

FED SHADOW

## FOMC Preview: A Political Decision?

Monday, July 29, 2024

Donald Luskin

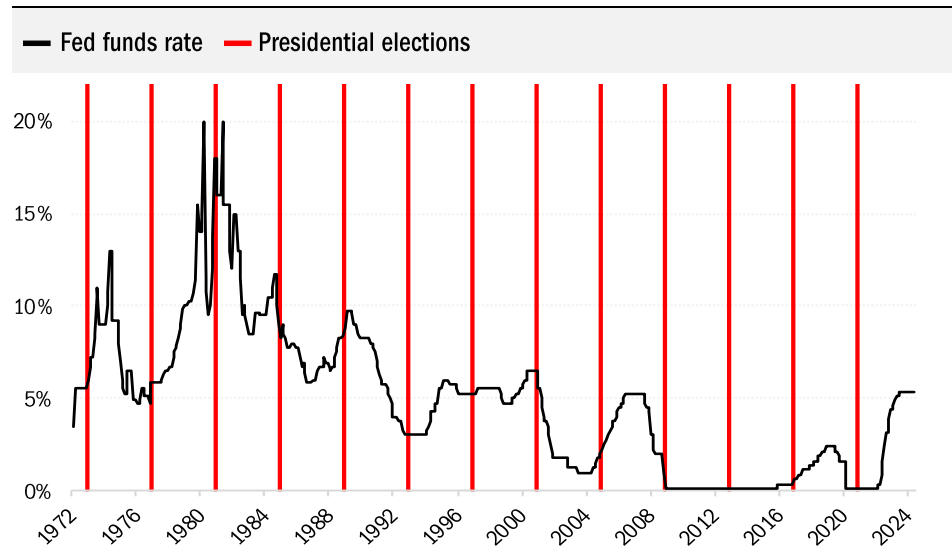
With the first rate cut coming, the Fed might fear it's a battleground state this election.

Leading independent journalists like [Seymour Hersch](#) (on the left) and [Victor Davis Hanson](#) (on the right) are converging on a history of President Joseph R. Biden's stand-down as Democratic candidate. They are reporting he was pressured with the threat of expulsion under the 25th amendment of the Constitution (exactly as we had reasoned *ex ante* – see [“Our Hot Take on Biden’s Stephanopoulos Interview”](#) July 6, 2024).

- We've been spared (so far) the first-ever use of the 25th Amendment, and the shock to markets that would have resulted. *But now we have a potentially much more competitive presidential election.*
- We don't believe the coalescence of Democratic party support behind Vice President Kamala Harris is evidence of her political skill or even of any actual enthusiasm for her. We think she's the only one who wanted to run – she, alone among possible rivals for the nomination, has no better career move than spending the next three months in a mud-fight with Donald J. Trump, which she very well may not win. So, no surprise, her party has made the best of the situation. The media that sets the dominant narrative has been in overdrive erasing her past mishaps (such as the rather silly

### Update to strategic view

**FEDERAL RESERVE, US POLITICS, US MACRO, US BONDS:** With Biden out, having been threatened with expulsion under the 25th Amendment, the presidential election has become more unpredictable. Harris's appeal as a candidate remains to be seen, but at the moment the media is making a full-court press to build enthusiasm for her after having spent four years diminishing her. It will likely be a close election. Our quantitative model has now, for the first time, flipped to predict Trump as the winner. The FOMC Wednesday will likely signal the first rate cut will come in September. That is deeply expected by markets, and there will be a reaction if they fail to do it. The perception of intervening in the election by acting so close to it could conceivably stay the Fed's hand, but there is no evidence over history that the Fed acts differently around elections. The Fed can be accused of bias whether it acts or doesn't, so it will likely do what it thinks is right objectively, which is start cutting in September in the face...



