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MACRO MORNING BRIEFING

September 23, 2024

Recalibration

- We view the jumbo move by the Fed as risk management around the jobs market
- Unemployment rate increases are not due to rising layoffs
- The real federal funds rate is expected to settle around 1%
- The markets and the Fed differ in the timing around achieving the neutral rate

Recalibration – to What, Exactly?

Rereading the transcript of Chair Powell's press conference last week after the FOMC cut rates by 50bp we're struck by the word "recalibration." It appears ten times in 25 pages, and as early as the second paragraph of his prepared statement: "…with an appropriate recalibration of our policy stance, strength in the labor market can be maintained in a context of moderate growth and inflation moving sustainably down to 2 percent." In other words, we interpret the Chair as asserting that a large level shift lower in the federal funds rate was to get in front of a weakening labor market. With the inflation trend now under control, the Fed had the policy space to focus on the labor market and reduce the amount of restrictiveness.

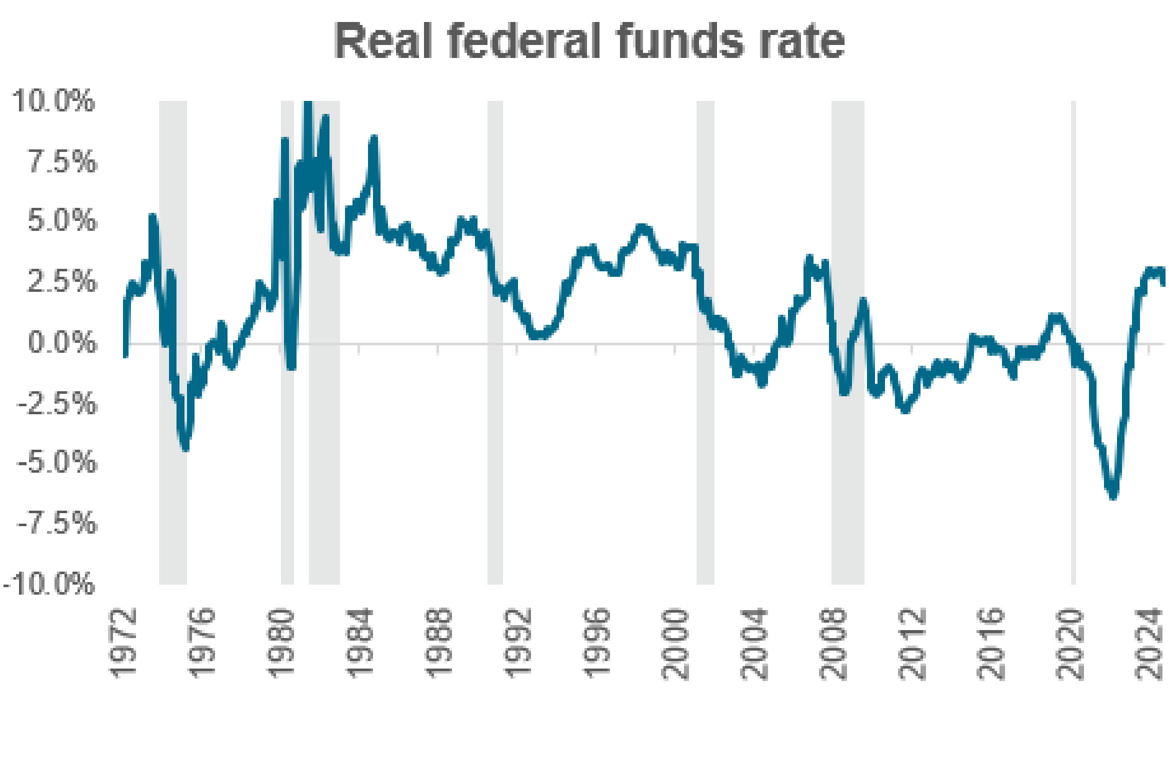
What did Powell mean by recalibration? Considering he came back to that term time and time again, it's obviously important – at least in marketing the size of the cut. We tend to think it simply means that going into last week's meeting, the policy rate, which had remained at 5.5% for over a year, had become restrictive – especially in real terms – as inflation fell and employment data softened. Exhibit #1 shows that the real funds rate had reached 3% in recent months and had spent over a year above 2%. The chart displays the real federal funds rate going back to the early 1970s. It's been over a decade since the real rate was so high, and for so long. Recalibrating this real rate lower seems to be behind the size of the move.

We think the labor market is the entire story (given a continuation of the recent encouraging inflation trend) for the Fed now, something that has been indicated by the Chair and others, at least since Powell's Jackson Hole speech in late August. Indeed, in response to a question at the press conference, Powell described the 50bp move lower as "a commitment not to get behind."

