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RESEARCH HIGHLIGHT
POLICY
September 19, 2024

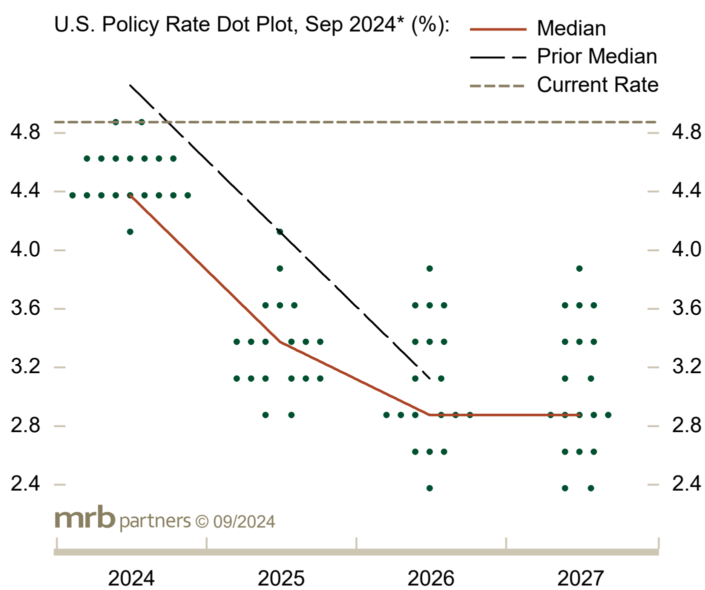
U.S. Fed Policy: The Makings Of Another Dovish Error

- Yesterday's 50 bps Fed rate cut was highly unusual compared with the start of past cutting cycles, when business cycle indicators showed much weaker trends and risk asset markets were deteriorating.
- We think that the Fed is underestimating the economy's resilience, and thus, the risk of a renewed upward push in inflation down the road.
- The Fed is projecting that the policy rate will be well below (our estimate of) the neutral rate by early next year. The implication is that the growth impetus on inflation will eventually strengthen, just as the disinflationary effects of immigration reverse.
- Given the Fed's strong dovish bias, the odds are that Fed policy will track the dot plot in the next 6-12 months.
- During this time, expect a continued rosy period for economic growth, an even more supportive environment for risk assets, and a cap on bond yields.
- Eventually, however, persistently above-target inflation will force the Fed to cut by less than the bond market is pricing in and by less than the dot plot shows, paving the way for another upleg in bond yields.

The Fed cut the policy rate by half a percentage point at yesterday's FOMC meeting, in line with its unofficial signal[1] to investors late last week. The Fed's new dot plot is penciling in an additional 50 bps of easing during the remaining two policy meetings this year, followed by a percentage point of cuts next year **(chart 1)**.

This dovish new dot plot is now closer to the bond market's view of a quick return to the Fed's estimate of the neutral policy rate; although the Fed envisions ending the cutting cycle at 2.9% in 2026 and the bond

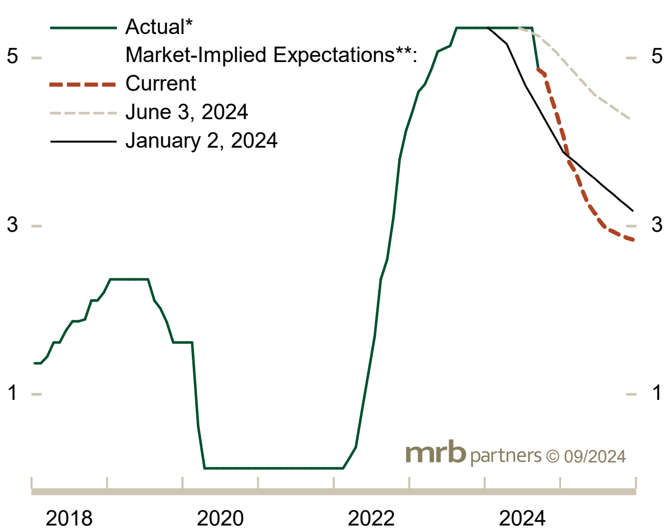
Chart 1 A Front-Loaded, More Dovish Dot Plot