Source: Bloomberg, TrendMacro calculations

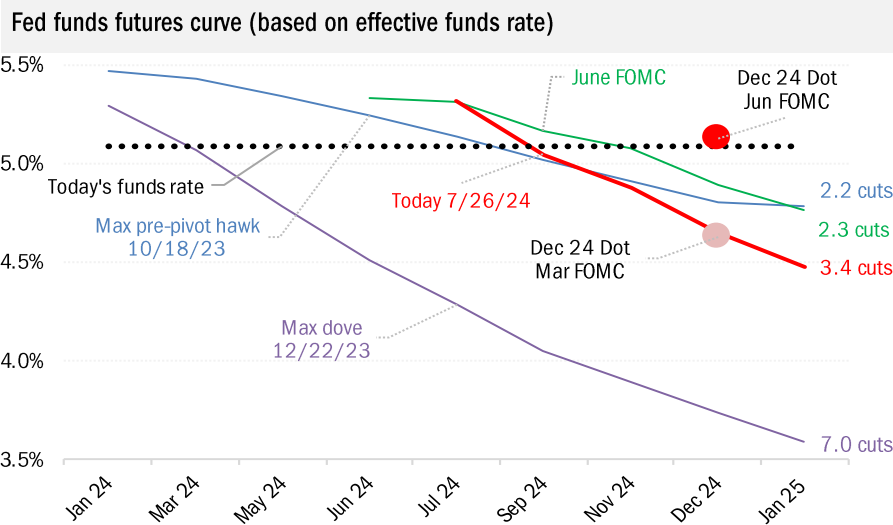
semantic debate about [whether she was the Biden “border czar”](#)). Until now, Harris has never been particularly protected by the media for some reason. But now it is [unashamedly repurposing all the narratives they themselves have used](#) for the last four years to diss her as evidence of her merit (it’s really quite an example of the power of [manufacturing consent](#)). *Until one minute after Biden stepped down, the conventional wisdom was that Harris would be an even worse candidate. She may yet turn out to be. But from here, the base case has to be that unless there’s yet another political black swan this election season, it’s going to be close – as it seems elections always are now.*

- For what it’s worth, our quantitative presidential election prediction model, as of just last week, for the first time this cycle, is predicting that Trump will win based on economic inputs. Already, though the inflation rate continues to fall toward the Fed’s target (see [“Data Insights: PCE Inflation”](#) July 26, 2024), its pace of improvement (which is the dynamic the model measures) has slowed. Then Thursday, though Q2-2024 GDP came in strong, income growth slowed and tax burdens grew (see [“Data Insights: GDP”](#) July 25, 2024). And the model flipped to Trump.
- *It is in this unstable political situation that the FOMC meets on Wednesday, with every reason to strongly signal the first rate cut will come at the September meeting. But would that be perceived as attempting to tip the election to Harris? Will fear of such perceptions stay the Fed’s hand?*
- The set-up going into Wednesday is that *markets strongly expect a cut in September, with a probability of greater than 100%* (please see the chart below). *If a cut is indeed coming in September, the communications style of the Powell Fed commands that it be signaled one meeting beforehand.* If that announcement happens, it will be no surprise, so we wouldn’t expect a large market reaction. With the first rate cut coming, the Fed might fear it has become a

[Continued from first page]

...of mounting proof of continued disinflation after an embarrassing false alarm in the first quarter. Easing has already begun with the dialing back of QT. The Fed is not as restrictive as it has been saying it is, as the strength in the economy proves. A decade out, based on the Treasury forward curve, today’s funds rate would be about neutral. In the meantime, secularly rising yields will gradually move the Fed’s perception of neutral higher. If the 10-year Treasury is the best proxy for the neutral rate, then today’s policy is only five rate cuts away.

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Source: Bloomberg, TrendMacro calculations

battleground state this election. But *if politics – or fear of the perception of politics – gets in the way and the announcement doesn't come, it will be a big disappointment that will drive a big reaction.*

- Don't underestimate how strong market expectations are now. At just the prior FOMC meeting in June (see "[On the June FOMC](#)" June 12, 2024), the FOMC raised its [Summary of Economic Projections](#) "dot plot" for the year-end funds rate to 5-1/8%, half a percent higher than the 4-5/8% [set in the SEP](#) three months before at the March FOMC (see "[On the March FOMC](#)" March 20, 2024). Yet today, the market-implied year-end funds rate is at about 4-5/8%, where the "dot plot" had been in March, down from 4-7/8% right after the June FOMC when the "dot plot" was raised to 5-1/8%. To be clear, yes, *the market now expects a lower funds rate than it did in June when the FOMC told it to expect a higher one* (again please see the chart on the previous page). *Therein lies the downside risk: if such strong expectations are not met.*
- *We think the announcement will indeed come on Wednesday, meeting expectations.* When [congenital hawks on the Board of Governors like Christopher Waller say](#) "I believe the time to lower the policy rate is drawing closer," that's more than a clue.
- *We don't think the Fed will let perceptions of political bias get in the way. It never has.* Well... that's too strong a statement. At least the record going back half a century shows no obvious pattern of funds rate target changes, or lack of changes, with respect to the timing of elections (please see the chart on this report's first page).
- *What's more, while the Fed has to be sensitive to perceptions, the reality is that at this point it's hard to argue that announcing a rate cut that's already expected, and then executing it as expected, would make any difference to the underlying economy, and therefore to the election.* We suppose it could influence sentiment by, say, allowing stock prices to move higher. But again, it's expected, so stocks are already higher.
- *For that matter, the Fed could be accused of playing politics if it does the opposite* – that is, *no* signal Wednesday, *no* first cut in September. It's as much playing politics to help Trump as it is to help Harris.
- *If the Fed is at reputation-risk either way, then it should just do whatever it thinks is the right thing, without regard to the fact that an election is coming up.*
- *So what will the Fed think is the "right thing"?*

