Economic INSIGHT

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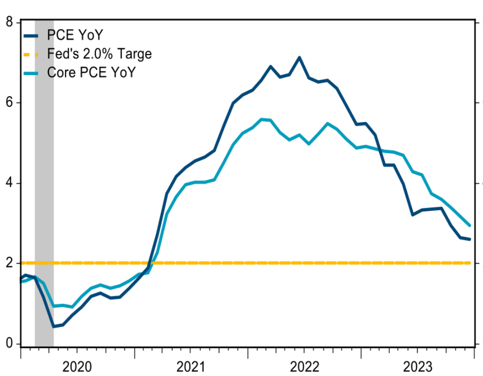
Federal Reserve Signals Need for Further Improvement amid Uncertain Inflation Pathway

In the first policy announcement of the year, the Federal Reserve (Fed) opted to hold rates steady for the fourth consecutive meeting at 5.25% to 5.50%. Acknowledging the strength in the economy and the still-too-high nature of price pressures, the Committee indicated it would be patient, waiting for further improvement in inflation before initiating a removal of the policy firming implemented over the past 23 months.

Of course, with key measures of prices retreating markedly from earlier peak levels and the 2% target level in sight, questions remain. How much additional improvement is needed before nudging the Fed into action? And when or how soon will further disinflation become evident, presumably forcing the Fed's hand, particularly as real rates continue to rise?

ACT AHEAD OF REACHING THE TARGET

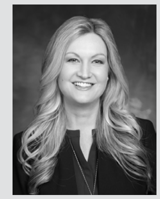
Inflation is retreating. Dropping from an earlier peak of 7.1% in June 2022, the Personal Consumption Expenditures (PCE) price index, the Fed's preferred measure of inflation, now stands at 2.6%, less than 100 basis points (bps) from the desired level. Of course, the pathway lower has been far less orderly and consistent than previously expected, with earlier revisions all but erasing an improving trend in price pressures in the back half of 2022 and a number of head fakes more recently in 2023.



Source: Bureau of Economic Analysis/Haver Analytic

Despite progress, against the backdrop of a solid economy, tight labor market, and a resilient consumer, Federal Open Market Committee (FOMC) committee members have insisted they can approach any forthcoming policy adjustment with patience and wait for further improvement in inflation. Although just how much further progress is needed remains unclear. As Federal Reserve Chairman Jerome Powell said during a Sunday interview on 60 Minutes, "*Basically, we want to see more good data.*"

That doesn't mean inflation needs to reach the Fed's target before taking action. According to Powell, the Committee anticipates reducing rates well ahead of achieving 2% inflation. He reiterated that the Fed is committed to achieving price stability, but policy makers need not wait until prices are at the desired level before reducing rates.



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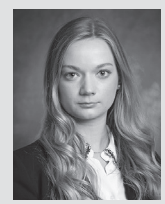

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There is no simple path when it comes to monetary policy. While the weight of elevated borrowing costs and relatively tight credit conditions continue to weigh on consumers and businesses alike, the FOMC has been resolute in its goal of reinstating price stability. Moving too soon with rate cuts could undermine the improvement already made, halt further progress, and potentially allow inflation to settle somewhere outside 2%. Of course, moving too slowly or keeping policy overly restrictive for a prolonged period of time could unnecessarily weigh on economic activity. At present, the Committee judges the risks of the two scenarios are "*moving into better balance*."