* Source: U.S. Federal Reserve

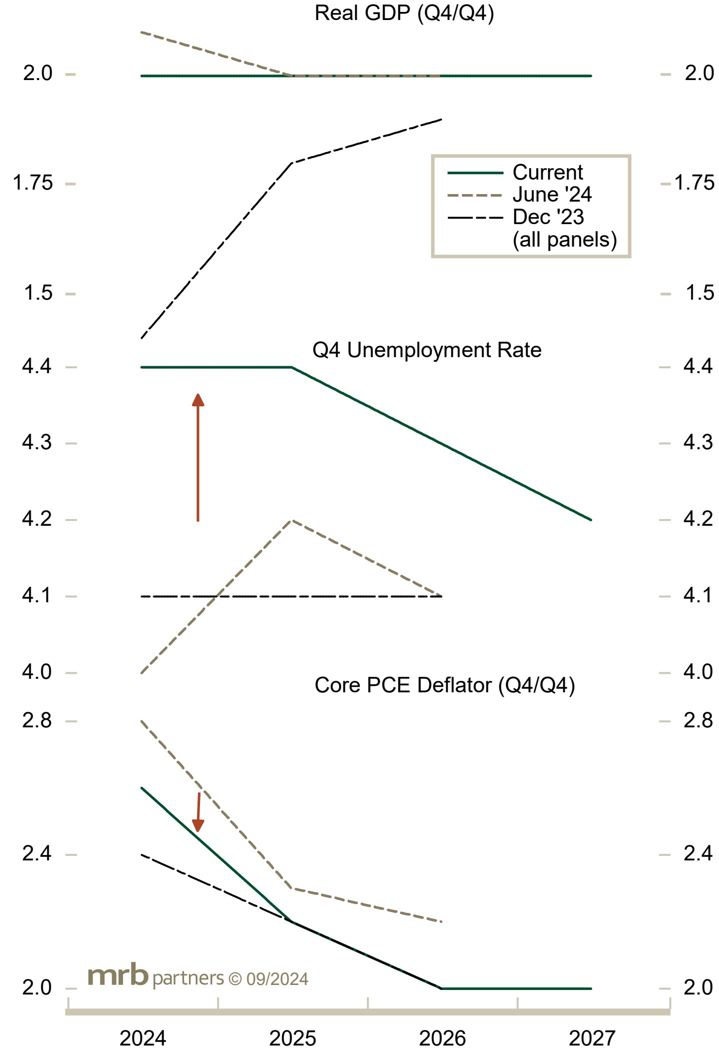
[1] See "*The Wall Street Journal*", September 17, 2024. Note that last week the forward market had been pricing in a 25 bps cut before the Fed's unofficial communication nudged investors to a larger cut.

Chart 2 **The Bond Market Is Anticipating A Still More Dovish Fed**



* Source: Federal Reserve
** Source: CME; data as of 19 Sep 2024 04:55:21 CT

Chart 3 **The Fed Sees Tepid Growth, Lower Inflation & Higher Unemployment**



* Source: U.S. Federal Reserve

market expects this rate to be reached slightly sooner, by December 2025 **(chart 2).**

Accompanying yesterday's policy pivot, the Fed marked up its unemployment rate forecast to 4.4% and marked down its core PCE inflation rate forecast to 2.2% by next year-end **(chart 3)**. All in all, the Fed's *Summary of Economic Projections* and the policy rate dot plot spelled a "soft landing".

