SMBC Group

US Macroeconomics

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Why is the Fed About to Cut Rates?

We have long argued that the inverted yield curve is problematic, and that the Fed should cut interest rates to realign the bond market and prevent a broader slowing in the economy. In fact, Chair Powell some time ago had even cited the Fed's own research to the same effect, even if policymakers did use a different metric than our preferred 2- to 10-year spread. The Fed has been mum on the curve ever since.

Moreover, **despite the yield curve's unblemished historical record in predicting downturns, a recession has yet to materialize**. Last quarter, real GDP grew at a sturdy 2.8% annualized rate and an even faster 3.1% year over year rate. The headline and core PCE deflators expanded by 2.6% and 2.9%, respectively. Their year-over-year rates were 2.6% and 2.7%, which hardly qualifies as price stability even by the Fed's own admission.

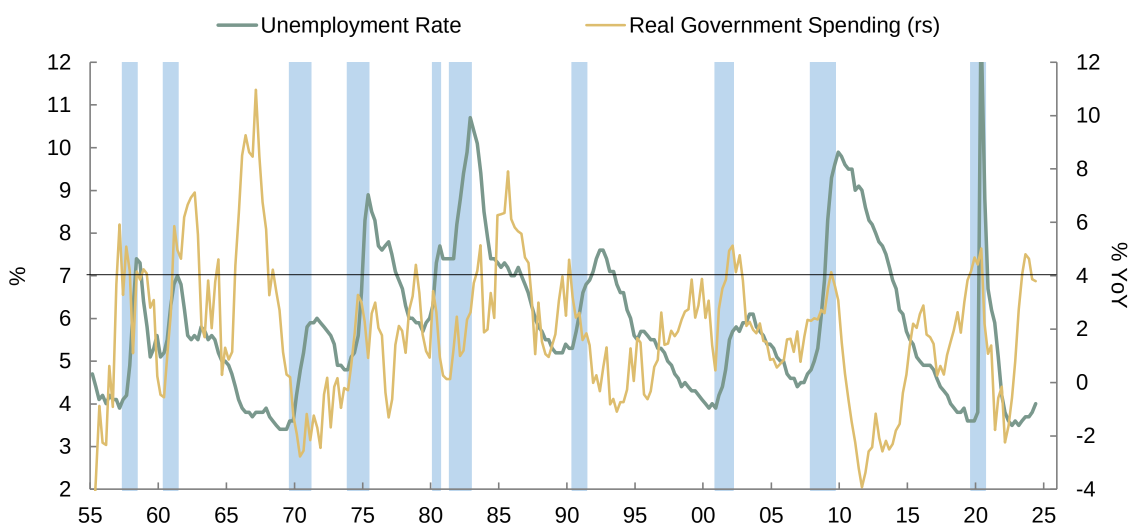
It is possible that growth is not as strong as it appears. We have highlighted numerous times that the income side of the economy has been growing much slower. Since income is based off tax receipts, we have always preferred this metric to the product side of the economy. But the income figures come out with a lag, and conventional macroeconomic analysis focuses on GDP rather than GDI, so we do also.

So why no recession, at least yet? One consideration is government spending — both federal as well as state and local. It is up nearly 4% over the past year. As we can see below, the unemployment rate is historically low relative to the current pace of public expenditures. In fact, **government spending has never grown this fast with unemployment so low** (4.1%).

In point of fact, there have been eight instances since 1960 where annualized, inflation-adjusted government spending was 4% or higher. It occurred in 1961, 1962, 1966, 1967, 1985, 1986, 2002 and 2023. Excluding last year when the unemployment rate averaged just 3.6%, the average unemployment rate for the remaining seven periods was 5.7%. **Since government spending is generally immune from higher interest rates, its fast pace is keeping the economy stronger than it otherwise would be and is also surely keeping inflation higher too.**

But that is not all. **The dramatic equity-led easing of financial conditions is also keeping growth afloat through positive wealth creation and changing corporate and household behavior.** Rising stock prices are creating enough wealth that households feel comfortable running down their savings. And rising stock prices are lifting CEO confidence enough to reduce the risk of any sizeable, economy-wide downsizing of headcount.

Against this backdrop, and arguments monetary policymakers have made in the recent past, near-term rate cuts are not fundamentally justifiable at this point. However, the Fed is loath to disappoint the bond market when it leans so heavily in one direction. Maybe it is time to change monetary policy, but we doubt it.



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