As we have argued, while we only expected the FOMC to cut rates by 25bp, we actually thought that a 50bp move would be justified. We maintain that had the Committee had the July employment data in front of it on July 31, it would have started cutting rates at that meeting. "We might well have," stated the Chair in response to a question along those lines.

Therefore, if we think of a 25bp reduction in rates in July (which wasn't delivered) and another one in August, the Fed should have cut 50bp to catch up to where it would have been had the timing of the previous FOMC meeting and the July data been just a bit different. That's at least one way to look at the jumbo move as delivering the same cumulative easing as if the Committee had moved in July.

Exhibit #1: High Real Federal Funds Rate



Source: BNY Markets, Federal Reserve Board of Governors, Bureau of Economic Analysis

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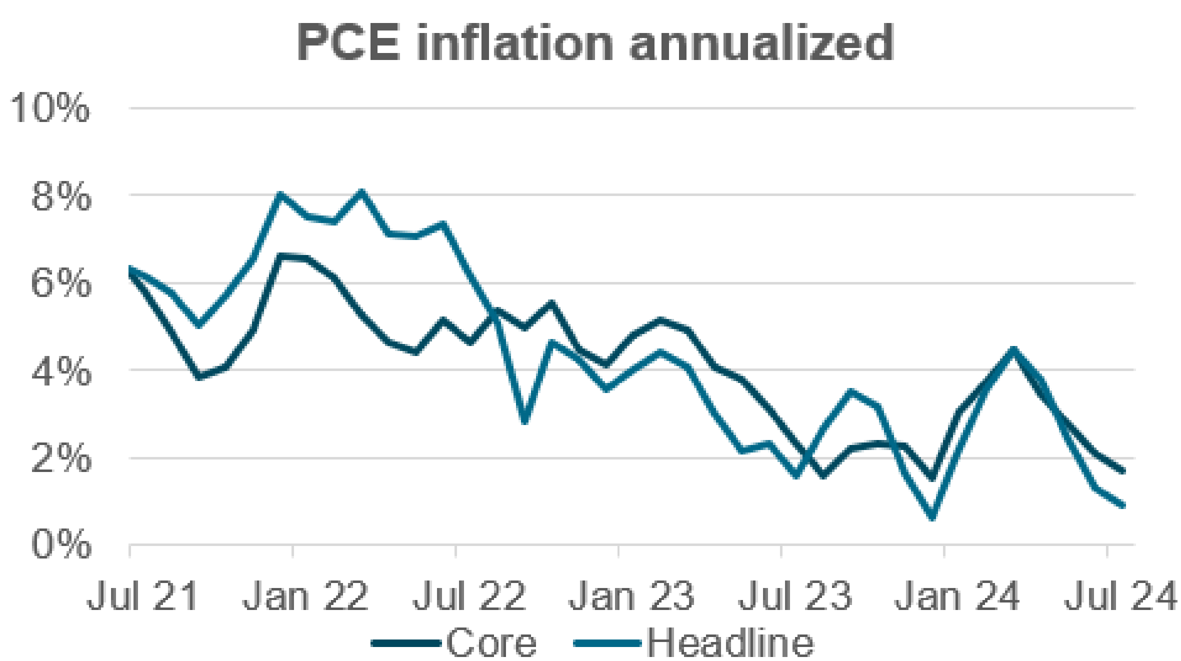
Interestingly, however, in a media appearance last Friday, influential Fed Governor Waller stated that it wasn't the employment data that were behind his decision to support a 50bp cut, it was the fact that the 3-month annualized rate of PCE inflation had recently dipped well below 2%. Exhibit #2 below shows that both the core deflator (down -1.7% on a quarterly annualized basis) and the headline index (-0.9%) are not only below the Fed's target but are at some of their lowest levels since the pandemic.

More importantly, going forward, Waller indicated that the Fed had gained much desired optionality for future rate moves, stating that additional jumbo cuts could be delivered if the data were to weaken, or that the Fed could proceed more cautiously if inflation progress stalls. "If labor market data worsens, or if the inflation data continues to come in softer than everybody was expecting, then you can see going at a faster pace," he said. So, the dual mandate still prevails, but the risk – in the Fed's mind, at least – is that with inflation moving in the correct direction, the size and pace of further cuts will be determined by economic (read: labor market) data.

For her part, Governor Bowman on Friday argued that "The committee's larger policy action could be interpreted as a premature declaration of victory on our price stability mandate." Last Wednesday, she dissented in favor of only a 25bp move last week. Bowman was the first Fed governor to dissent since 2004. To be more precise, this was the first dissent by a Fed governor (as opposed to a regional bank President) on policy grounds since 1994. That's noteworthy and suggests that there are still some on the FOMC who have lingering inflation concerns.

