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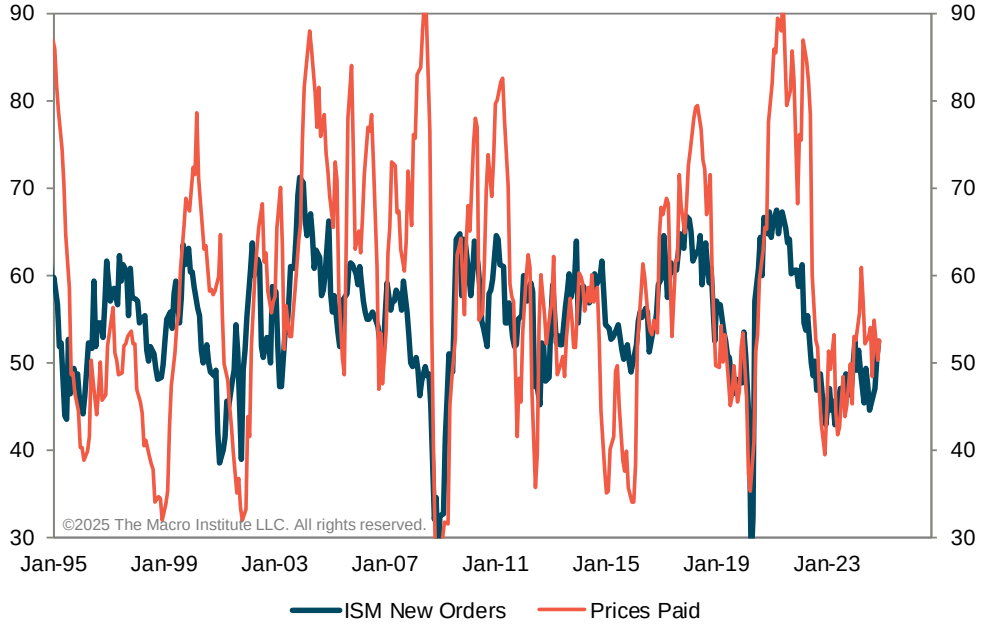
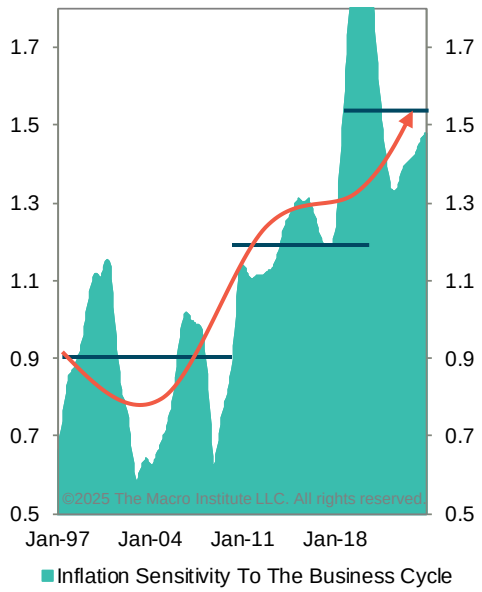
The Fed On Track To Tighten Policy Despite Mounting Pressures

We should learn a lot this week from the first FOMC meeting of 2025. There are a lot of crosswinds that the Fed will need to manage when setting policy this year, and not all are related to economics. Indeed, political pressure might be a real force for the central bank for the first time since the Arthur F. Burns era of the 1970s. Our biggest concern is that the Fed focuses too much on the potential policies of the new administration (tariffs) and not enough on the underlying state of the economy. It seems clear that the U.S. economy is geared for higher inflation whether the administration pushes forward with tariffs or not. In our minds, inflation recovers with or without the help of tariffs. That is the case we make in this report,.

Inflation Sensitivity To Growth Evolves Across Time …



… Now Near Generational Highs



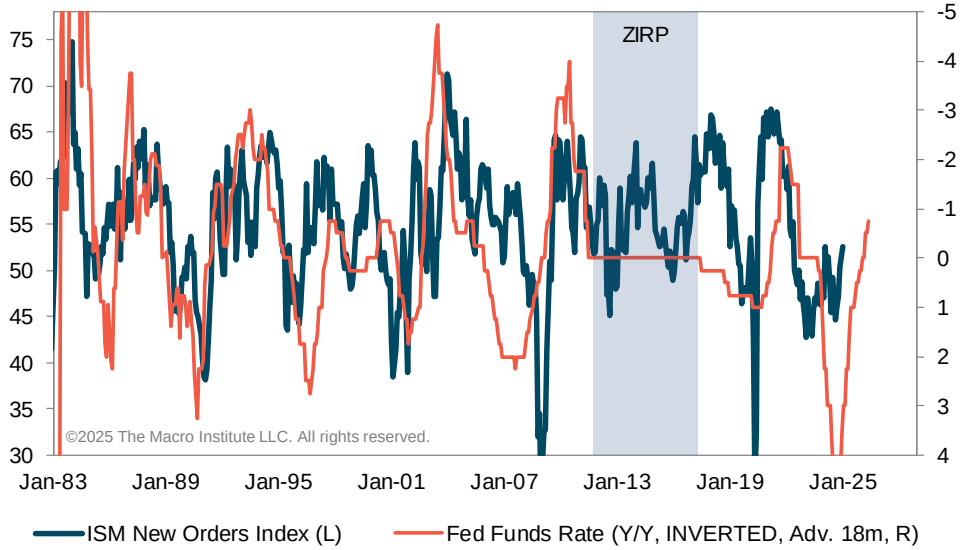
The first thing the Fed needs to acknowledge is that the U.S. economy is structurally different regarding inflation than it has been in the last 40-odd years. There are a lot of influences behind this last statement, including protectionist policies, BUT the single most important variable is demographics. There are simply fewer available workers today than there were during the heyday of the baby boomers. Worded differently, when was the last time the U.S. lived though an economic recovery from a 4% unemployment rate? The short answer is the late 1960s, or the period that preceded the Great Inflation of the 70s.

