December 9, 2024

Longstanding, Elevated Inflation Prompts Federal Reserve to Focus on Labor Market for December Policy Decision

Inflation remains stubbornly elevated, with nearly all measures of price pressures above – or noticeably above – the Committee's 2% target. That being said, the lack of downward momentum and an uneven pathway for prices has been longstanding. After considerable improvement in 2023, inflationary pressures reversed course early in 2024, leaving much of the second quarter to simply recapture lost ground. More recently, inflation has only marginally improved, largely moving sideways, with some measures even accelerating slightly. In other words, while the cause of ongoing frustration for Federal Reserve (Fed) officials, the lack of meaningful – or sustainable – progress has been a reoccurring, well-established storyline. Thus, with less than two weeks before the December Federal Open Market Committee (FOMC) meeting, amid an ongoing expectation for further complications in *eventually* reaching the Fed's goal of price stability, the primary decision factor for further near-term adjustments appears to be the labor market, as it has been since the Fed's Q3 policy pivot.

A LABOR MARKET FOCUS

Buoyed by fears of emerging weakness in the labor market, the Fed opted to take "*a good strong start*"[1] out of the gate, cutting the target rate a sizable 50 basis points (bps) in Q3. Shortly after the Fed's inaugural rate cut, however, the September jobs report offered no support for such an elevated level of concern. In fact, with payrolls rising the most since March (255,000),[2] the unemployment rate unexpectedly moving *down* to 4.1%, and a stronger-than-expected uptick in wages, the Fed's outsized rate cut in September appeared downright excessive in nature, particularly against the lack of gains on the inflation front.

Although the strength in the September jobs report proved short-lived, as it was more than offset by a disappointing read just one month later. Nonfarm payrolls rose 36,000[3] in October, the weakest pace of monthly hiring since December 2020, when the economy was in lockdown during the COVID-19 pandemic. The weakness, however, was largely the result of temporary weather-related effects in the aftermath of Hurricanes Milton and Helene. Nevertheless, given the cover provided by the feeble October report, and the fear that taking a pause just one meeting after a supersized rate cut would likely be interpreted as an admission of an earlier policy error, the Fed opted to continue along the easing

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[1] "*We made a good, strong start to this, and that's really, frankly, a sign of our confidence—confidence that inflation is, is coming down toward 2 percent on a sustainable basis. That gives us the ability. We can, you know, make a good, strong start. But—and I'm very pleased that we did.*"
- Chair Powell, September 18 FOMC Press Conference

[2] Initially reported at 254,000, September payrolls have been revised up to 255,000.

[3] Initially reported at 12,000, October payrolls have been revised up to 36,000.

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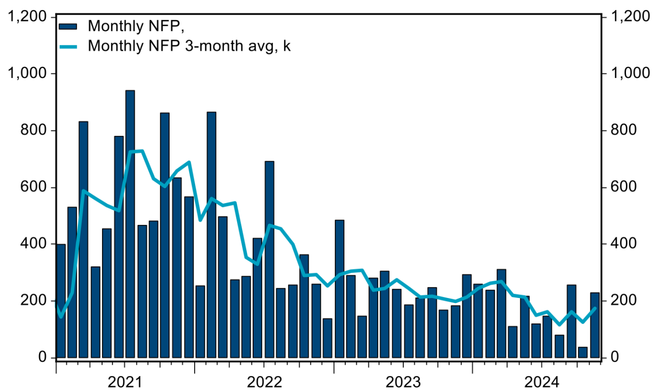


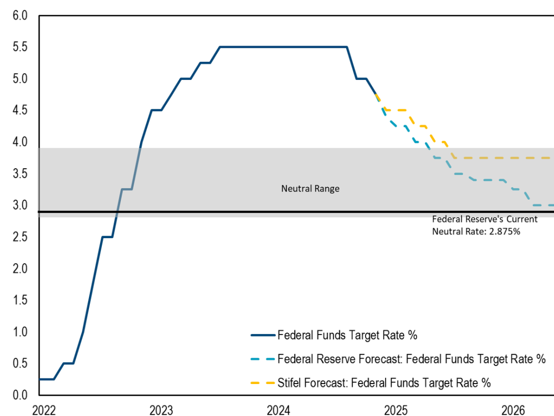
pathway, albeit with a lesser 25-bp move in November.

This week, the latest employment report showed a sizable rebound in hiring with payrolls rising 227,000, surpassing the 220,000 gain expected and reaching a two-month high. Despite the stronger-than-expected headline gain, however, given a noticeable contraction in household employment, the unemployment rate unexpectedly ticked up one-tenth of a percentage point to 4.2% in November, a three-month high, albeit still well below what the Fed designates as the full employment range. Also, average hourly earnings rose 0.4% in November, a tenth of a percentage point more than expected, and 4.0% year-over-year, matching the gain the month prior.

The latest strength in the November labor market data underscores the Fed's earlier assessment of a reduced risk to softening employment conditions. According to the November 6-7 FOMC meeting minutes, for example, the Fed sees an improved picture in the jobs market, with policy makers noting that the downside risks to employment have "*decreased somewhat*," with officials largely agreeing "*that there was no sign of rapid deterioration in labor market conditions, with layoffs remaining low*." And while the elevated pace of hiring in November is unlikely enough to dissuade the Fed from further action in December given the two-month average remains a lackluster 132,000 and offers near-term coverage for further action, more broadly, the persistent strength in job creation underscores the longer-run need for a more patient approach to policy adjustments as we turn the calendar page into 2025.

