US Macroeconomics

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Prudence is the Better Part of Valor

Inflation unexpectedly surged in the first four months of the year. In fact, the headline and core PCE deflators both increased 4.1% annualized. Expectations of Fed easing were dramatically reduced from roughly seven 25 basis point (bp) cuts to approximately one. The Fed, which formerly had three 25 bp cuts as its central tendency, recently lowered the forecast to include just one. It is possible the Fed does not cut rates at all this year. We expect only one cut but not until December, following the November General Election and when the FOMC provides updated economic and financial forecasts. **Could the Fed cut more and sooner? We doubt it because the Fed has explained that more than one or two "friendly" inflation reports are needed before pivoting towards easing.** And the economy still looks decent on the surface. For example, the widely followed Atlanta Fed GDPNow model is still tracking current quarter activity at close to 3%. While we estimate underlying growth to be much softer, sturdy GDP growth on the surface does not make for a compelling case to cut rates.

For the Fed to cut rates this year, either inflation must be consistently soft and/or economic activity must meaningfully slow. Simply, there is not enough time between now and the Election to get enough soft inflation data for the Fed to cut on better price news alone. After four above target inflation reports, the Fed would need to see a similar four-month slowdown. Having been surprised by the unexpected year-to-date increases in inflation, policymakers do not want to be blindsided by another unexpected pickup. **They are likely to be extra cautious in easing for fear that inflation remains sticky.**

If, however, the economy rolls over, specifically the labor market, then the case for sooner and more rate cuts could be made. But what kind of weakening would this entail? Close to zero, if not negative, nonfarm payroll readings combined with an unemployment rate coming in well above the FOMC's projected 4.2% peak. 4.5% could be sufficient. But such jobs weakness is unlikely because roughly 60% of all job growth in the last year has been in the acyclical, healthcare and government sectors. Even if the cyclical sector employment slows materially, the acyclical hiring is likely to remain robust. Furthermore, as we have noted previously, when the economy goes into recession, it is generally only known long afterwards that payrolls were actually negative. In other words, the payroll figures are much weaker after revision. If history repeats, policymakers are likely to see artificially strong real-time numbers.

Unless there is an utterly compelling case for interest rate cuts, it will be difficult for the Fed to change policy in the next few months even if there are some downward surprises in the inflation data. Moreover, the Presidential Election may even raise the bar for rate cuts as the Fed does not want to risk harming its credibility. In other words, the need to lower interest rates needs to be obvious.

However, **if the fundamentals do not clearly support rate cuts, and the Fed still makes a policy shift, long-term interest rates could rise sharply. The resulting bearish steepening in the yield curve would then be ultimately worse for the economy and the financial markets.** Surging long term interest rates would push household mortgage rates well above 8% while also lifting corporate borrowing costs. This tightening in interest rates would then weigh on stock prices, thus further dampening economy-wide demand. Clearly the Fed would want to avoid such a scenario.

While the next move in interest rates is down not up, our economic projections and more importantly how we interpret the Fed's reaction function means rate cuts are unlikely before the December 18 FOMC meeting. Chair Powell should reiterate as much when he provides semi-annual monetary policy testimony before the Senate Banking Committee on July 9th. Stay tuned.

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