The easiest way to demonstrate that the U.S. economy is MORE sensitive to inflation than it used to be is with the help of the ISM data set. The chart above plots the New Orders series alongside the inflation proxy from the survey called Prices Paid. The two series ebb and flow together, but as the clip on the right illustrates, their relationship has changed. It now takes a smaller increase in New Orders to move Prices Paid higher, so the Fed's rate cuts might throw us back into a 2021 dynamic sooner than we are accustomed to. The report makes the case for a resumption of Fed tightening this year. We shall see. Best, Francois

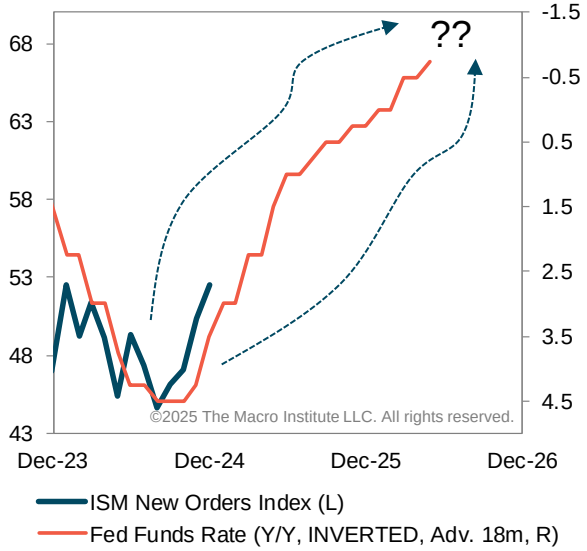
The 2025 Backdrop: Lots Of Stimulus BUT With Little Excess Capacity

Economic prospects in the U.S. usually start to normalize about 18 months after the last rate hike, and we are there! It makes sense for LEIs to look better currently, AND with Fed rate cuts now in the pipeline that story has become even more compelling. On top of that, reshoring has been helped along by the policies of the new administration and bank lending standards have also improved. On the surface, this is a great combination for improved demand ahead. In context, however, we realize very quickly that there are consequences to a soft landing. Namely, little excess capacity.

LEIs Typically Recover ~18 Months After Last Rate Hike

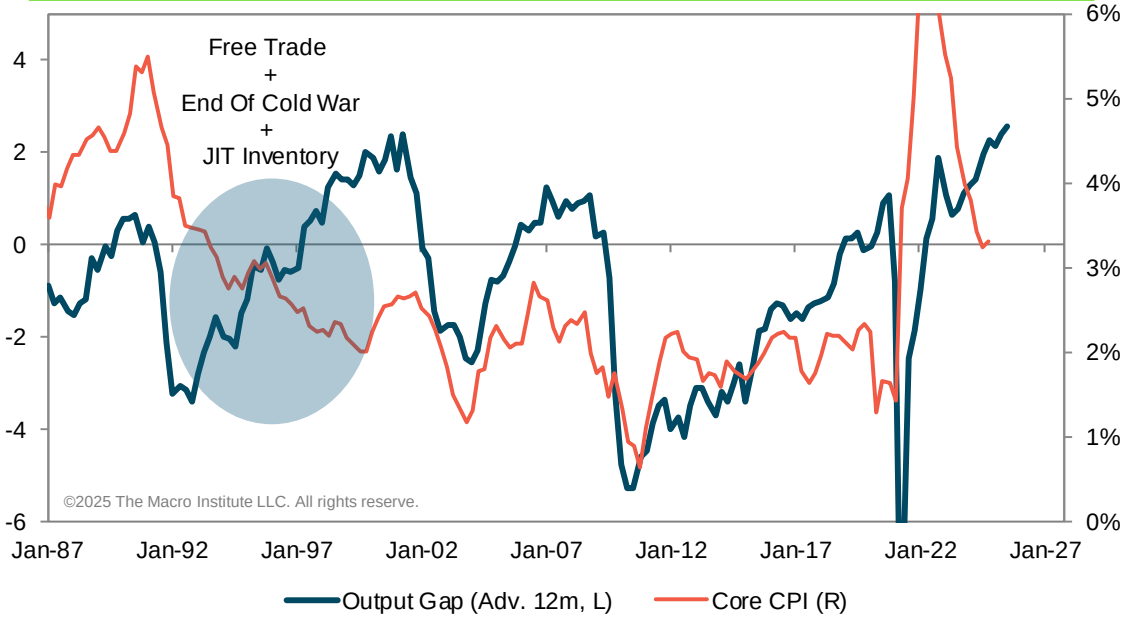


Higher LEIs In 2025?!?