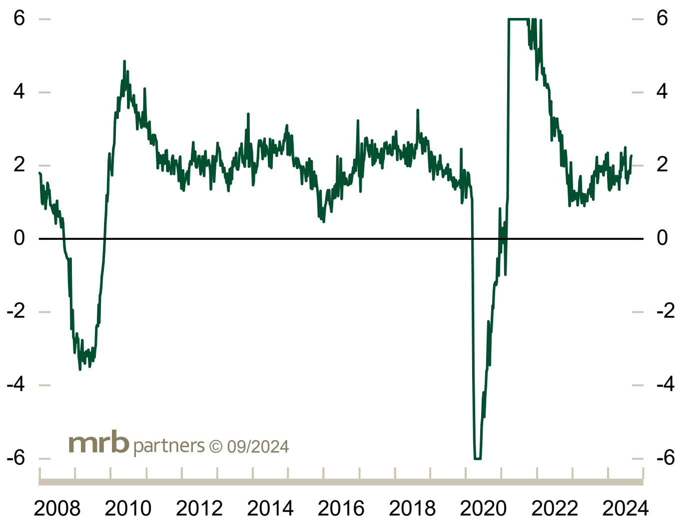
The Fed's decision to cut rates yesterday, let alone by 50 bps, was highly unusual, especially in the context of past rate cutting cycles, when the NBER's business cycle indicators were showing much weaker trends **(charts 4** and **5)**. Indeed, seemingly at odds with the action of a 50 bps rate cut, Fed Chair Powell acknowledged that "*the U.S. economy is in good shape. It's growing at a solid pace. The labor market is at a strong place*".

The Fed's new policy stance would normally be justified by a rise in the unemployment rate, but as we have shown[2], the rise in recent months has been led by an exogenous, immigration-driven increase in the labor supply, as opposed to rising layoffs **(charts 6** and **7)**. In short, rising unemployment does not signal that the labor market is calling for aggressive easing.

[2] MRB ***Research Highlight:*** "***U.S.: Don't Fret About Rising Unemployment***", July 18, 2024

Chart 4 Economic Momentum Remains Solid

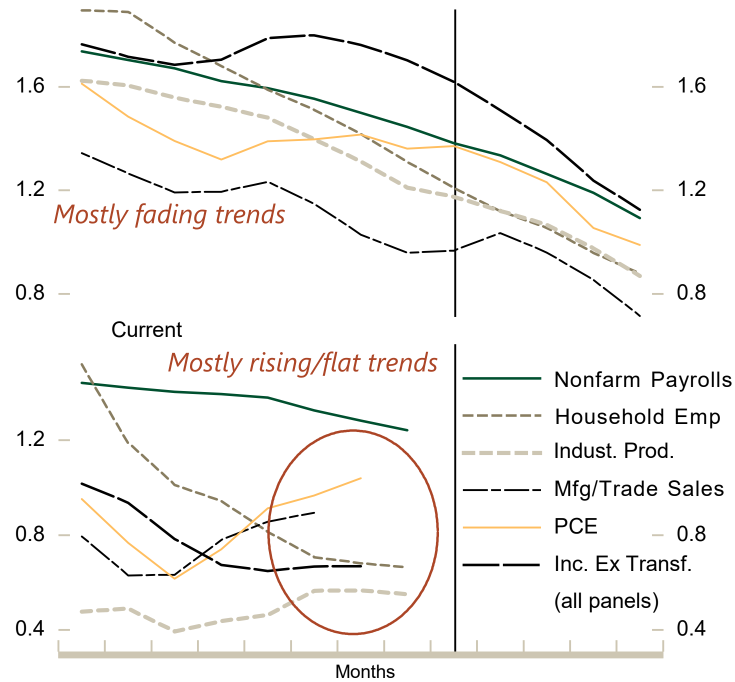
U.S.: Weekly Economic Index*:



* Truncated at +/- 6; source: Federal Reserve Bank of New York

Chart 5 Past Economic Data Trends Were Usually Worse At Rate Cuts

U.S.: NBER Real Activity Recession Indicator YoY Growth Index Average, 1990-2019 Rate Cut Cycles