At this point, who really knows. But [they've been saying for many months](#) that they are looking for "greater confidence that inflation is moving sustainably toward 2 percent." The trick there is the fundamentally subjective notion of "confidence" – in invoking that as the standard, they are talking about their inner mental state more than about the material world. But the evidence in the world is that inflation has come down dramatically and is continuing to do so (please see the chart on the following page).

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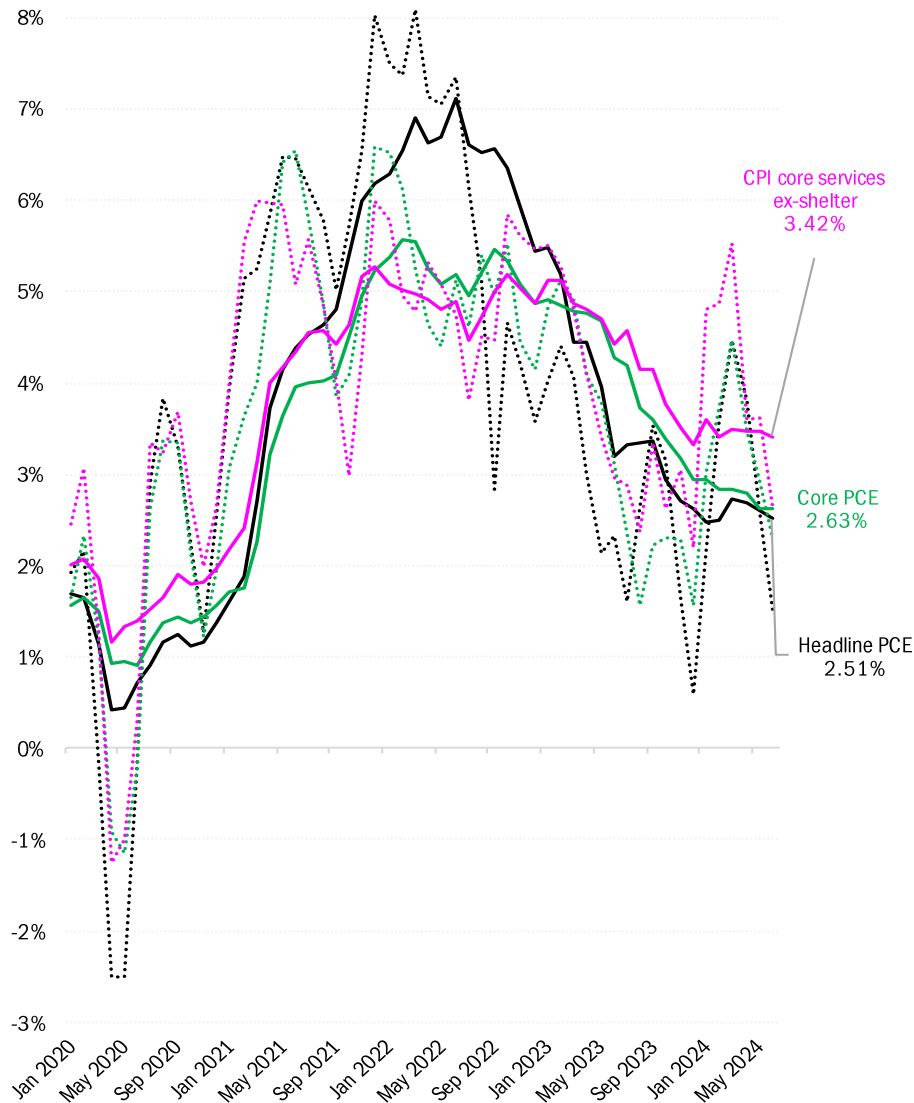
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Personal Consumption Expenditures inflation — Year-over-year ••• 3-month at annual rate



