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FED SHADOW

FOMC Preview: Paradoxes Mean Probable Policy Paralysis

Tuesday, March 19, 2024

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Or just call it a perfect balance of risks.

Tomorrow's FOMC faces paradoxes that will likely paralyze it, leading us to expect the meeting will yield no important changes to policy guidance.

- On the one hand, inflation would seem to have been conquered. Core CPI ex-OER is at 2.41%, now below the Fed's 2.5% year-over-year target for six months straight. On the other hand, it has been at 3.19% – that is, above target – over the last three months at an annual rate. On the *other* other hand, *that* is far below the 7.7% year-over-year rate seen two years ago.
- On the one hand, the unemployment rate is at 3.9%, the highest in 25 months. On the other hand, that's lower than all but 20 readings over the 52 years before that. And it's lower than the FOMC's 4.1% median estimate, reflecting maximum employment, published in the Summary of Economic Projections.
- On the one hand, growth is booming. Real GDP this quarter is estimated by the Atlanta Fed at 2.33% at an annual rate, above the 2.23% average in the prior business cycle. On the other hand, that would seem to be a deceleration after Q3-2023's 4.9% and Q4-2023's 3.2%.
- On the one hand, with the 10-year yield at 4.32%, financial conditions have eased considerably compared to the October 2023 highs at 5.01%. On the other hand, they've tightened almost as considerably from year-end when the 10-year was at 3.80%.

The easiest thing for the FOMC to do is just say, as it did in January, that "the risks to achieving its employment and inflation goals are moving into better balance" (see "On the January FOMC" January 31, 2024).

- Despite ways of telling the story that suggest worrisome deceleration of growth, *we are struck more by the resiliency of growth in the wake of one of history's most aggressive rate-hiking cycles*.
- This suggests to us that these *hikes have been more normalization than tightening*, and that policy is not, as Chair Jerome Powell always says, "well into restrictive territory" (see "Video: What you're not hearing about why it doesn't matter when the Fed cuts rates" February 26, 2024).

Update to strategic view

FEDERAL RESERVE, US MACRO, US BONDS: Inflation as we measure it is below target, but arguably accelerating in the short term. Unemployment is very low, but higher than it has been for two years. Growth is strong, but less strong than H2-2023. Financial conditions have eased from their worst, but tightened from their best. We think the Fed will process all this as a balance of risks and make no substantive change to policy or guidance. Evidence is strong that the neutral rate is higher than during the post-GFC era of "secular stagnation," and we wouldn't be surprised to see the "longer-run" dot moved up from 2-1/2% where it has been for more than five years. There will be a discussion of principles for ending balance sheet run-off, but little in the way of specific timing. This should not be a market-moving FOMC.

[Strategy dashboard]

- That, in turn, suggests that *the FOMC's 2.5% estimate of the neutral interest rate published in the Summary of Economic Projections – the "dot plot" for the "longer-run" – is far too low*.
- The funds rate target at 5-3/8% now is more than twice the FOMC's 2-1/2%, and it's been above it for a year and a half. If 2-1/2% were the neutral rate, we'd be seeing more dire effects on growth by now. It was appropriate for the post-Global Financial Crisis era of "secular stagnation," but not the new productivity boom following the pandemic.
- *It wouldn't surprise us to see that "longer-run" dot moved up a bit tomorrow* – for the first time in more than five years. Similarly, it wouldn't surprise us to see the dot for year-end 2026 move up by the same amount (it is currently at 2-7/8%). We expect no changes to the dots for 2024 and 2025.

We expect most of the focus at the post-meeting press conference to be on the eventual end of balance sheet run-off, so-called "quantitative tightening." The minutes of the January meeting made it clear that the discussion on this would begin at the March meeting (see "Data Insights: FOMC Minutes" February 21, 2024). We expect *all that will come of this tomorrow will be laying out principles for thinking about it* – we'll be surprised if there is anything more than hints as to timing.

If our expectations laid out here are about right, we expect this will not be an especially market-moving FOMC. As of this writing, markets expect the first rate cut at the July FOMC, and three cuts by year-end. We don't expect that to change, and we think the implications of it for growth and inflation are appropriate (again, see "Video: What you're not hearing about why it doesn't matter when the Fed cuts rates").

Bottom line

Inflation as we measure it is below target, but arguably accelerating in the short term. Unemployment is very low, but higher than it has been for two years. Growth is strong, but less strong than H2-2023. Financial conditions have eased from their worst, but tightened from their best. We think the Fed will process all this as a balance of risks and make no substantive change to policy or guidance. Evidence is strong that the neutral rate is higher than during the post-GFC era of "secular stagnation," and we wouldn't be surprised to see the "longer-run" dot moved up from 2-1/2% where it has been for more than five years. There will be a discussion of principles for ending balance sheet run-off, but little in the way of specific timing. This should not be a market-moving FOMC.