INSIGHTS & PERSPECTIVES

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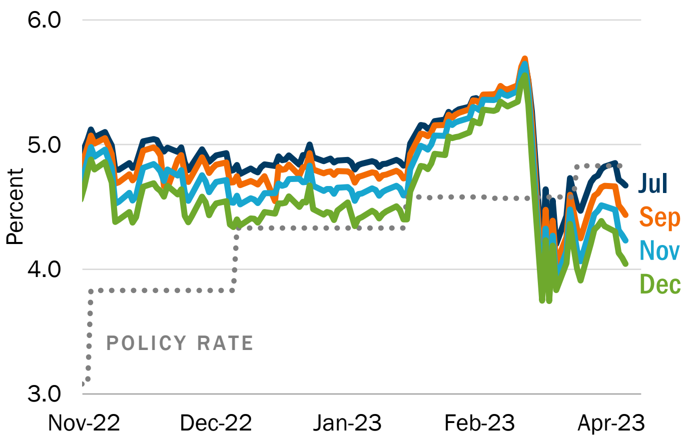
Is the Fed on the Verge of Cutting Rates?

Authored by Steven Friedman, Managing Director and Senior Macroeconomist

Don't count on it. The Fed is willing to tolerate labor market pain in order to bring inflation back to target and make sure it stays there.

The data flow this week has been fairly weak, and coming on the heels of concerns about a coming credit crunch, it has led to increasing expectations for Fed rate cuts in the near term. In fact, markets are now pricing less than 50 percent odds of a final rate hike in June, and an 80 percent probability of a rate cut at the July meeting. This is occurring despite the Fed signaling one more rate hike, and no cuts until next year. Investors appear to view recent data, especially the February Job Openings and Labor Turnover Survey and the March ADP employment report, as fitting into a narrative of immediate and rapid disinflation, or a Fed that will get "cold feet" if the labor market shows signs of softening over the next few months.

FIGURE 1: FED FUNDS RATE AND MARKET-DISCOUNTED RATE AFTER FOMC MEETINGS IN THE SECOND HALF OF THE YEAR



Data as of April 6, 2023
Market-discounted rate refers to the expected policy rate following FOMC meetings based on the prices of overnight index swaps.
Source: Bloomberg

Last fall, in response to questions from clients and colleagues, I had put together a "Fed pivot checklist" when market chatter first emerged about the Fed not following through on telegraphed rate hikes, or cutting rates quickly after the terminal rate had been reached. I retired the checklist early this year as discussion shifted to the potential for additional rate hikes. But given that markets are again pricing in meaningful rate cuts, I've dusted it off. It remains a useful guide for considering what it would take for monetary policy to differ significantly from what FOMC members are communicating. The checklist suggests that there is still a high bar for rate cuts.

First, policy-makers would need clear and convincing evidence that inflation is on a path back to two percent on a sustainable basis. In my view, that requires at least three months of core Personal Consumption Expenditures (PCE) inflation[1] running at or below a 2.5 percent annualized rate. And the underlying disinflation has to be evident not just in goods, but services as well.

Second, wage gains would need to moderate to a level that is consistent with inflation moving back to target. In theory, that level should be the inflation objective of two percent, plus an estimate of productivity growth. In my prior note I had said that this equates to a wage gains pivot threshold of 3.25 percent. But Powell has specified 3.5 percent, based on a rosier

1. PCE inflation: change in the Bureau of Economic Analysis' price index for personal consumption expenditures

productivity growth estimate, so I will use that as my pivot threshold.

Third, an unemployment rate at or above the median FOMC participant's estimate of its longer-run equilibrium level of four percent. As long as the unemployment rate remains below this level, the Committee will not be convinced that inflation will return to the two percent objective and stay there.

And fourth and fifth, well-anchored short- and long-term inflation expectations.

Of these conditions for policy to deviate meaningfully from what is being communicated, only the last two - well-anchored inflation expectations at all horizons – are currently being met. Core inflation is running at an annualized rate of 4.9 percent over the past three months. My preferred wage measure, the Atlanta Fed's wage tracker[2], is still running at a 6.1 percent y.o.y. rate. And while the unemployment rate rose slightly in February from a 53-year low, at 3.6 percent it is still far too low for the Fed to believe that any sustained disinflation will prove durable.

A lot can change over the next few months. The effects of past tightening now seem to be taking hold more broadly, and recent banking sector turmoil may serve as a meaningful headwind to credit growth. But policy-makers have set a high bar for rate cuts. Absent a very sharp slowdown in the labor market and a rapid disinflation in prices and wages, market expectations for near-term rate cuts are very likely to be disappointed.

FIGURE 2: FED PIVOT CHECKLIST

Condition	Condition Met?
CORE PCE INFLATION RUNNING AT AN ANNUALIZED RATE OF 2.5 PERCENT OR LOWER, FOR AT LEAST THREE MONTHS. DISINFLATION MUST BE EVIDENT IN CORE SERVICES	No
WAGE GAINS CONSISTENT WITH PRICE STABILITY (3.5% OR LOWER)	No
UNEMPLOYMENT RATE OF 4% OR HIGHER	No
WELL-ANCHORED LONG-RUN INFLATION EXPECTATIONS	Yes
WELL-ANCHORED SHORT-RUN INFLATION EXPECTATIONS	Yes

Source: MacKay Shields

2. Atlanta Fed Wage Growth tracker: The Atlanta Fed's Wage Growth Tracker provides an estimate of nominal wage growth based on survey data. More information can be found here: https://www.atlantafed.org/chcs/wage-growth-tracker.