Source: BEA, TrendMacro calculations

- Headline Personal Consumption Expenditures inflation is now at 2.51% on a year-over-year basis. Core is at 2.63%. These readings are a rounding error away – or, at least, the normal band of historical revisions away – from the 2% target. Fed Chair Jerome Powell’s “supercore” – that is, core services ex-housing – is higher at 3.42%, and if there’s a rub, that’s it. He’s said in the past he sees it as the best indicator of underlying inflation impulses, but it only comprises a plurality of the consumption basket and he’s sort of stopped talking about it.
- All three versions of PCE inflation are lower still on a 3-month annual basis, indeed sharply so (again, please see the chart below). Throughout this inflation and disinflation cycle, 3-month

measures have been a leading indicator for where year-over-year measures were headed – that is, until a false alarm in the first quarter of this year which caused the Fed to pull back from its late-2023 pivot. That’s all reversed now, and we think the Fed ought to be somewhat chagrined to have been tricked by what we have said all along was mere noise (see, for example, (see [“Video: What you’re not hearing about that horrible March CPI report”](#) April 10, 2024). Having been whipsawed like that, all the more reason to cut rates now.

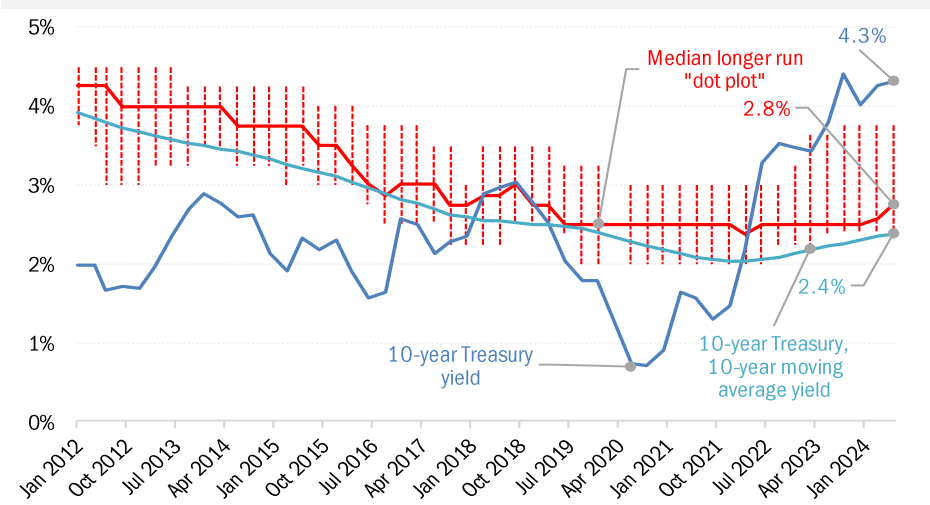
- Especially now, when as [the FOMC said in June](#), the “economic outlook is uncertain, and the Committee remains highly attentive to inflation risks.” That is to say that the unemployment rate has risen from a low of 3.4% in April 2023 to 4.1% today.
- And remember, this isn’t like we’re starting from scratch – *the Fed has already started easing*. As we talk to clients, we discover that they seem to forget that the FOMC announced at the May meeting that they would sharply slow the pace of balance sheet run-off – so called “quantitative tightening” – starting in June (see [“On the May FOMC”](#) May 1, 2024). To be sure, we’ve always downplayed the actual tightening effect of QT (see, among many, [“Is Quantitative Tightening Over?”](#) January 29, 2024). But such an effect does exist to at least some extent, and so slowing the pace of QT has to be at least some degree of easing.

A signal for a first rate cut in September will be the high-priority factor Wednesday in terms of short-run market reaction. But markets will also want to take on board the Fed’s vision for the long-term path of a coming easing cycle – how long will it take, and how low will rates go?

