Global Macro Views – What is the Fed Looking At?

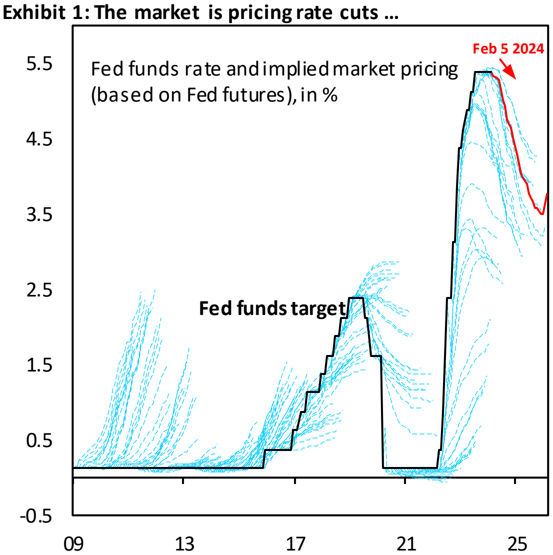
February 8, 2024

Jonathan Fortun, Economist, jfortun@iif.com, @EconChart

- Recent Fed speak suggests that rate cuts will take further time…
- citing the need for more patience and *"clarity"* on the data.
- This ***GMV*** goes over the many variables that the Fed is looking at…
- financial conditions, recent PMI data, and the Phillips Curve…
- as well as spots of uncertainty, including an election year.
- Most variables indicate it will be at least June before there is a pivot.
- However, we see normalizing inflation as the greater argument for cuts …
- and believe that the Fed should move to a dovish stance by May.

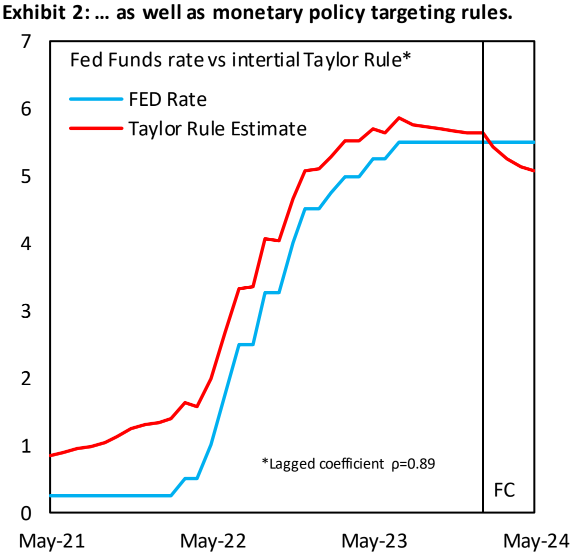
Recently, the Fed surprised the market by stating that it will wait for *"more clarity"* on the data to start thinking about cutting rates, with Gov. Powell saying that the first rate cut would probably come by June and that there is still a *"danger of moving too soon"*. In this ***Global Macro Views*** we apply our views on normalizing inflation to argue that the Fed should move to a more dovish stance sooner than what has been publicly stated. On one hand, the key metric we use to gauge the level of prices – the degree to which inflation is broad-based – has been turning lower for quite some time, falling inflation generalization has been consistent with supply shocks being the primary inflation driver and recent readings on core PCE confirm our prediction. Conversely, the unanticipated increase in employment during January indicated that the Federal Reserve isn't under immediate pressure to initiate monetary policy relaxation, allowing it the opportunity to observe whether inflation is on a sustainable path towards its 2% objective. Added to this mix is the always challenging context of an electoral year in the US, which -despite formally not being a variable of decision for the Fed- it always brings a different flavor to the policy making process. While we believe that the Fed should move to a dovish stance by May, all the Fed talk seems to indicate that any rate cut would come in June or later.

Exhibit 1: The market is pricing rate cuts …



Source: BBG, IIF

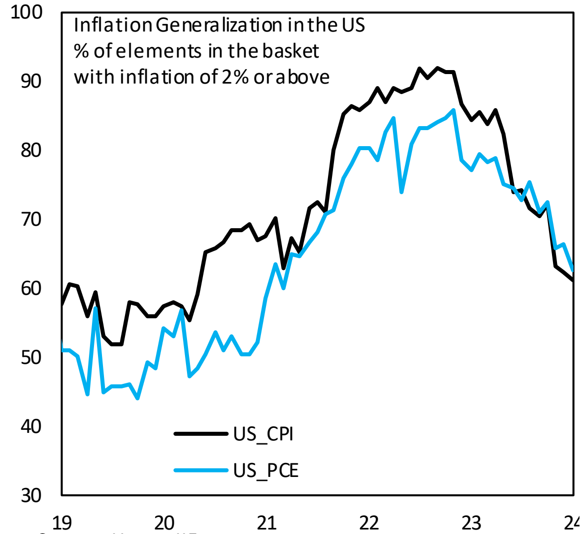
Exhibit 2: … as well as monetary policy targeting rules.