INFLATION IMPROVEMENT

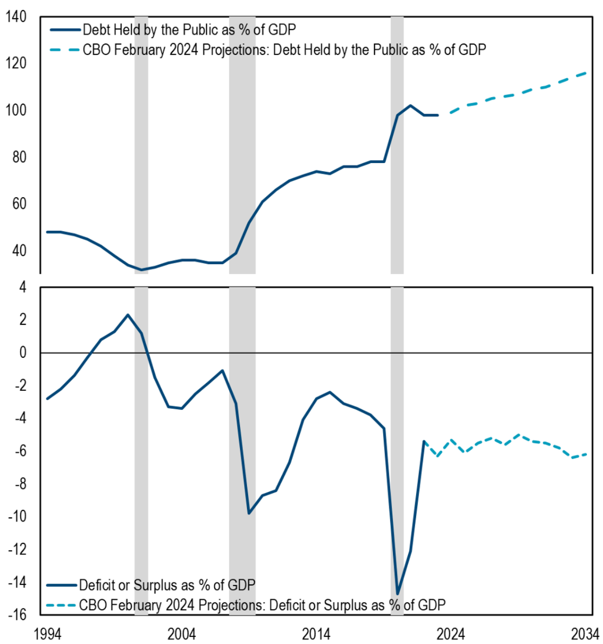
The pathway forward for inflation is far from certain but strong disinflationary pressures suggest further improvement, potentially near term. Global demand, for example, is cooling. Weighed down by the effects of tighter financial conditions over the past two years, constricting credit and housing market activity, Euro area GDP, for example, was reportedly flat at year-end after dipping 0.1% in Q3. Looking out to 2024, according to the Organisation for Economic Co-operation and Development (OECD), Eurozone growth is expected to rise just 0.6% for the year, down from a previous forecast of 0.9%.

China's slowing economy, meanwhile, is also mitigating global growth prospects and undermining inflationary fears. With its annual growth slowing to 5.2% in the latest Q4 report, more than a half percentage point below the pre-COVID average, Chinese officials are reportedly contemplating a stock market rescue on top of an earlier outlay of 2 trillion yuan ($278 billion) amid reports of significant banking sector weakness.

Of course, not all forces are pointing in the direction of disinflation. International conflict and geopolitical disruptions remain a significant upside threat to prices. Despite containment efforts by the current administration, sizable threats remain from China, Russia, and Iran, while the conflict in the Middle East continues to escalate in size and scope, shifting market metrics and potentially policy directives. Any additional conflict and/or military response overseas in and of itself may not be cause to adjust domestic policy specifically, however, a renewed threat of elevated price pressures from food, energy, fertilizer, and/or shipping, if sustained, could at the very least complicate the policy pathway.

"Attacks on ships in the Red Sea have raised shipping costs sharply and lengthened delivery times, disrupting production schedules and raising price pressures," according to OECD Chief Economist Clare Lombardelli.

Domestic fiscal policy also remains a key piece of the inflationary puzzle. Articulating somewhat of a rare warning against fiscal policy, speaking on 60 Minutes, Federal Reserve Chairman Jerome Powell said, "In the long run, the U.S. is on an unsustainable fiscal path. The U.S. federal government's on an unsustainable fiscal path.



Source: Congressional Budget Office

GLOSSARY

FOMC – Federal Open Market Committee

GOP – Gross Domestic Product

OECD – Organization for Economic Cooperation and Development

PCE – Personal Consumption Expenditures

YoY – Year over Year

And that just means that the debt is growing faster than the economy. So, it is unsustainable.

The country's debt level has now topped $34 trillion, more than doubling in just ten years and is projected to rise another 59% over the coming decade. The debt held by the public, meanwhile, which excludes intragovernmental debt, is expected to rise from $26.2 trillion to $48.3 trillion by the end of 2034. As a percentage of GDP, public debt is expected to reach 116% by the end of 2034, the highest level ever recorded. Meanwhile, the federal deficit alone as a percent of GDP is expected to be at 5.6% in 2024 and is projected to rise to over 6% by 2034.

Of course, as debt begets more debt, the U.S. Treasury is expected to significantly increase issuance up and down the curve presumably at higher rates to entice buyers into the market to buy said debt. This will result in a stubbornly elevated level of real rates over time, or at least a relatively higher floor to longer-term rates. In other words, deficits matter and will complicate the Fed's pathway with any additional expansion of the government's balance sheet furthering potential inflationary implications.

CONCLUSION

According to Chairman Powell, almost all FOMC members believe rate cuts will prove appropriate at some point this year. But, support for less restrictive policy will not come unilaterally; the Committee needs to see further improvement in inflation before taking action. Policy makers are willing to begin to move towards a more neutral level, but first need to be convinced of the downward trajectory of inflation on a *sustained* basis back to 2%.

With the March policy meeting seemingly off the table, the market is convinced the first reduction in rates will be announced shortly thereafter at the May 1 meeting. Of course, investors had been calling for a preemptive 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. At some point, market players will be correct and finally be rewarded with that long awaited first rate cut. But with the uncertainty and volatility in the (global) economy and inflation data, the wait may still be longer than expected.

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