A recession, in the field of economics, is sometimes referred to as a cleansing mechanism. What this really means is that capacity runs lower, and unemployment moves higher. This is what allows for the earlier stages of an economic recovery to be "inflation free" for some time. The issue this time around is that we did not get an excess capacity reset. The chart below shows the output gap in the U.S. and how it is at its most inflationary in almost 40 years. This tells us that it will not take much to revive inflationary pressures this time around. If true, this Fed-fueled recovery will feel very different from the typical experience of the last 40-odd years.

Little Excess Capacity: Output Gap At Its Most Inflationary In Decades

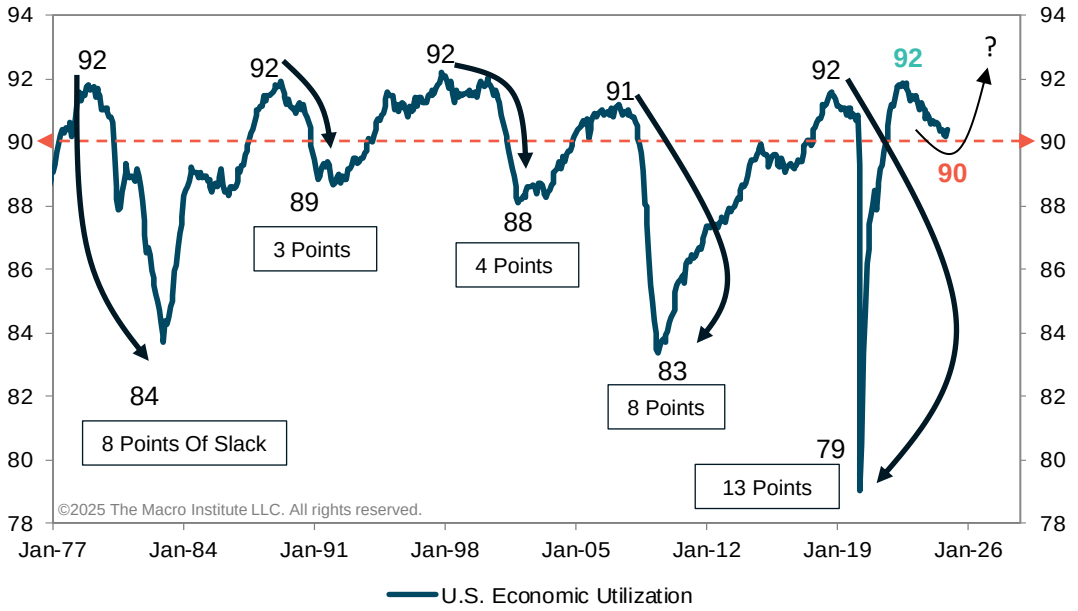


The **output gap** is the difference between an economy's actual output and its potential output.

Dearth Of Excess Capacity + Monetary Stimulus = Return Of Inflation

We use a simple tool called Economic Utilization to measure excess capacity. It is a blend of manufacturing capacity and labor market capacity (i.e., unemployment). As the chart shows, Economic Utilization in the wake of Fed tightening is typically lower than what we are currently faced with. It is that infamous "cleansing mechanism" that gets us there, but alas, we don't get this reset with a soft landing. The real problem is that it looks like Economic Utilization is headed higher.

Lack Of Excess Capacity Already Inflationary



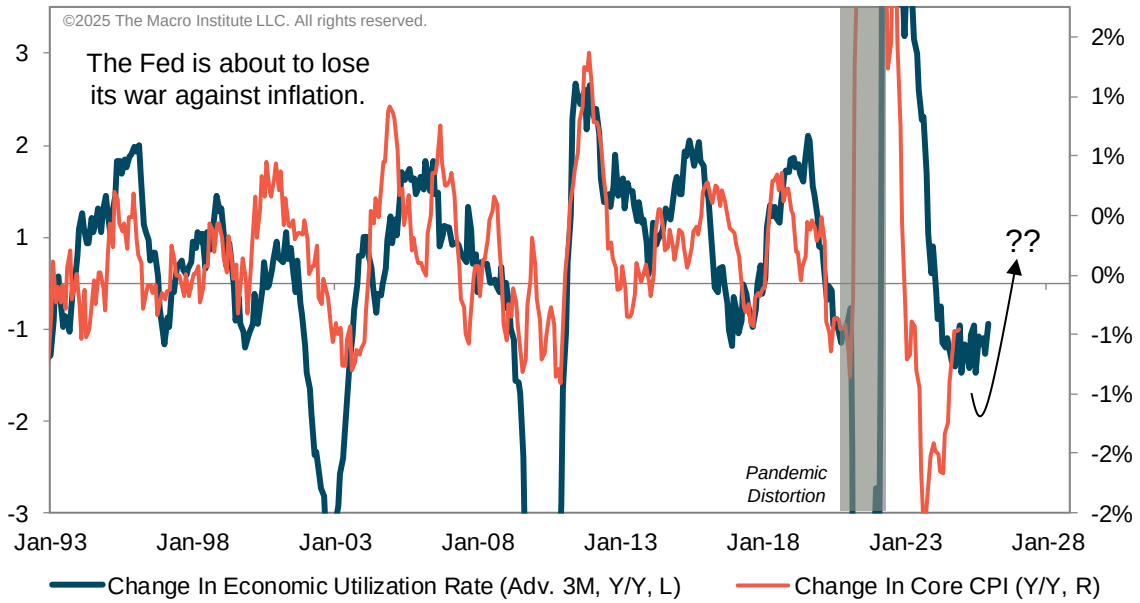
Description	Avg. Change In Core CPI
EU Above 90	+1.0%
EU Below 90	-1.3%