- Powell keeps saying the policy rate is “restrictive” (again, see [“On the June FOMC”](#)). That means he thinks it is above the “neutral rate.” But as he said of the neutral rate at [the post-meeting press conference in June](#), “It, it really is a theoretical concept – can’t be directly observed.” Yet he insists, apparently without basis by his own admission, “Well, we think – we think policy is restrictive.”
- How restrictive? And while unobservable, what does the FOMC *think* the neutral rate is? If it’s below the policy rate, that tells us that the Fed knows it has to ease eventually – and it tells us how far that easing will go once it gets started.
- *Our best indication of the Fed’s estimate of the neutral rate comes from the Summary of Economic Projections, which provides a “dot plot” for what it calls the “longer run” funds rate.* This can be understood to be the funds rate that would be appropriate with the Fed’s dual mandate perfectly satisfied – maximum employment co-existing peacefully with stable prices. That’s the neutral rate, because in that perfect world the Fed has no need to either tighten or ease.
- This longer run “dot plot” has been published since January 2012, after the worst days of the Global Financial Crisis, but before it was well understood that we would have to endure an aftermath of [“secular stagnation,”](#) with persistent low interest rates and low inflation, despite what seemed like wildly accommodative central

bank policy everywhere in the world. The first longer-run “dot plot” was at 4.25%. By June 2019, after more than six years of “secular stagnation,” the longer-run “dot plot” had drifted down to 2-1/2%, where it sat for almost five years, until March of this year (please see the chart below).

The neutral rate: SEP longer run funds rate versus 10-year Treasury yields



Source: FRB, Bloomberg, TrendMacro calculations

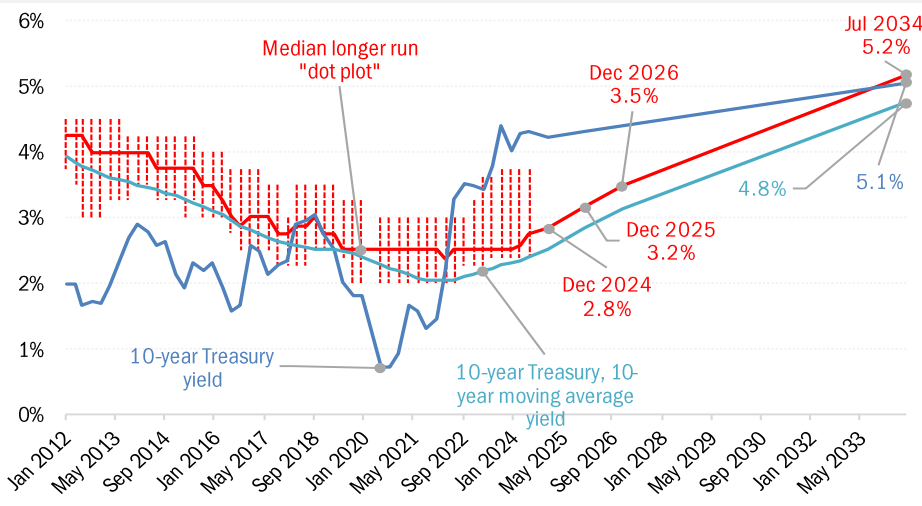
- The SEP nudged the longer run “dot plot” from 2-1/2% in December 2023 to 2-9/16% at the March 2024 FOMC (as we predicted it would – again, see [“On the March FOMC”](#)). It nudged it harder in June, this time to 2-3/4% (also as predicted, again, see [“On the June FOMC”](#)).
- This is approximately consistent with the SEP’s estimates in March and June for the funds rate at year-end 2026 (the longest-range estimate associated with a particular year) at 3-1/8%. These were raised from 2-7/8% in December 2023.
- *The FOMC is coming to terms with the seeming paradox that, huff and puff as it has with a policy rate above 2-1/2% now for almost two years, the economy has only strengthened, while inflation has fallen.* We don’t know if they are wondering how the fall in inflation squares with the strengthening of the economy (considering that they believe the canard that inflation is an unfortunate by-product of growth). But we do know they are wondering why their seemingly restrictive policy hasn’t slowed the economy – because they wonder aloud about it in the [minutes of the June meeting](#) (see [“Data Insights: FOMC Minutes”](#) July 3, 2024). We are particularly interested in one musing, which we have highlighted:

“Some participants noted that there was uncertainty about the degree of restrictiveness of current policy. Some remarked that the continued strength of the economy, as well as other factors, could mean that the longer-run equilibrium interest rate was higher than previously assessed, in which case both the stance of monetary policy and overall financial conditions may be less restrictive than they might appear. A couple of participants noted that the longer-

run equilibrium interest rate was a better guide for determining where the federal funds rate may need to move over the longer run than for assessing the restrictiveness of current policy.”

