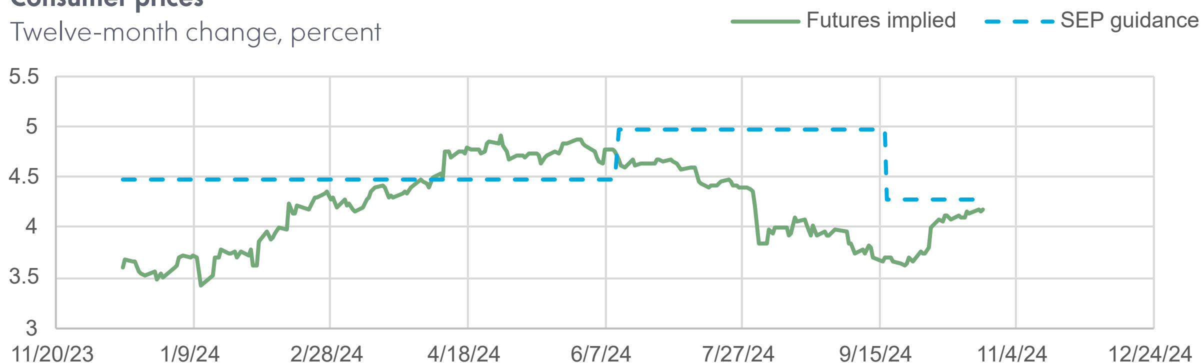
We find the plot compelling but recognize that not everyone shares that view, as reflected across the term structure of interest rates. Since the fall of 2022, medium- and longer-term yields have shown that some investors may be ahead of the Fed in expecting rate cuts sooner and more sizable than the Fed's guidance. Given the record of Fed action, this policy response would only be prompted by a weakening in the economy. The chart on the following page details the difference of opinion this year. The dashed line plotting the Fed's quarterly guidance for the lower bound of the target range of the appropriate funds rate at year end and the solid line showing the comparable market-implied rate from futures contracts. Futures prices normally track a lower path than Fed advice, except when inflation reports serially disappointed in April and May and the extant guidance was universally deemed too old and too low. At times, the difference is considerable.

We think this is due to investors overreading the slowing in the labor market and underappreciating the ongoing support to spending. The recent increase of those expectations after incoming data pointed to 3% annual growth of real gross domestic product (GDP) in the third quarter reflects the grudging acceptance of the Fed (and our) view of an acceptable denouement. If we are right, more adjustment may narrow the space between the market outlook and Fed guidance as two more quarter-point cuts are delivered in the remaining policy-setting meetings of the year.

Doubts are legitimate and a happy ending should not be assumed. As the stage is set, tragedy, an unacceptable slowing in activity and mounting unemployment, seems a low probability given the aggregate demand dynamics in motion under the slow removal of Fed restraint. Other forces may disrupt the plot, including an unexpected darkening in the global outlook. For one, Chinese officials may not offset the drag from the ongoing correction in the property sector there. For another, the world can become an even riskier place, starting with current wars. At home, our affairs are far from tranquil and politics could materially disrupt economic decision-making.

Consumer prices

Twelve-month change, percent



Source: CME FedWatch Tool, Federal Reserve, Summary of Economic Projections (various), and firm analysis, accessed 10/24/24.

Note: Reading market expectations for policy from the thirty Fed funds futures contracts traded on the CME can be tricky due to two institutional features. First, the Fed sets a quarter-point range for its target rate, using reserves and administered rates to keep the actual market rate within this range daily. The effective rate, or the actual average funds rate, varies within this range due to market pressures. Second, the futures contract settles on the average effective Fed funds rate each calendar month, meaning it averages market expectations of potentially different targets when the FOMC meets mid-month. We use the January 2025 contract to represent year-end 2024 because the FOMC meets late enough in the month that the target in December sets the prevailing level. We then apply the CME's estimates of implied probabilities of policy action to the lower bound of the target range to account for predictable market variations within the range. "SEP guidance" is taken as the entry for the year-end appropriate funds rate in the Summary of Economic Projections, adjusted to the lower bound of the range rather than the reported midpoint.

However, we put more weight on the other side of the risk balance. The Fed's plan assumes that sticky-price inflation will continue to wane, not a bad bet, and will not be offset by a resurgence in flexible prices, which is a more debatable proposition. Importantly, flexible prices depend on global commodity markets and some wend their way through intricate supply chains. The unknowns—both the known and unknown varieties—that concern us about demand are possibly more consequential for prices than quantities.

A precedent was provided in the first act. The backup in commodity prices and impairment in supply chains derailed the Fed's plan for a time, seen as the half-point revision to guidance in June. A repeat performance would call the Fed's action into question and raise doubts about its ability to parse inflation into its permanent and transitory components. That is how a happy ending turns farcical. This is not our central tendency, but it is bracing to recall the most damaging episode to Fed credibility in its history. The Great Inflation of the 1970s was considered a series of unfortunate events in real time of an institution struggling to understand price dynamics.

Vincent Reinhart
Chief Economist & Macro Strategist

Vincent is the firm's Chief Economist and Macro Strategist. In this role, he is responsible for developing views on the global economy and making relative value recommendations across global bond markets, currencies and sectors.

Previously, Vincent served as the Chief US Economist and a managing director at Morgan Stanley. For the prior four years, he was a resident scholar at the American Enterprise Institute (AEI). Vincent also spent 24 years at the Federal Reserve, holding several roles including Director of the Division of Monetary Affairs and Secretary and Economist of the Federal Open Market Committee (FOMC). His responsibilities at the Federal Reserve included directing research and analysis of monetary policy strategies and the conduct of policy through open market operations, discount window lending and reserve requirements. Prior to these roles, he was the principal liaison with the domestic desk at the Federal Reserve Bank of New York and was responsible for preparing a document outlining policy alternatives for each FOMC meeting. He was Deputy Director in the Division of International Finance and Associate Economist of the FOMC and spent five years at the Federal Reserve Bank of New York in both the domestic and international research departments.

His academic publications primarily concern the conduct of policy and issues related to the monetary transmission mechanism as well as an analysis of alternative auction techniques and Treasury debt management. After an undergraduate training at Fordham University, he received graduate degrees in economics at Columbia University.

Endnotes

[1] U.S. Bureau of Labor Statistics, Employment Situation Summary, "The Employment Situation, -- October 2024," accessed 10/31/24.

[2] Federal Reserve Bank of Atlanta, Sticky-Price CPI, accessed 10/31/24.

[3] Sticky and flexible prices are terms used to describe how prices change in response to market conditions. Flexible-priced items, such as gasoline, are free to adjust quickly to changing market conditions, while sticky-priced items, such as prices at the laundromat, are subject to some impediment or cost that causes them to change prices infrequently.

[4] The Rorschach test is a projective psychological test in which subjects' perceptions of inkblots are recorded and then analyzed using psychological interpretation, complex algorithms, or both.

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