Economic utilization is the extent to which an economy is being used relative to its maximum potential.

(Manuf. % of GDP) x (Cap Utilization)
+
(Services % of GDP) x (Employment Rate)

Economic Utilization is not nearly as vague as the Output Gap. Still, for anyone doubting its efficacy, look at its relationship with core inflation trends in the chart below. The relationship argues that momentum for underlying inflation in the U.S. economy has already shifted. We have different versions of this chart, but all generally point to a pause in core inflation trends before an uptrend resumes later in the year. There are some parts of the inflation story that look constructive, BUT it is the tightness in labor markets, and what it means for wage inflation, that is the core source of the problem.

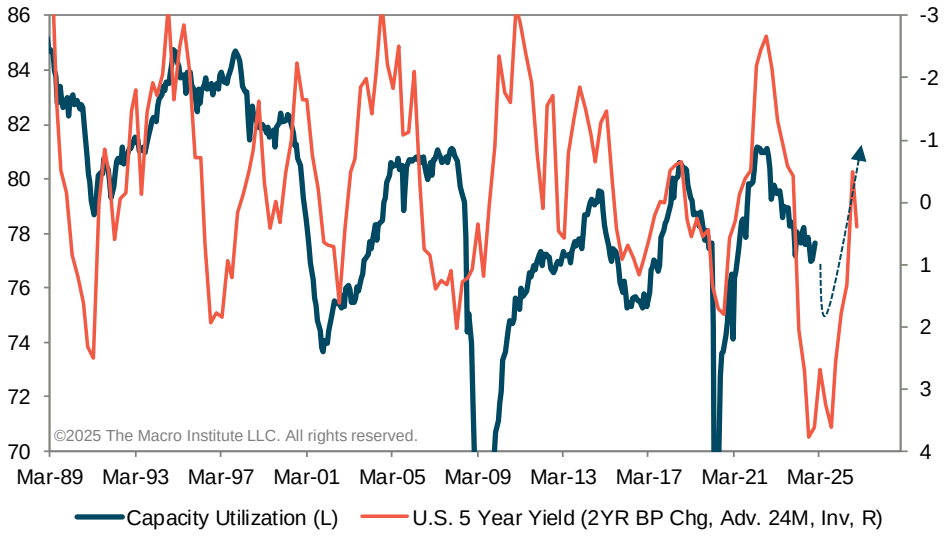
Economic Utilization Already Troughing Sets Stage For ↑ Inflation



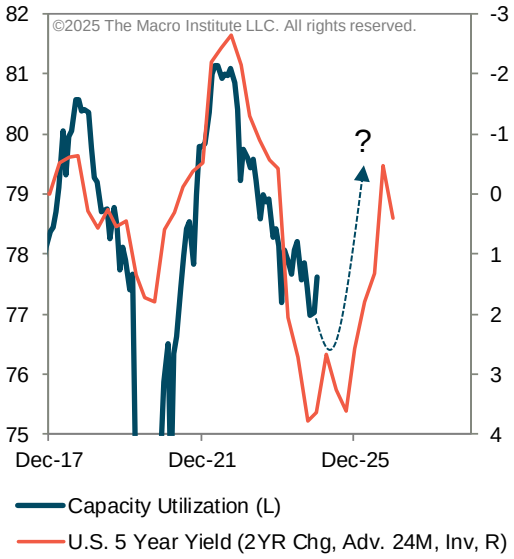
Economic Utilization Set To Tighten Further In 2025 => Inflationary!

This is a simple concept in economics, but cyclically speaking, capacity utilization rates tend to rise as the economy improves. Demand becomes supportive while supply takes longer to adjust. In essence, capacity utilization will look a lot like the rest of the economy and will follow earlier trends in interest rates. The chart below is the same we use to forecast real GDP growth. It takes about two years for a change in rates to impact the economy and that process begins in 2025. In other words, capacity utilization for manufacturing should start to climb higher later this year.