- Really, it seems that the 10-year Treasury yield very closely explains the longer run “dot plot.” Specifically, the 10-year moving average of the 10-year yield correlates almost perfectly – with an R-squared of 0.98 – with what would appear to be the Fed’s proxy for the neutral rate. This is consistent going all the way back to 2018.
- To be very clear, we are not saying that the 10-year moving average of the 10-year Treasury rate is the neutral rate in reality. We are just saying that it appears very much that the Fed thinks it is. The evidence the economy is presenting to us points more to the contemporaneous 10-year yield as the neutral rate. This is actually more consistent with a little-appreciated [statement by Powell](#) all the way back in 2018.
- The FOMC thinks the funds rate at 5-3/8% is restrictive because the 10-year moving average of the 10-year Treasury is much lower – at 2.4%. But the contemporaneous 10-year Treasury yield is 4.3%, still below the funds rate, but not that far. This is why we have been saying for a long time that the Fed is far less restrictive than it thinks.
- With all that said, we will use the 10-year forward yield of the 10-year Treasury at 5.1% to predict not the *actual* neutral rate (the contemporaneous 10-year yield), but what the Fed will *think* the neutral rate is (the 10-year moving average of the 10-year yield).
- In July 2034, with the contemporaneous 10-year yield at 5.1%, the 10-year moving average will be 4.8%. So the longer run “dot plot,” which gives us the Fed’s idea of the neutral rate, will be 5.2% based on this historical relationship between the two (please see the chart below). So in a decade the Fed’s conception of the neutral rate is likely to be almost exactly where the funds rate is