* Household employment adjusted for BLS's immigration undercount; source: Federal Reserve Bank of St Louis FRED database & MRB calculation
Note: Vertical line denotes start of rate cuts

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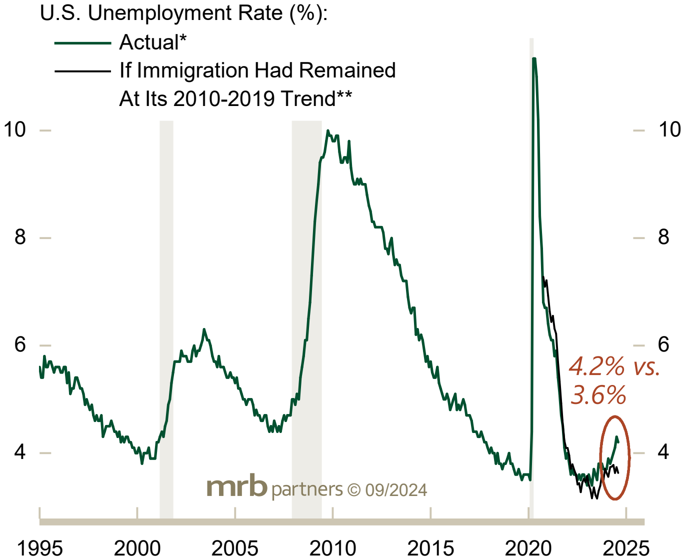
Chart 6 A Jump In Labor Supply Has Boosted The Unemployment Rate

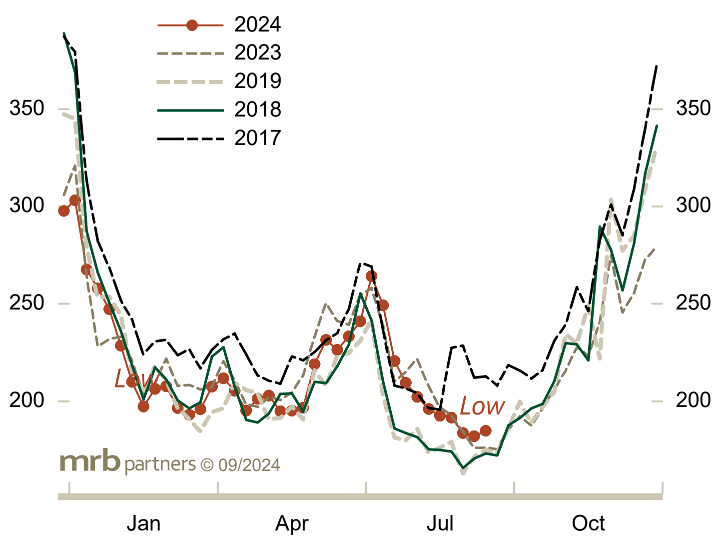
U.S. Unemployment Rate (%):



* Trucated at 11.3%; source: U.S. Bureau of Labor Statistics
** MRB calculation
Note: Shaded for NBER-designated U.S. recessions

Chart 7 Layoffs Remain Low

U.S. Initial Unemployment Insurance Claims, NSA* (000s):



