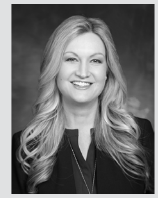
Economic **INSIGHT**

January 30, 2024

Q1 Rate Cuts: A Wall Street Fairy Tale?



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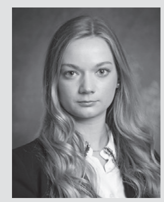

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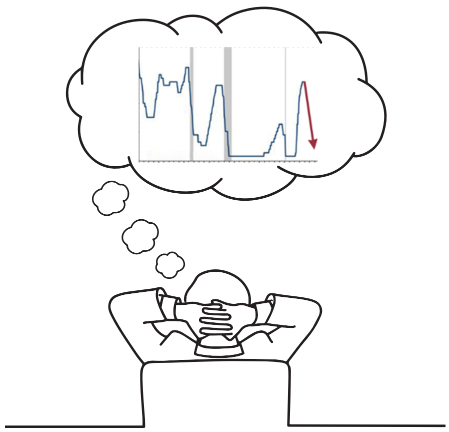


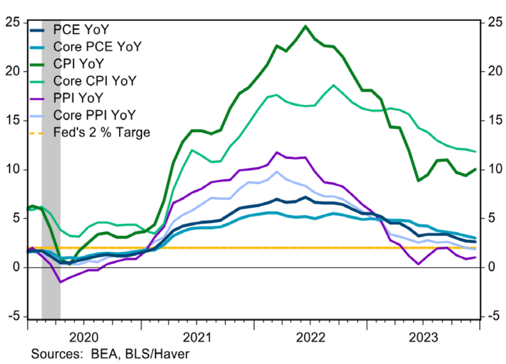
Investors remain exuberant, calling for a series of Federal Reserve (Fed) rate cuts over the next several quarters. Like fairy tales with sugarplums, investors have visions of returning to the easier credit conditions of years past dancing in their heads. Such a desire for relief, however, may be clouding their judgment, given the Fed's ongoing message of patience and caution.

While willing to include the notion of rate cuts in the conversation more recently, policy makers are not yet convinced of the sustainability of the improved trend of disinflation. Investors are likely to face further disappointment, as the Fed is again expected to hold policy steady with the accompanying statement absent of any commentary supporting a near-term reduction in rates.

A BIG "*IF*"

Policy makers are increasingly willing to support rate cuts in 2024, but not unilaterally. A readiness to implement less restrictive policy is contingent on the notion that inflation continues to fall towards the Fed's 2% target. Without a further retreat and convincing evidence of reinstating price stability on a *sustained* basis, the Committee is poised to remain on the sidelines.

In the aftermath of the latest December policy decision, several Fed members have been clear in their support and willingness to cut rates, *but only* when the time is right. According to Fed Governor Christopher Waller, the Committee still needs further information to confirm the directional momentum of inflation. The data, he said, in the last few months is "*allowing the committee to consider cutting the policy rate in 2024*." However, there are concerns about the sustainability of these improved trends, particularly given recent volatility in price pressures.



Inflation has fallen markedly from peak levels, but the painfully slow pace of improvement suggests the Fed may still have work to do. As New York Fed President John Williams noted the week of January 7, to fully achieve the goal of low, stable inflation, even with the recent improvement, the Fed "*will need to maintain a restrictive stance of policy for some time.*"

Housing costs remain elevated – up more than 6% as of December – the core Producer Consumption Expenditure (PCE) remains near 3%, and the supercore, which excludes food, energy, and housing, is still nearly two times the Fed's desired level of inflation.

Additionally, there is a clear lack of downward momentum, or at least a lack of convincing downward momentum, in key measures of inflation. The latest read on consumer prices was notably hotter than expected, pushing the annual pace of headline prices up from 3.1% to 3.4% at year end, the fastest pace in three months. Commenting on the latest consumer inflation report, Federal Reserve Bank of Cleveland President Loretta Mester said it "*shows there is more work to do, and that work is going to take restrictive monetary policy.*"

MIXED MESSAGING

Leading up to the Fed's first policy announcement of the year next Wednesday, the Committee's latest message has been one of a *balanced* approach to policy. While Committee members want to avoid maintaining an overly restrictive policy for longer than necessary, they also want to avoid a reduction in rates before achieving price stability at 2%. The former could unnecessarily slow the economy – potentially into recession – while the latter would allow price pressures to become further embedded into the economy.

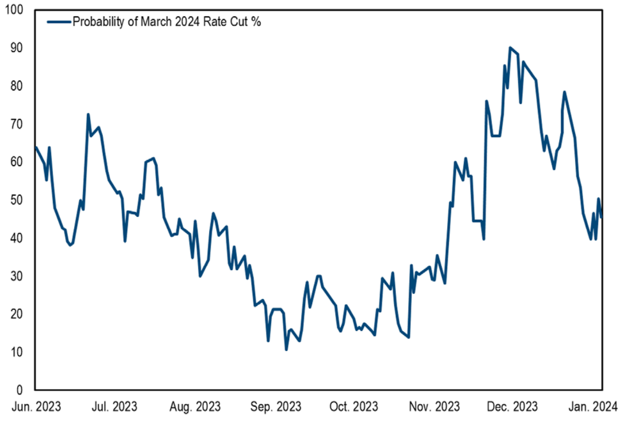
At present, the domestic economy remains solid, with an ongoing resilient consumer. End of the year growth exceeded expectations, rising 3.3%, the sixth consecutive month of stronger-than-expected activity, amid a welcome outperformance in spending, with retail spending alone rising 0.6% at year end. Thus, with the consumer and broader-based growth surpassing earlier forecasts, easing credit conditions, and still nominally elevated price pressures, clearly the risk – at least for now – is weighted towards an anticipatory policy adjustment to lower rates.

There is no urgency for the Committee to remove restrictive policy other than to return to a more balanced or neutral level once the Fed's inflation goal has been reached. Furthermore, the notion that the Committee would need to lower rates to help stabilize the economy seems clearly unjustified.

NO RUSH

While continuing to acknowledge the improvement in price pressures, even with an expected fourth-round pause in January, officials are unlikely to go so far as to say their mission of price stability has been accomplished and that an initiation in policy adjustment(s) is warranted. Furthermore, even when it "*eventually*" becomes appropriate to begin the process of lowering rates, as Waller and other Fed members have noted, the path of policy will be "*carefully calibrated and not rushed.*" In other words, not only will the start date for rate cuts likely prove later than expected, but the pace of rate cuts will expectedly be slower and more tempered than anticipated.

Investors, meanwhile, continue to disregard the prerequisite of further disinflation as a catalyst for rate cuts and the Committee's cautionary warning of a patient approach. According to the CME FedWatch tool, the market continues to price in between six or seven cuts over the next 12 months with a first-round rate cut as early as March at 46% (albeit reduced from a peak of 90% in December).



Source: Bloomberg

GLOSSARY

CPI – Consumer Price Index

PCE – Personal Consumption Expenditures

PPI – Producer Price Index

YoY – Year over Year

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Of course, this isn't the first time the market has disagreed with, or completely disregarded, the Fed's message. Led by an experiential basis where the "*normal*" world, or the only world known, is the low yields of the near-two decades prior to COVID, the market has been preemptively calling for an end to rate hikes for the better part of the past two years and pricing in rate cuts that have yet to come to fruition. Thus, now, as the market again pushes against the current policy message of patience for *eventual* rate cuts, it is important to remember investors have been wrong before, each time disappointed with the reminder of the old adage, *"Don't fight the Fed."*

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