Capacity Utilization For Manufacturing To Climb In 2025

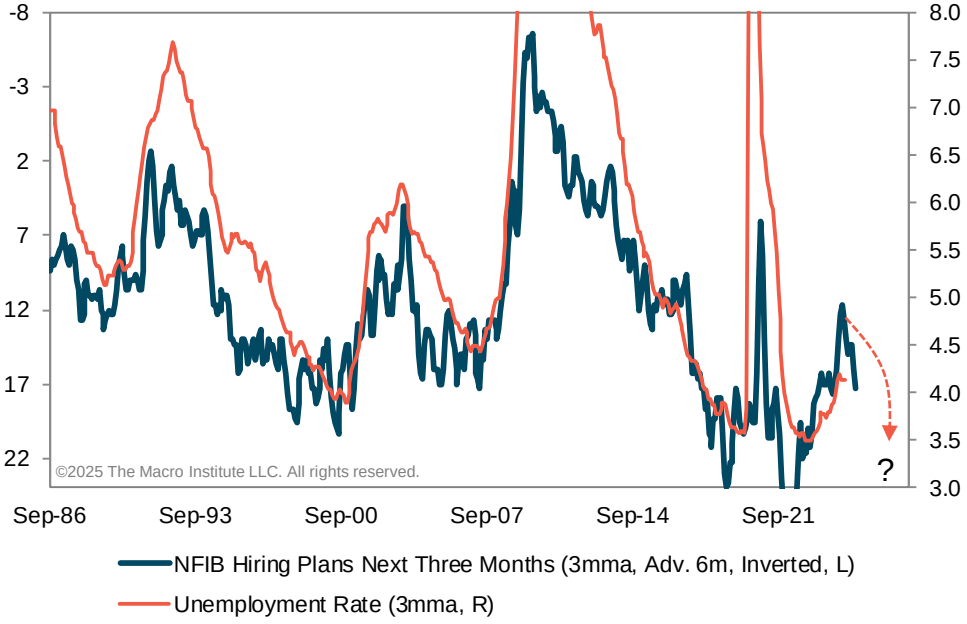


Policy Tightens Cap Ut This Year?

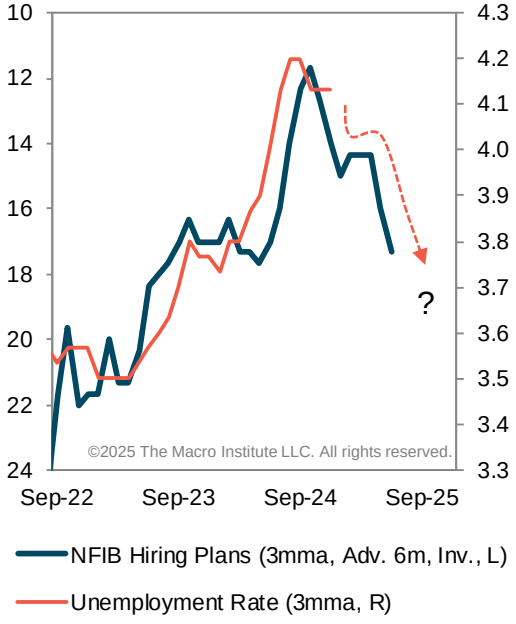


The bigger influence for Economic Utilization comes from the labor markets. Indeed, labor utilization (1 – unemployment rate) is about 75% of the driving force behind this concept. Most leading indicators of employment have started to look better in recent months and the very best ones, from the NFIB in our opinion, look dramatically different than in mid-2024. The NFIB Hiring Intentions series has rebounded significantly in recent months (not just after the elections!) and argues that the unemployment rate is already in a downtrend. Time will tell, but this will push Economic Utilization higher from elevated levels.

Hiring Intentions Already On The Rise In The U.S. …



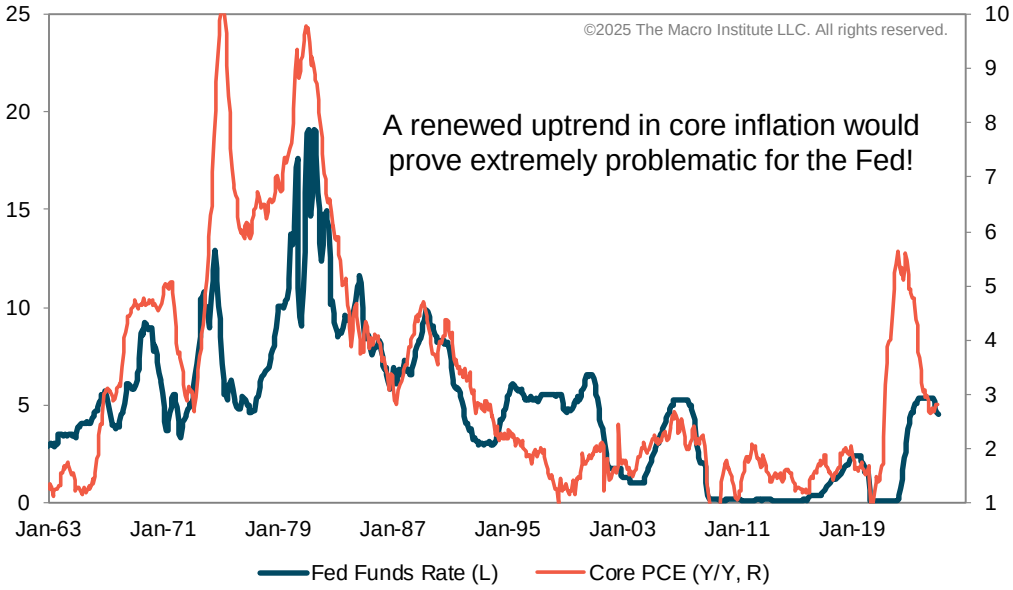
… Pointing To Lower Unemployment!