Exhibit #2: Short-Term Inflation Trend Encouraging



Source: BNY Markets, Bureau of Economic Analysis

Still, we think the majority of the Committee is squarely focused on labor data. The unemployment rate, currently at 4.2%, has risen from a recent low of 3.4% in April 2023. That 0.8% increase seems big, but we – and presumably the Fed – would argue that in early 2023 the labor market was running “hot” and well above full employment. In the recent Summary of Economic Projections, the FOMC collectively saw the longer run unemployment rate at 4.2% – the same level as it is now. So even though the unemployment rate has increased rapidly over the last several months, by the Fed’s reckoning, it’s close to equilibrium now and the restrictive policy required to get it there is no longer needed, especially with inflation now trending in a constructive direction. Real policy rates can and should come down now.

The trick the Fed is trying to pull off is to prevent (or “not get behind”) employment from weakening much further by getting the real funds rate down. The problem is that once the unemployment rate starts to rise, it tends to do so quickly and by a lot. Exhibit #3 shows how much unemployment worsens in the 12 months after a recession begins. We use the NBER recession dates to identify the start of a recession, even though in real time, we would not have known we were in recession until after it actually began. Nonetheless, we can see that the average increase in the unemployment rate in the year after a recession’s onset is around 2.5%. So, moving faster and sooner on policy this time around is an effort to forestall such a result, even if a recession is clearly not upon us presently.

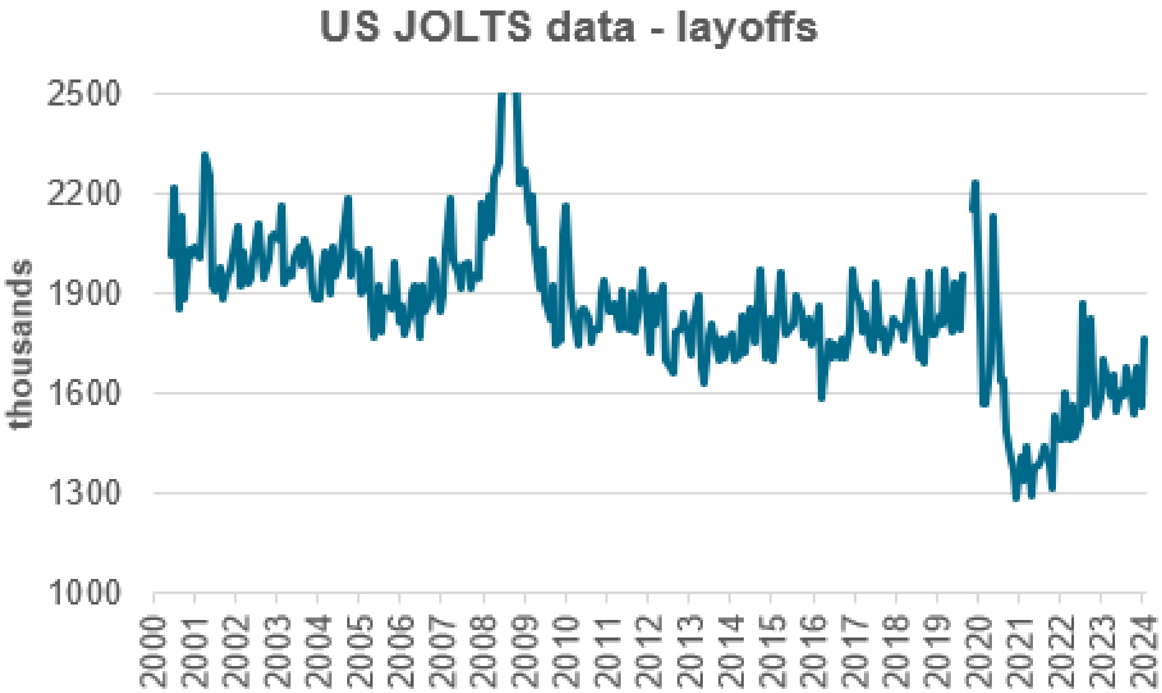
Exhibit #3: Recessions and Unemployment Rate

Source: BNY Markets, Bureau of Labor Statistics, National Bureau of Economic Research

One mitigating argument currently is that most of the rise in the unemployment rate hasn't been due to workers losing their jobs as much as it has been due to new entrants into the labor force not finding work. Year-to-date in 2024, about 1.1m people have entered the labor market, with the majority of them not finding work (800k). Firms are holding back hiring, but not shedding labor – at least so far.