* Source: U.S. Department Of Labor

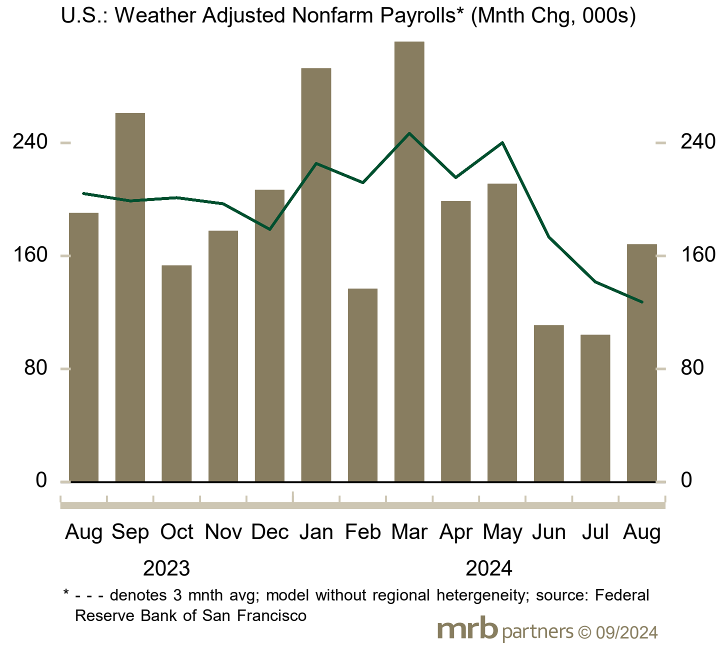
New job creation has cooled, but not perilously so. Adjusted for weather, the 3-month average rate of job gains is close to 130,000 **(chart 8)**. For context note that that the economy's breakeven[3] rate of

[3] The breakeven pace is the gain in employment needed to keep labor demand and supply in balance, that is absorb the trend additions to labor supply each month.

MM's breakeven inflation calculation showed ~130k

job creation (accounting for the current stepped-up rate of immigration) is around 120,000; if immigration were to revert to its 2012-18 average rate, then the breakeven rate of job creation would be even lower, around 85,000. Given this benchmark, job growth does not seem to justify a large shift in the policy stance either.

Chart 8 Adjusted For Distortions, A Slowdown But Not Pernicious



What's Driving The Fed?

Needless to say, the Fed has a very strong dovish bias, a legacy of the Great Recession. In our assessment, the Fed's large rate cut, and dovish future policy guidance can best be explained by the following motive: the Fed has been very uncomfortable with maintaining a 5.25-5.5% policy rate for a while[4], believing that policy was extremely restrictive, and has sought to avoid being blamed if a recession were to develop (even though the latter is currently very unlikely).

With inflation easing in recent months and payroll gains cooling, the Fed has seized the opportunity to cut rates and is trying to cut quickly (while they can) and move rates closer to their estimate of the neutral policy rate. So long as inflation remains low (as the Fed thinks it will), the Fed will end up in the clear, seemingly pulling off a soft landing.

The step-down in inflation has had little to do with the Fed's tightening

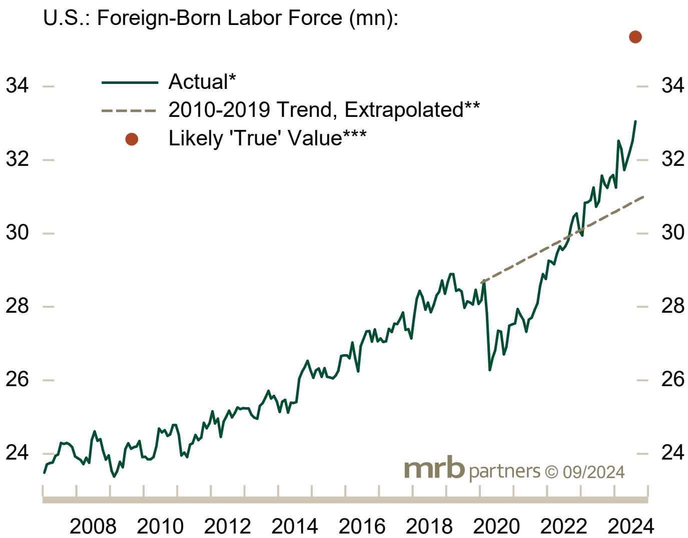
The trouble with this strategy is that it fails to account for the fact the stepdown in inflation since last year has had relatively less to do with policy tightening, since restrictive Fed policy would have impacted inflation via the demand channel, and demand growth has maintained an above-potential rate. ***Cooler inflation has been mostly an exogenous gift*** - it has eased partly due to the unwinding of the pandemic's distortions and due to the unprecedented surge in immigration that has dampened services inflation via the supply side, through cooler wage growth **(chart 9)**.