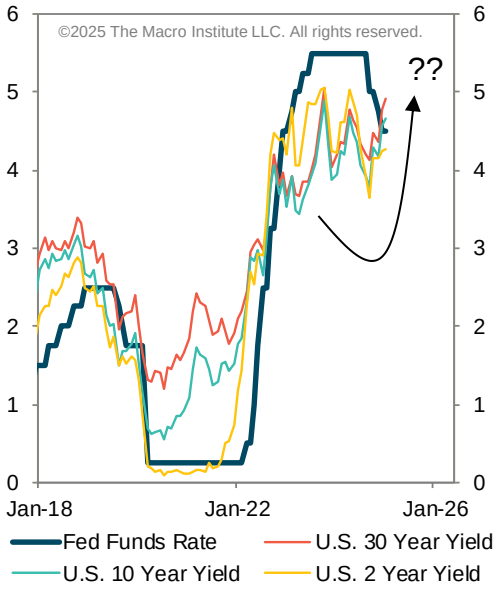
Inflation Concerns ALREADY Having An Influence On Interest Rates?

If inflation does indeed stage a recovery in 2025, which we foresee in the second half of the year, the Fed will need to revise their forecasts once AGAIN and change their tune on policy. Worded differently, the "soft landing" celebration should fade as the year progresses and it becomes clear the Fed never really did what they needed to do the first time around (i.e., tighten enough to eradicate the inflation threat). Chairman Powell was quick to quote Paul Volcker back in 2022 but, overall, acted more like Arthur F. Burns than anything else.

Another Inflation Surprise For The Fed In 2025?



Bonds Sniffing Out Inflation?

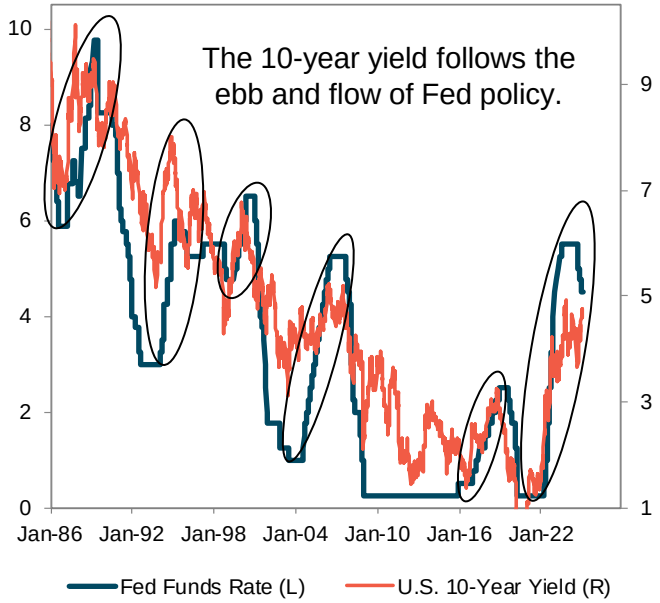


Logically, if inflation surprises to the upside and the Fed does eventually change its tune then it seems clear that interest rates across the spectrum are headed higher. The clip chart below shows the link between the 10-year Treasury bond yield and the fed funds rate. The table below left quantifies this a little more precisely for Fed tightening cycles. Simply put, bond yields ALWAYS move higher as the Fed raises rates. Needless to say, we all got a good reminder of this dynamic in 2022/23. At the end of the day, the Fed's forecasts are not consequence free for the investment community.

The 10-Year Follows The FFR

Tightening Cycle	Δ 10-Year Yield
1987-89	1.37
1993-94	2.83
1999-00	2.04
2004-06	1.37
2016-18	1.82
2020-23	4.38
Average	*2.30*

The FFR And The 10Yr Closely Correlated



The "Repeatable" Phases Of A Fed Tightening Cycle … Look Familiar!?