Exhibit #4 shows the number of layoffs each month as reported by the JOLTS data series. JOLTS data only go back to the beginning of the 21st century, but even with this relatively short sample, we can see where layoffs are currently – averaging 1.6m per month, well below previous (non-recessionary) values. If, however, layoffs start to increase as firms actually trim labor, we could see what has been an expected and even welcome softening in the labor market turn into a recession – requiring even deeper and faster cuts.

Exhibit #4: Layoffs Lay Low

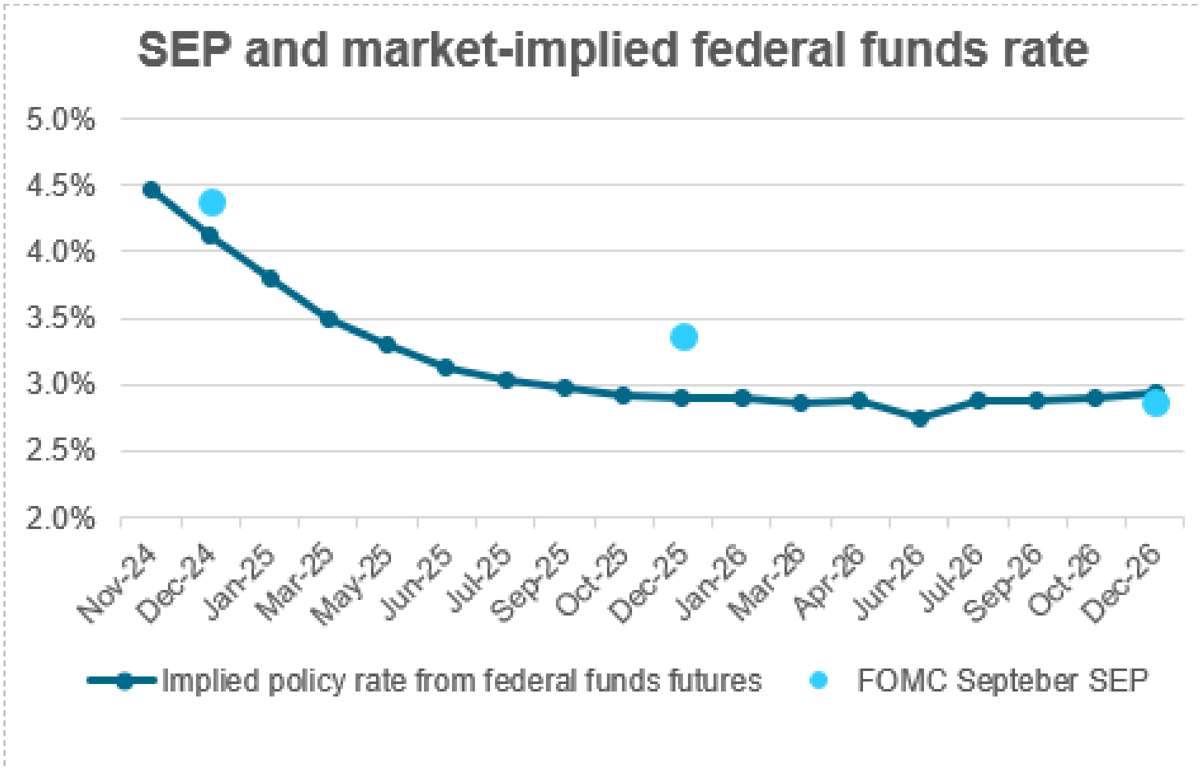


Source: BNY Markets, Bureau of Labor Statistics

Finally, let's return to the concept of the real funds rate. Even after the jumbo rate cut last week, it is now at 2.5%, probably too high for the economy at present. If we take Governor Bowman's view that inflation risk still lingers, perhaps it should remain restrictive for a while longer. The Fed's longer run projection for the equilibrium federal funds rate is 2.875%. Naturally, its view of the long run inflation rate settles at 2%, leaving it just under 1% for the real rate in equilibrium. In its SEP forecasts, the Committee sees that level coming about by the end of 2027.

The market sees the same nominal level for the policy rate – just under 3%, but has it being realized by the middle of next year! Perhaps the market is not as optimistic that labor data will avoid a significant deterioration in the short term, and thinks the Fed has to move faster in coming months than the SEP indicate. See Exhibit #5 below. Completing the circle of the preceding discussion, the disconnect between the Fed and the market on the speed and size of upcoming rate cuts revolves around the Fed's optimism that the job market can avoid a major sustained downturn (the SEP sees the highest unemployment rate being realized at the end of 2024 – just 4.4%) and the markets fear that it cannot. A 50bp cut, through a risk-management lens, seems like a strong move by the Fed to bring a soft landing about.

Exhibit #5: Terminal Rate Tango



Source: BNY Markets, Board of Governors of the Federal Reserve System, Bloomberg

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Please direct questions or comments to: iFlow@BNY.com

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