This disinflationary unwind of pandemic distortions has already run its course and the immigration impact will reverse, as it will gradually start to exert upward pressure on rent inflation[5] **(chart 10)**. As Powell himself has admitted in the past,

[4] **MRB *Research Highlight:*** "***U.S.: The New Fed Is Still The Old Fed***", December 14, 2023

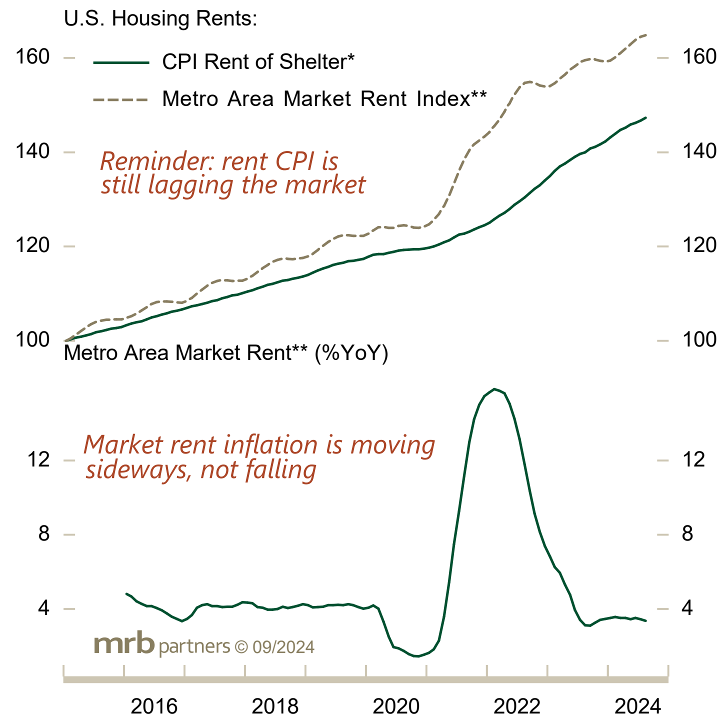
[5] Note that the CBO's population estimates indicate that the economy needs 1.8 million housing units this and the next two years. Housing completions are around 1.8 million at present, but new starts are running at only 1.4 million, meaning a shortfall of 400,000 homes next year and into 2026, unless construction picks up.

Chart 9 The Strength Of Immigration Has Exceeded All Expectations



* Source: U.S. Burea of Labor Statistics
** MRB calculation
*** Based on U.S. DHS data

Chart 10 Rent Inflation Will Remain Problematic Given Immigration

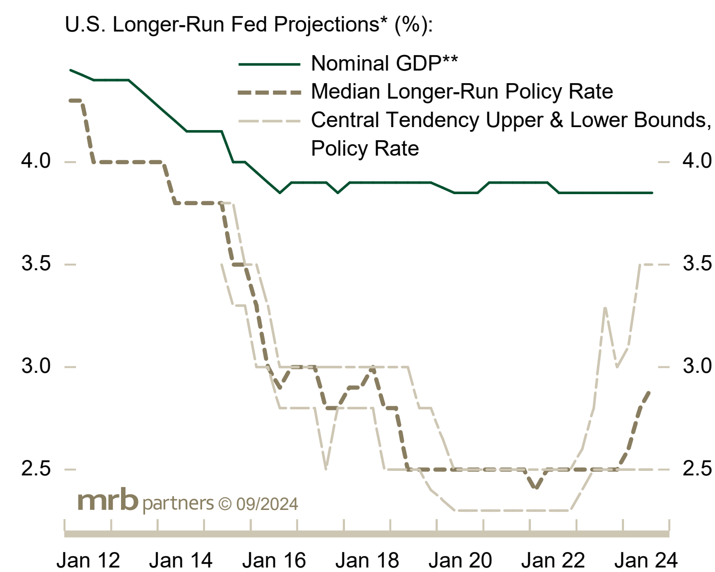


* Source: U.S. Bureau of Labor Statistics
** Source: Zillow

immigration should be a wash for inflation in the long run. Its impact to date has been unambiguously disinflationary, which means that some inflationary payback awaits in the future. Goods inflation could also add to some upside next year. The long post-pandemic downshift in goods spending has already ended except for autos[6].