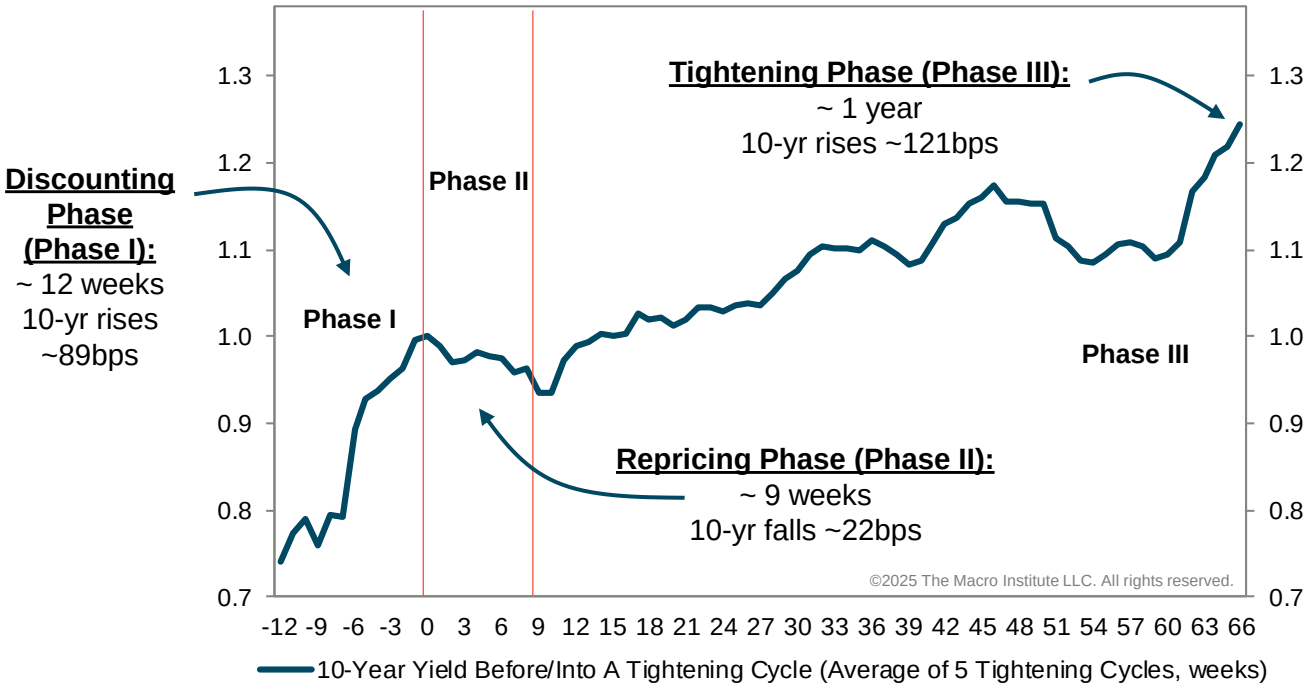
We know bond yields rise in every Fed tightening cycle. A more detailed analysis reveals that their rise has followed three distinct phases historically. First, in the *Discounting Phase,* yields rise in anticipation of that first rate hike. Second is the short-lived *Repricing Phase* when yields typically give back some of their earlier gains. Lastly, the *Tightening Phase* occurs when yields move higher following the path of Fed intentions. This is the longest part of the story and its timeframe hinges on the length of Fed tightening.

Bond Yields Have Followed A Consistent Pattern In Fed Tightening Cycles

	Δ 10-Year Yield						
Fed Tightening Cycle	**1987-89**	**1993-94**	**1999-00**	**2004-06**	**2016-18**	**2022-23**	**2025-?**
Discounting Phase	0.29	0.59	1.38	0.99	1.19	0.81	0.95
Repricing Phase	0.06	0.16	-0.34	-0.41	-0.51	0.23	?
Tightening Phase	1.02	2.04	0.98	0.76	1.15	1.59	?
All Phases	**1.37**	**2.79**	**2.02**	**1.34**	**1.83**	**2.63**	**?**

The rise in bond yields lately certainly looks like the Discounting Phase. We know from the Kim-Wright model that a large share of the recent rise in yields is explained by inflation and the term premium so we can't entirely rule out this being an "early" Discounting Phase. No two cycles are perfectly alike but the chart below is a good graphical interpretation of the behavior in yields in the prototypical Fed tightening. The question on our minds is whether it is already in action or rather if the Discounting Phase begins later in the year? We lean toward the former but we will know more this later week.

Behavior Of Bond Yields In Past Tightening Cycles

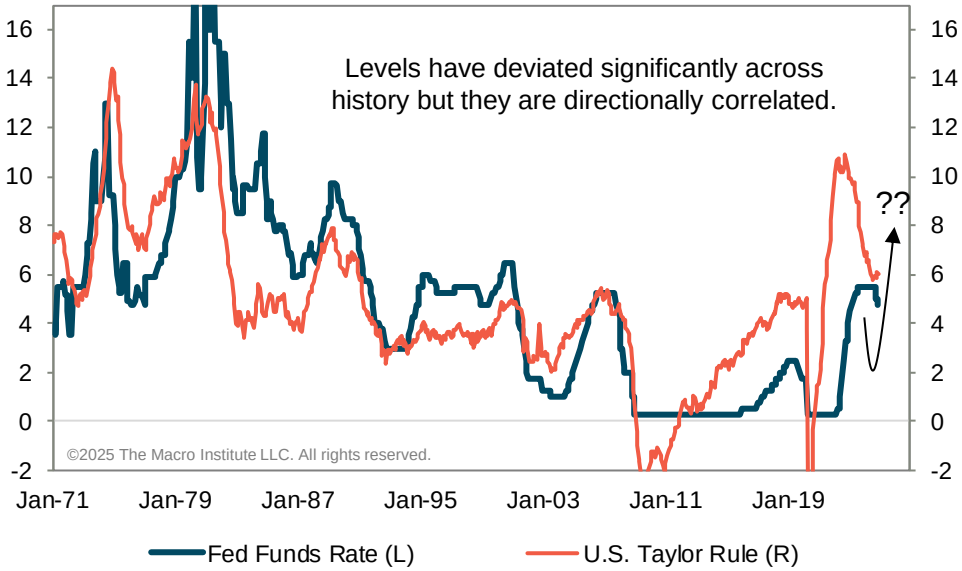


Regardless of what fixed-income markets are currently telling us, it is clear that if inflation recovers from these levels then the Fed will have to at least turn hawkish with implications for bonds. Some would even argue that the bond vigilantes will force the Fed's hand if fails to react to higher inflation or yields a little too much to political pressure. The U.K.'s experience in the Fall of 2022 was a clear reminder than the bond vigilantes are still a force to reckon with at times.