GEARING UP SUPPORT

Anxious to provide less firm policy on a nominal basis after 14 months at peak levels, and to presumably offer as much relief as possible before fiscal policy complications limit the Committee's potential downside for rates, Fed officials appear to be solidifying their support for a third-round rate cut at year end. Despite acknowledging the ongoing resilience of the consumer, a "*remarkably good*" performance in the broader economy, and still uneven momentum in inflation, not to mention dissipating downside risks in the labor market, the Committee appears to be making an argument to push through another rate reduction by the end of the year and simultaneously raise the threshold for a potential pause.



Speaking earlier this week in Washington D.C., Fed Governor Christopher Waller, for example, said he's inclined to support another cut later this month, although he stopped short of committing one way or the other, noting a final decision was dependent on the

GLOSSARY

FOMC – Federal Open Market Committee

NFP – Nonfarm Payrolls

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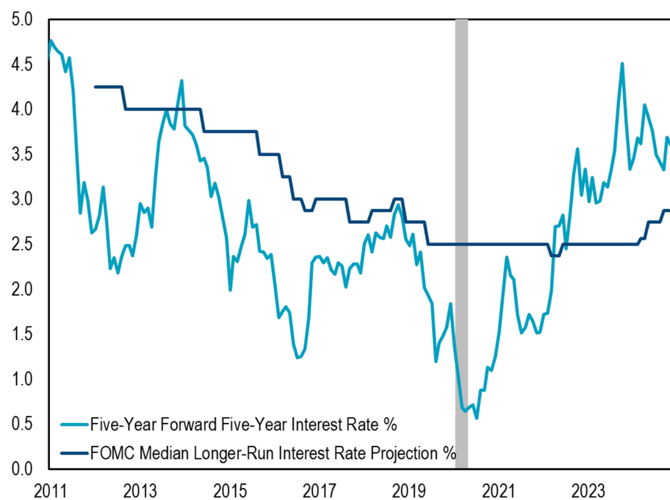
incoming data. "*At present I lean toward supporting a cut to the policy rate at our December meeting. But that decision will depend on whether data that we will receive before then surprises to the upside and alters my forecast for the path of inflation.*" Waller went on to note that the inflation data has been concerning as of late, but "*there is no indication*" that price pressures will remain at their current – elevated – levels, let alone increase.

Raising the bar for a potential pause from simply a solid or strong economy, Chicago Fed President Austan Goolsbee said that unless there are signs of an economy "*overheating,*" the Fed should move forward with additional easing in December and beyond. "*Barring some convincing evidence of overheating, I don't see the case for not continuing to have the fed funds rate decline … How fast that happens will be determined by the outlook and conditions.*"

Initially, Minneapolis Fed President Neel Kashkari emphasized a cautious approach to further policy moves, but more recently, he – like Waller – said it was "*reasonable*" to consider another cut at the December meeting unless there are "surprises" in the data. "*If we saw inflation surprises to the upside between now and then, that might give us pause,*" Kashkari said at a conference hosted by Yahoo Finance. "*Right now, knowing what I know today, still considering a 25-basis-point cut in December — it's a reasonable debate for us to have.*"



Source: Bloomberg

POLICY GUIDANCE

While changing conditions do warrant less firm policy and thus, additional rate cuts into 2025, the pace of additional policy adjustments should be slow and tempered. Adjusting rates too low or too fast runs up the risk of reigniting inflationary pressures and potentially reversing progress already made. At this point, while Fed officials may still opt to move forward with a third-round rate cut in less than two weeks, the Committee does appear to be on the verge of a policy pause sooner than later, as Chairman Powell himself has been unable to rule out a rate pause, or even a rate hike, in the coming months. Furthermore, with persistently solid data, particularly in the labor market, the Committee is likely to maintain a relatively hawkish tone and positive assessment of current conditions in the December statement. Additionally, given the ongoing "*hot*" reads on inflation exceeding earlier Fed predictions, the Committee will expectedly materially revise their forecast for additional policy adjustments over the next 24 months, resulting in a reduced number of cuts and a notably higher r*.[4]

Emphasizing a sense of patience at the November press conference and in subsequent comments, Powell said there is "*nothing*" in the economic data that suggests the Committee has any need to be in a hurry to get back to lower rates.

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[4]As a purely theoretical concept, the neutral rate cannot be measured or quantified. It simply represents the ideal or utopic level of policy that neither stimulates nor slows underlying growth. Also known as r*, the neutral rate helps guide policy decisions in terms of how aggressively to adjust rates higher or lower throughout a rate cycle. Equation for neutral rate of interest: xt – n xt-1 = Et (xt+1 – n xt) + c (rtn – rt), where xt is consumption and rt is the short-term real interest rate.

While the Committee wanted to send a "*strong signal*" of support for the labor market early on, this week, speaking at The New York Times DealBook Summit in New York, Powell said the economy has proven "*stronger than we thought it was going to be in September.*" As such, the Fed "*can afford to be a little more cautious*" as the data normalizes, and the Committee navigates policy towards neutral.

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