In addition, if the policy rate is lowered to 3.75%-4% by the middle of next year (as the current median projections suggest) then it will be firmly below our estimate of the neutral rate. (MRB believes that the economy's neutral policy rate is closer to 4.5%[7], as opposed to the Fed's rising, but still-too-low estimate of 2.9%, **chart 11**). The implication is that growth momentum will pick up at the margin, via housing, manufacturing, better business sentiment and/or greater generalized risk-taking.

Chart 11 The Fed's Neutral Rate Estimate Is Up But Needs To Rise Further



* Source: Federal Reserve
** Midpoint of central tendency plus 2% inflation

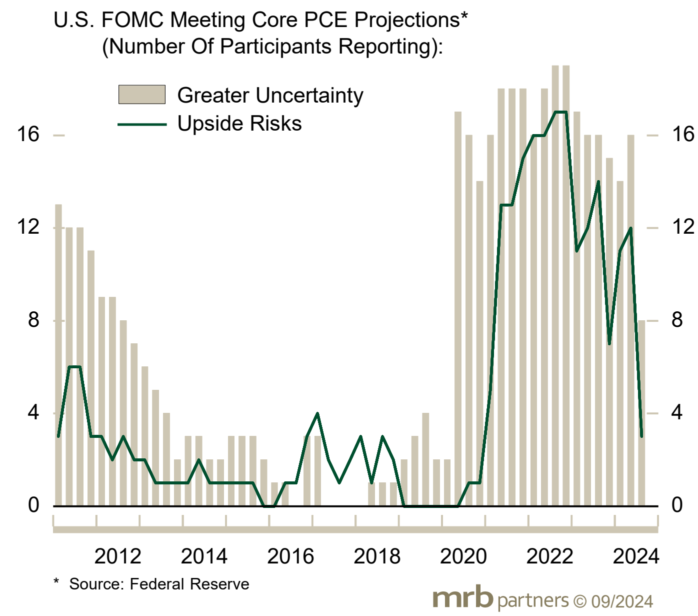
6 MRB *Research Highlight:* "*When Will Inflation Steer The Fed Again?*", September 12, 2024

7 MRB *Research Highlight:* "*R-Starring The U.S. Economy*", September 6, 2023

WOWW!!!

This means that given the Fed's dovish projected rate path, real GDP growth will meaningfully outpace the Fed's (unrealistically low) 2% forecast for this year and the next two years[8]. Growth being further above potential than it already is, will apply greater cyclical impetus to inflation than at present.

Chart 12 The Fed Is Getting Complacent On Inflation Again



Growth Matters For Inflation

Unlike the Fed and the consensus, we believe that economic growth matters greatly for the underlying trend of inflation, which will become crucial ahead as one-off distortions run their course. In short, we think that the Fed is being myopic, badly underestimating the risk of a renewed upward push on inflation down the road, or at least the risk of inflation remaining stubbornly elevated near 3% rather than 2%.

The Fed's focus on recent inflation trends, and the extrapolation of these trends into the future, suggests that the post-pandemic bout of inflation has had no lasting effect on policymakers' mindset. The inflation complacency acquired by the Fed in the years following the Great Recession is resurfacing **(chart 12)**.

The Fed is badly underestimating the risk of a renewed upward push on inflation down the road

The problem is that the pre-pandemic decade was dominated by household sector deleveraging, which held back growth and inflation. With no such financial restraint in this cycle, and with the Fed rapidly turning the dial back on policy rates, it is unlikely that inflation will match its benign, pre-pandemic performance over the next two to three years.

