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TRENDMACRO LIVE!

On the December FOMC

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Donald Luskin

Powell loses control of his committee. Luckily, the new policy path is accidentally optimal.

Coming into today's FOMC, markets were entirely set up for a "hawkish cut" – a 25 bp rate cut to 4-3/8% from 4-5/8%, and a strong signal that there will be a pause at the January FOMC. The fed funds futures curve has been discounting this almost entirely for several weeks. *And that's just what we got. With markets priced for it so fully, this shouldn't drive any big reaction. But as of this writing it feels like a panic. But it will subside.*

- The big tell was the "dot plot" in the FOMC's Summary of Economic Projections, *now calling for only two rate cuts throughout 2025. At the September SEP, it was four*.
- In today's FOMC statement, "additional adjustments" – as rate cuts were referred to in November as though they were inevitable – was modified to "*the extent and timing of* additional adjustments" as though they are now entirely contingent [*our emphasis*]. *There were literally no other language changes, which begs the question of why there would be such a consequential change to the policy path with no change in the environment worth putting into words?*
- *There was even a hawkish dissent from Beth Hammack, president of the Cleveland Fed.*
- It would appear to be all about inflation. Yes, there have been a couple of less than brilliant inflation reports. The Personal Consumption Expenditures Price Index the Fed watches is at 2.3% year-over-year – up from 2.1% in September. We've been

Update to strategic view

FEDERAL RESERVE, US MACRO: The FOMC cut the funds rate by 25 bp, and signaled with the "dot plot" there would only be two more cuts across eight meetings in 2025. The statement put "the extent and timing of adjustments" at risk. It appears to be an inflation panic, with the SEP strongly upgrading 2025 inflation expectations, and not returning to target until 2027. When asked why the cut today, then – or any at all in 2025 – Powell had only word salad. It is clear to us that he does not support this new hawkish bent, has lost …

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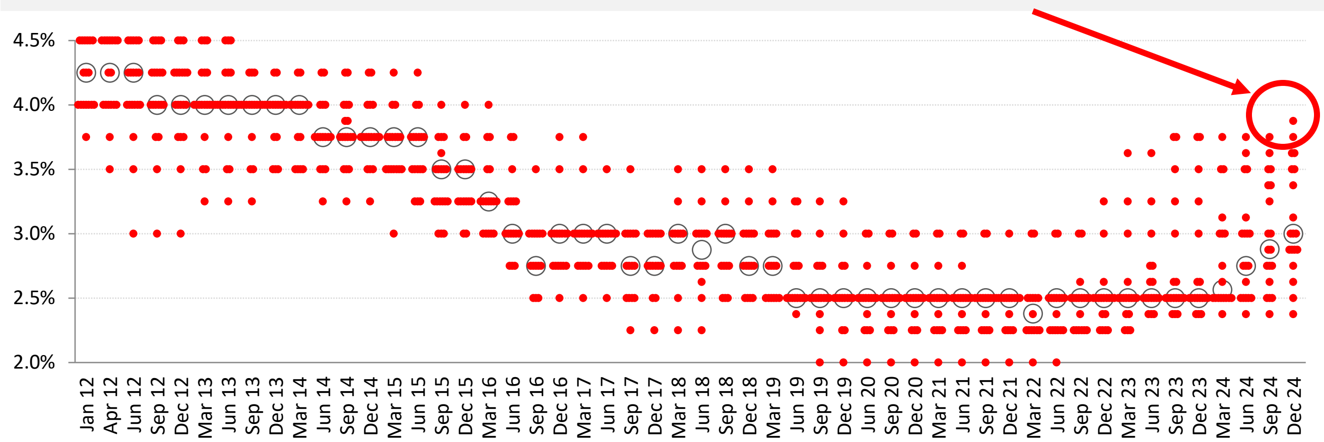
"Dot plots" of "appropriate policy path" for the "longer run"



Source: FRB SEP, TrendMacro calculations

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disappointed that there hasn't been more disinflation, and we've wondered why (see "Has the Economy Become Inflation-Prone?" October 9, 2024), *but we're basically at target*. The Fed doesn't have any theory that would predict why inflation would re-accelerate from here. *And yet the SEP upgraded the Committee's expectations for core PCE inflation in 2025 to 2.5% from 2.2% at September. It now doesn't expect a return to the 2% target until 2027!*