The neutral rate: SEP longer run funds rate versus 10-year Treasury yields

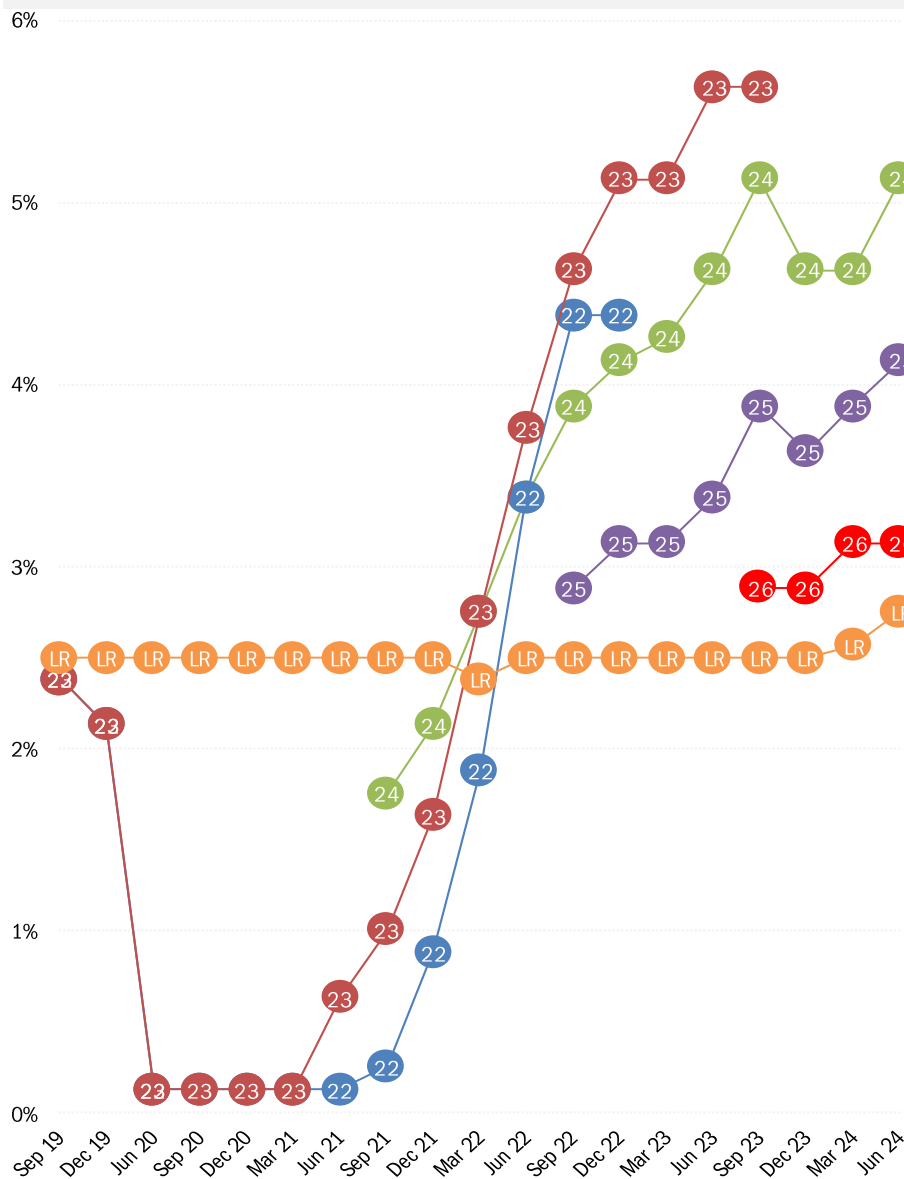


Source: FRB, Bloomberg, TrendMacro calculations

today – though today the Fed says that rate is restrictive.

- Along the way, as the moving average rises, the Fed’s *conception* of the neutral rate will rise, too. But it will rise slowly.
- The 2026 “dot plot” at 3-1/8% is the first one that positions at or below the longer-run “dot plot” implied by the 10-year moving average of the 10-year yield – which at year-end 2026 will be at 3.5%. So unless the Fed cuts rates dramatically, it will remain “restrictive” according to its own definition for something like two years.
- But that’s according to the Fed’s *definition*, not *reality*. If the contemporaneous 10-year yield (not its 10-year moving average) is the *actual* neutral rate, then the “dot plots” have the Fed hitting neutral at about year-end 2025, at a funds rate of 4-1/8%. The

“Dot plots” from the FOMC Summary of Economic Projections



Source: FRB, TrendMacro calculations



forward curve has the 10-year year at about 4.3% then.

- *But we believe the annual “dot plots” for 2024, 2025 and 2026 are now placed quite conservatively in order to signify the Fed’s inflation-fighting resolve, just as they were placed insanely liberally in the pandemic and its aftermath to signify the Fed’s recovery-promotion resolve* (please see the chart on the previous page). Remember the “dot plot” for year-end 2023 at 5-5/8% was at zero as recently as March 2021, when Gross Domestic Product had already made new all-time highs after the pandemic depression.
- *We think as disinflation continues, the annual “dot plots” will come down faster than the longer run “dot plot” will rise – the former driven by rapidly evolving data, the latter driven by the glacial rise of the 10-year moving average of the 10-year Treasury yield.*
- *All we need to hit the neutral rate as we conceive it is about 4-1/2 rate cuts, assuming the 10-year yield stays where it is.* Actually, we think yields are near the lows here, so as the funds rate falls over the coming year, the 10-year yield will rise to meet it – bringing the day policy is back to neutral all the nearer.
- But remember – if we’re right about a coming era of secularly higher growth and higher bond yields – for that matter, just if the forward curve is right and the 10-year Treasury will be at 5% in a decade – then the Fed wouldn’t need to cut from today’s funds rate to be neutral. Having lowered it in the meantime, it would have to hike rates to stay neutral.

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## Bottom line

With Biden out, having been threatened with expulsion under the 25th Amendment, the presidential election has become more unpredictable. Harris’s appeal as a candidate remains to be seen, but at the moment the media is making a full-court press to build enthusiasm for her after having spent four years diminishing her. It will likely be a close election. Our quantitative model has now, for the first time, flipped to predict Trump as the winner. The FOMC Wednesday will likely signal the first rate cut will come in September. That is deeply expected by markets, and there will be a reaction if they fail to do it. The perception of intervening in the election by acting so close to it could conceivably stay the Fed’s hand, but there is no evidence over history that the Fed acts differently around elections. The Fed can be accused of bias whether it acts or doesn’t, so it will likely do what it thinks is right objectively, which is start cutting in September in the face of mounting proof of continued disinflation after an embarrassing false alarm in the first quarter. Easing has already begun with the dialing back of QT. The Fed is not as restrictive as it has been saying it is, as the strength in the economy proves. A decade out, based on the Treasury forward curve, today’s funds rate would be about neutral. In the meantime, secularly rising yields will gradually move the Fed’s perception of neutral higher. If the 10-year Treasury is the best proxy for the neutral rate, then today’s policy is only five rate cuts away. ▶