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Fed Thoughts: Knock on Wood

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There's no drama associated with the upcoming meeting of the Federal Open Market Committee (FOMC), the policy-setting group of the Federal Reserve (Fed). Fed officials hate surprises and conveyed clearly at the last meeting of 2024 that policy was in a holding pattern. Subsequent economic data mostly met expectations and gave no reason to change the flight plan, which is why future prices sit on a 98% probability that the target range will likely be maintained at 4.25% to 4.50% at the conclusion of the meeting on January 28 and 29.

Fed Chair Powell pressed his luck at his last press conference on December 18, 2024, declaring that "…the outlook is pretty bright for our economy."[1] We think he's right, even if he may have provided an embarrassing sound bite if events turn south. The US economy retains significant momentum. Uncomfortably, some of the future support to demand owes to fiscal stimulus that worsens longer-term challenges — and some to uncertain political wrangling. Even so, US economic prospects appear more favorable than most of our trading partners. Inflation will likely only edge lower, limiting the extent to which the Fed can ease further. Political risks at home and in a perilous world, partly stirred up by domestic decisions on trade and tariffs, may tilt outcomes to more inflation and Fed hawkishness, not less.

For now, we believe a low profile for the Fed may be safest during the presidential transition. The Fed, however, finds itself in a bind of its own making. Action depends on the data, but guidance is about the forecast, and a forecast depends on an assessment of the political economy. Such an assessment is hard to make and to voice during the political transition. The Fed cannot presume policy action by the incoming administration without appearing judgmental. Moreover, policy options discussed early in an administration may not be delivered on, especially those dependent on Congress.

Particularly awkward for the Fed is that the new administration's policies, if implemented, will likely push up prices this year, especially the flexible ones that are more reliant on trade. That would require an adjustment of monetary policy guidance.

- **Tariffs** directly raise the prices of imported goods in the consumption basket.
- **More aggressive policing of the border** cuts the flow of new workers, and deportation would reduce the count of existing ones, putting upward pressure on labor costs.
- **Extending the existing tax structure** prolongs fiscal support of aggregate demand, and more aggressive changes, a distinct possibility, would impart more stimulus.
- **Looser regulation**, likely welcomed by capital markets, should spur capital spending.

We think the directional change in the SEP in December was the beginning. In our view, the hawkish cut in policy in December presages further hawkish adjustments this year. Given that they still lean into easing policy, one or two more quarter-point cuts are probably in the cards for 2025.

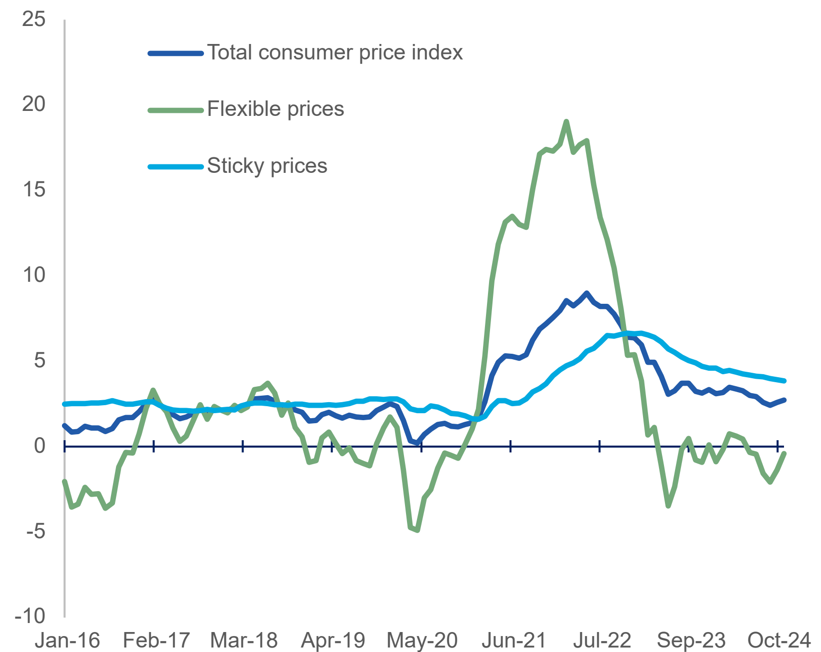
In December, the Fed leaned into the direction of travel in its Summary of Economic Projections (SEP), with the forecasts for inflation and the appropriate policy rate shifting up. But that awaits Fed officials seeing some progress in the rest of the government putting policies in place. The schedule matters, too, in that policy action and adjustment to its guidance are more convenient at the four meetings of the year in which they put out a new SEP. This is another reason we believe the off-cycle meeting in January will be uneventful.

All this, of course, depends on the data. Chair Powell showed a superstitious streak at his November 7, 2024, press conference in explaining the inflation process, holding:

> *"...we've been able to see inflation come down a whole lot, you know, much closer to our goal without the kind of sharp increase in unemployment that has often accompanied programs of disinflation. So, knock on wood, we've gotten this far without seeing a real weakening ... in the labor market. And we believe we can complete the inflation task while also keeping the labor market strong, and that, of course, is exactly what we're trying to do."*[2]

The dynamics of consumer prices is about the arithmetic of the index. The headline progress in reducing inflation has come from flexible prices (mostly goods that make up 30% of the consumption basket and more represented in producer prices). Sticky prices (mostly services and the other 70% of the basket) are contractual, habitual, set independently and non-synchronously by many actors worried about market share and perceptions of fairness. The tenth-or-so decline in sticky-price inflation-per-quarter represents durable success for the Fed, but it has been, and will continue to be, slow.