What To Expect Ahead

First, on a more practical note, it is important to note that the timing of the cyclical pass through of stronger growth to inflation is uncertain and could take longer than 12 months. Moreover, with border flows still in a state of flux, immigration's disinflationary impact may take longer to play out.

[8] The Atlanta Fed estimates that Q3 real GDP growth is tracking a robust 3% annualized QoQ gain- it would take less than 1% annualized growth in Q4 to achieve the Fed's 2024 forecast.

Second, the Fed may look straight through the early stages of a rise/persistent stickiness in rental inflation. Note that Powell downplayed the potential upside risk to rent inflation yesterday, by referring to it as a lagging component of inflation and hinted that the Fed may be willing to accept that it may continue to overshoot historical rates for a number of years.

Third, as we have previously noted, the BLS is currently undercounting the actual volume of immigration. ***The 'true, unofficial' unemployment rate is likely above 5%***, if one were to account for the yet-to-be measured unemployed immigrants using external estimates from the Department of Homeland Security. Assuming that the BLS's foreign worker counts will get better going forward, the consequence is that the published, official unemployment rate will rise. Although this will not represent a cyclical labor market deterioration (and the Fed knows it), it will nonetheless fuel the Fed's dovish bias.

The bottom line is that the Fed will continue to view the data through its dovish lens; there is a high possibility that the Fed will follow through on next year's dot plot rate cuts for 6-12 months and "ignore" stronger growth. However, it will eventually be cornered by sticky/higher inflation and cut less than the bond market anticipates, and less than is embedded in the dot plot.

The actual unemployment rate is likely above 5%, accounting for under-measured immigration

Fed members may also be tempted to adopt the line of thinking that immigration represents a rise in the economy's potential growth rate, giving them more leeway in the short term to let the economy run hot without boosting inflation[9]. However, assuming a higher potential growth rate means accepting that the economy's (real) neutral rate is also higher than before, which also means that the Fed will have to stop its rate cutting cycle well shy of current expectations. There is no free lunch.

Final Word: *The Fed is poised to take away any potential restraint that the policy rate could have imposed on the economic cycle in the future, by signaling the policy rate to be well below (our estimate of) the neutral rate by next year. We don't anticipate any other impediment to the economic cycle in the foreseeable future-aside from the potential for protectionist policies following the U.S. election (although such an election outcome would bring upside risks to inflation as well).*

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[9] The CBO estimates that immigration may boost the potential growth rate from 1.8% to 2.1% for the next five years.

We think that the Fed is setting itself up for a dovish policy mistake by signalling an extended rate cutting cycle. The Fed's uber-dovish pivot means that the future cyclical inflationary impulse will strengthen ahead. At the same time, the ongoing idiosyncratic disinflationary drag from immigration and pandemic-related distortions will eventually fade.

The consequence of the Fed's excessive dovishness means that there will be another runup in inflation down the road, which will ironically be counter-productive to the Fed's efforts to cement a soft landing. Core inflation will ultimately remain well above the Fed's target, in a 3%-plus range rather than around 2%.

Still, even if we are right, the inflationary consequences of premature easing won't be evident for a while. On a 6-12 month basis especially, inflation could undershoot our expectations because of immigration's potentially prolonged ongoing impact on the services economy.

Consequently, expect the Fed to proceed to cut rates another 50 bps this year as it is signaling, and continue rate cuts into next year. The interim result will be a Goldilocks period for economic growth, an even more supportive environment for risk assets, and a cap on bond yields (albeit the downside also will be limited). Eventually, we expect that firmer, persistently above-target inflation will force the Fed to rethink its policy path later in 2025; eventually the Fed will not cut as much as the bond market is pricing in or as the dot plot shows, coinciding with another upleg in Treasury yields.

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