Source: BBG, IIF

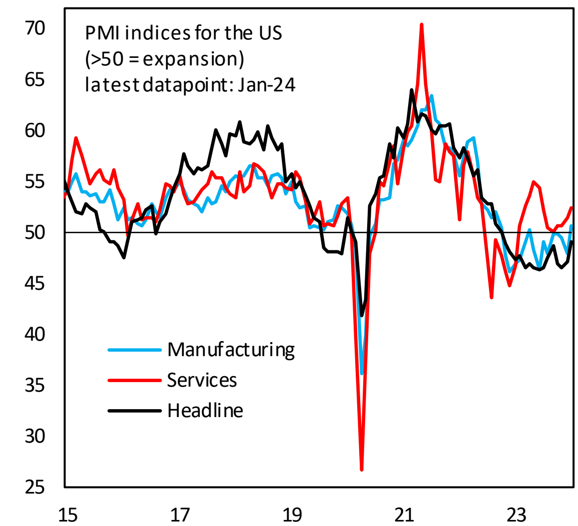
Fed Chair Jerome Powell's approach during uncertain times leans towards a cautious and deliberate policy-setting, which occasionally contradicts the prevailing market sentiment (Exhibit 1). This inclination is a significant factor behind the recommendation to postpone a rate reduction, despite compelling inflation data, including anticipated adjustments to CPI seasonal factors on February 9, which would advocate for a cut in March. If the Federal Reserve indeed opts to maintain the status quo in March, it would mark a notable departure from their consistent adherence to the inertial Taylor Rule since early 2021 (Exhibit 2). This shift signifies a substantial structural change in their response pattern to economic conditions, underscoring the significance of their decision-making process. While inflation measures propose a strong argument to initiate a dovish cycle (Exhibit 3), other datapoints like weakening PMIs still cast doubt for the path to follow (Exhibit 4).

Exhibit 3: Our measures suggest cooling inflation ...



Source: Haver, IIF

Exhibit 4: ... but PMIs still show some weakness.

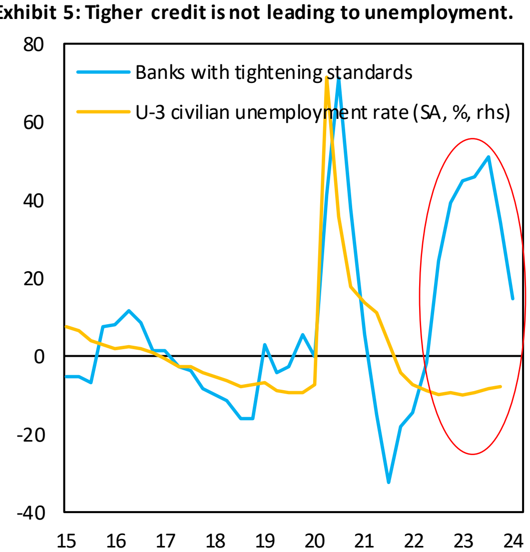


Source: Haver, IIF

Another datapoint that the Fed closely monitors is the state of financial conditions. The recently published SLOOS shows weakening signs of the economy, most US consumer banks reported that they were tightening lending standards and on top of that they stated that the demand for corporate and industrial loans was falling. A significant tightening of credit standards, similar to what occurred in the early stages of the SVB crisis, has a strong historical association with forthcoming economic downturns. When financial institutions become more cautious about extending credit, it often results in job losses in the aftermath; this time is different though. Currently, the unemployment rate remains relatively low, while the challenges faced by banks are gradually improving (Exhibit 5). This situation bodes well for overall economic growth, and it adds arguments for the Fed to be more cautious in cutting rates.

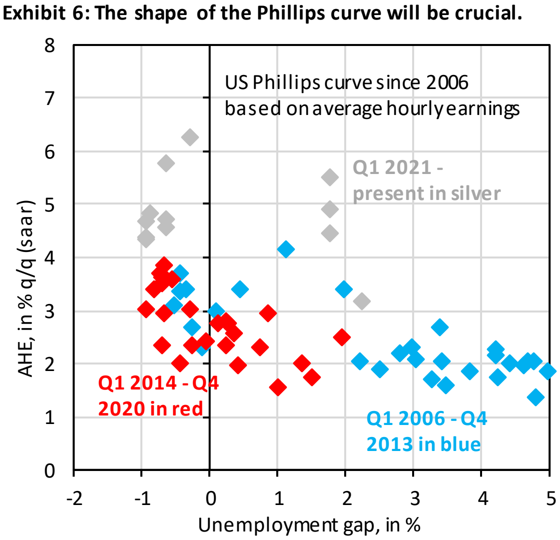
A core question will be how the Fed understands the current shape of the Phillips curve (Exhibit 6). The recent increase in US inflation following the pandemic has raised doubts about the previously held belief that the Phillips curve is flat -indicating little correlation between unemployment and price levels-. Simultaneously, the unique circumstances of a period marked by both a pandemic and a war make it challenging to draw definitive conclusions about how this relationship will appear when we return to more typical economic conditions, if we add to this interesting mix the odd ball of an election year, an open question remains about the future path that the Fed will take.

Exhibit 5: Tigher credit is not leading to unemployment.



Source: Haver, IIF

Exhibit 6: The shape of the Phillips curve will be crucial.



Source: Haver, IIF