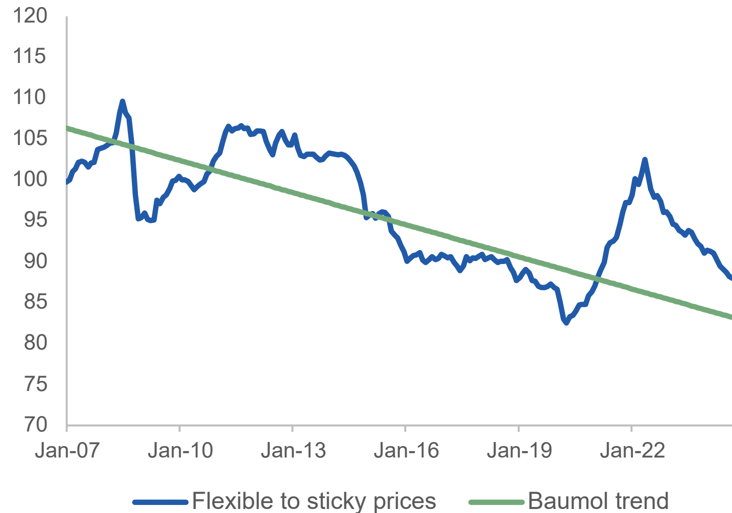
Consumer Prices and the Flexible and Sticky Price Components
Twelve-month change, percent



Source: Bureau of Labor Statistics (consumer prices) and Federal Reserve Bank of Atlanta (flexible and sticky prices), accessed from FRED, 12/31/24. Flexible prices are the 30 percent of the household basket identifies as adjusting frequently. Sticky prices are the remaining 70 percent that move inertially.

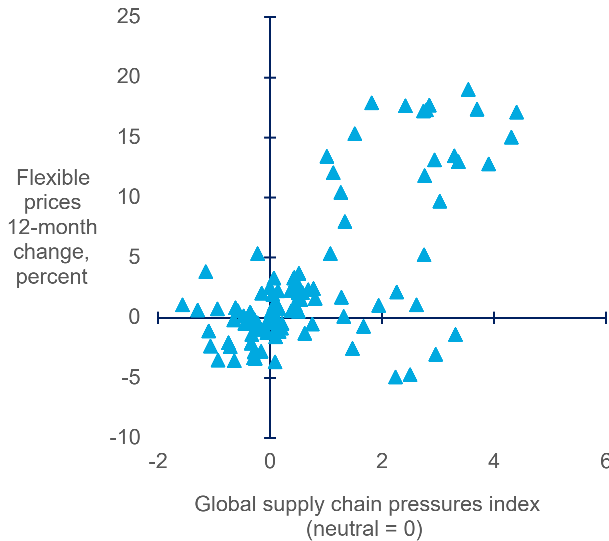
Flexible prices, which have a high tradable commodity component, tend to respond to global supply chain pressures. Sticky prices are very sensitive to excess-demand pressures in the labor market but much less so to slack. The levels of both are related over the long run as the ratio of flexible to sticky price reverts to a downtrend over time. Note that the goods sector is much more productive than the service sector, so flexible prices fall relative to sticky prices over time. In current circumstances, where the level of flexible prices is still high relative to sticky prices because of the lingering effects of the pandemic shock, sticky prices have to rise a bit faster to lower the ratio back to trend.

Flexible Relative to Sticky Prices
Index, 2007=100

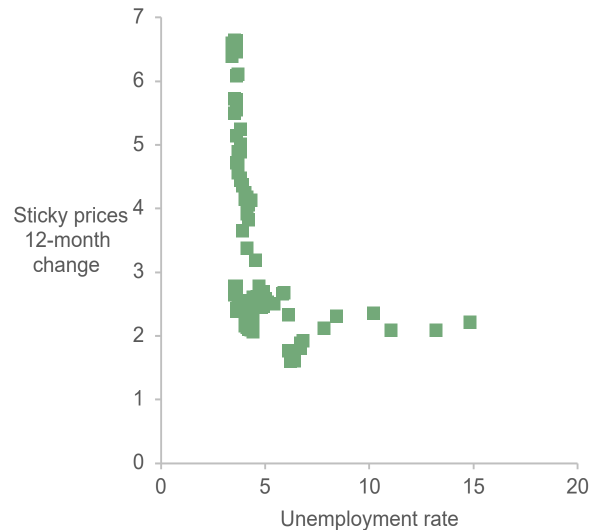


Source: Bureau of Labor Statistics (consumer prices and unemployment rate) and Federal Reserve Banks of Atlanta (flexible and sticky prices) and New York (global supply chain pressures). Accessed from FRED, 12/31/24. The "Baumol" trend to relative prices is estimated from 2007 to 2019. Firm analysis.

Flexible Prices and Global Supply Chain Pressures
Percent and index



Sticky Prices and the Unemployment Rate
Percent



Disinflation has been the product of supply chains healing and the labor market moving into balance even as sticky prices rise faster to catch up to goods prices to correct the relative price gap. We believe the Fed's inflation strategy is patience: Hope that supply chains continue to heal, keep the labor market in balance so that pressures do not emerge, and expect the impetus to inflation from the mean reversion of sticky relative to flexible prices to wane over time. If so, a modest realignment in the nominal fed funds rate would be appropriate. Hope is always a strategy, but politics may intrude.

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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. Federal Reserve: Transcript of Chair Powell's Press Conference, December 18, 2024.

2. Federal Reserve: Transcript of Chair Powell's Press Conference, November 7, 2024.

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