- And it's not like the labor market is flaring up and posing a risk to inflation (at least to those who believe that prosperity of workers causes inflation). At 4.2%, the unemployment rate is higher than it was in September when the FOMC lowered rates by 50 bp to be sure they were not falling behind the curve (see "On the September FOMC" September 18, 2024). *The last two jobs reports have been sloppy* – with storms disrupting October's numbers (see "On the October Jobs Report: Blockbuster in Disguise?" November 1, 2024), but then showing less recovery than expected in November (see "On the November Jobs Report" December 6, 2024).
- If the Fed is suddenly so cautious about inflation – and suddenly so unworried about the labor market – then why signal any cuts at all in 2025, and why cut at all today? That very logical question was the first one Fed Chair Jay Powell was asked in the post-FOMC press conference.
- Powell's answer was word salad. He characterized today's cut as a "close call." He said, "Inflation is broadly on track." He said, "We have a much cooler labor market – it is gradually cooling." Okay – that means he thinks we have approximately a mandate-consistent economy. But then he adds that policy is "still meaningfully restrictive." *So what was the close call here? And why not keep cutting until we get back to neutral like Powell strongly indicated they would at the November FOMC, when he said: "We're on a path to a more neutral stance. And, and that's very much what we're doing."*
- So the only sensible argument for a pause here is that, as we've been saying for some time (see "FOMC Preview: A Political Decision?" July 29, 2024), *the neutral rate is higher than generally expected*. The higher the neutral rate, the sooner this easing cycle will end – and the sooner the Fed will pause in order to bring the funds rate in for a landing.
- But are we really there already?
- The Fed doesn't exactly declare what it thinks the neutral rate is, but the "longer-run" policy rate given in the Summary of Economic Projections is strongly indicate. Stuck at 2-1/2% for many years, it has been edged up at every SEP this year – including today's – and now stands at a median of 3% (please see the chart on the first page). The single highest "dot" is at 3-7/8%, so at 4-3/8% now, we're not even at the outer boundaries of what Powell called in November "levels that are plausibly neutral or close to neutral."
- And yet they are signaling a pause.
- In the presser Powell talked about how difficult it was to know what the neutral rate actually is. He emphasized over and over, though, that whatever it is, the policy rate is closer to neutral that it was –

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… control of his committee, and is unable to put a coherent public face on it. Markets fully expected this "hawkish cut," but are reacting badly to the institutional disarray on embarrassing display. Powell insists that policy is "still meaningfully restrictive," but at the same time he does not know where the neutral rate is. The SEP upgraded it again, with the top "dot" only 50 bp above the funds rate. We think policy is indeed approximately neutral already, and do not see any recession risk in the Fed's policy path. When markets have processed the institutional confusion seen today, they will recover smartly.

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but only in virtue of the fact that there has been 1.00% of cumulative rate cuts over the last three FOMC meetings. Yet at the same time, he emphasized several times that policy is "still meaningfully restrictive."

- *This is purely subjective, but for what it's worth, we get the strong impression that Powell's word salad today indicates he does not personally support the path forward outlined in today's FOMC. Indeed, as Chair, he was thwarted. Any yet he has to face the public and try to tell the consensus story,*
- As of this writing, as he portrays an FOMC that would seem to be in considerable intellectual disarray, markets are reacting quite badly. Considering that, as we said at the outset, markets have broadly expected this for weeks, we think it's not the policy *per se* but rather the disarray that is so disturbing.
- Once the dismay has passed, and markets can consider the actual consequences of two rate cuts in 2025 rather than four, we think they will recover smartly – and it shouldn't take long.
- *We are not at all worried objectively that the Fed's pause will slow the economy, or trigger a recession?*
- *We anchor the aggressive end of the spectrum in terms of the neutral rate – we're comfortable saying we're at the neutral rate already, because a mandate-consistent economy is acting like we are. What better evidence could you ask for?*
- To be sure, there is a widespread belief that growth is improved everywhere and always by loose monetary policy. But we believe that, in the absence of some kind of emergency, growth is in fact optimized by neutral policy – in which the Fed effectively becomes transparent and invisible, and lets markets freely decide the proper rates are which borrowers and lenders deal with each other.

Bottom line

The FOMC cut the funds rate by 25 bp, and signaled with the "dot plot" there would only be two more cuts across eight meetings in 2025. The statement put "the extent and timing of adjustments" at risk. It appears to be an inflation panic, with the SEP strongly upgrading 2025 inflation expectations, and not returning to target until 2027. When asked why the cut today, then – or any at all in 2025 – Powell had only word salad. It is clear to us that he does not support this new hawkish bent, has lost control of his committee, and is unable to put a coherent public face on it. Markets fully expected this "hawkish cut," but are reacting badly to the institutional disarray on embarrassing display. Powell insists that policy is "still meaningfully restrictive," but at the same time he does not know where the neutral rate is. The SEP upgraded it again, with the top "dot" only 50 bp above the funds rate. We think policy is indeed approximately neutral already, and do not see any recession risk in the Fed's policy path. When markets have processed the institutional confusion seen today, they will recover smartly.

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