How Much Upside Is There Exactly To The FFR/10-Year Bond Yield?

The title of this page is the million-dollar question. One tool that can help us answer it is the Taylor Rule (TR). Now, some of our readers are not crazy about the TR and view it as an antiquated tool. It certainly comes with many limitations but it does still have its usefulness. Indeed, it provides us with a framework for quantifying the Fed's likely forthcoming actions. It is 100% true that the TR does not correlate with the fed funds rate the way it once did. In our case, we find it useful when it is used directionally to gauge where the Fed debate is likely headed. In this case, the direction is hawkish!

Taylor Rule: A Quantitative Gauge Of The Fed's Mandate



What Is The Taylor Rule?

[Original 1993 Paper by John Taylor]

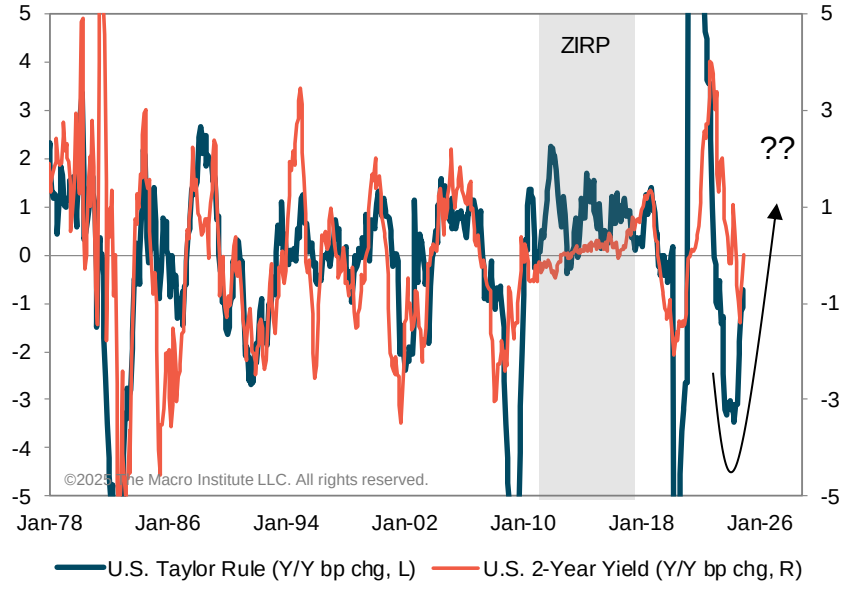
- Developed by John Taylor (Stanford Economist) and published in 1993;
- Designed as a framework for how the Fed should set monetary policy;
- Has done a consistent job at illustrating how monetary policy has been conducted across time.

How Is The Taylor Rule Calculated?

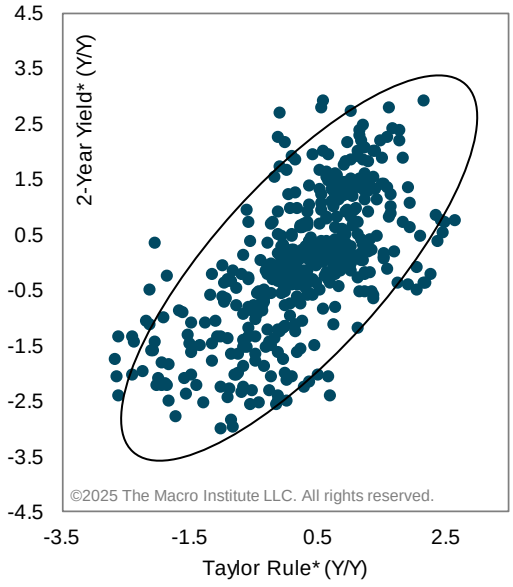
$$r = p + .5y + .5(p - 2) + 2$$

The main reason why we find the TR helpful is because it correlates with interest rates WHEN it is analyzed on a rate of change basis. In that sense, it can be used as a tool to frame the Fed debate. When core inflation or employment data intensifies, the TR moves higher, which is indicative that pressure is building on the Fed. If you look at the chart below, the relationship between the change in the TR and the 2-year yield shows us that this is not a fruitless exercise. The TR reacts to data in the same manner as short-term interest rates do. In summary, if you have a strong opinion of where core inflation and the unemployment rate is headed, you can end up with a pretty good forecast for short-term rates.

Change In The Taylor Rule Correlated With Trends In Rates …



… Hard To Argue?!?

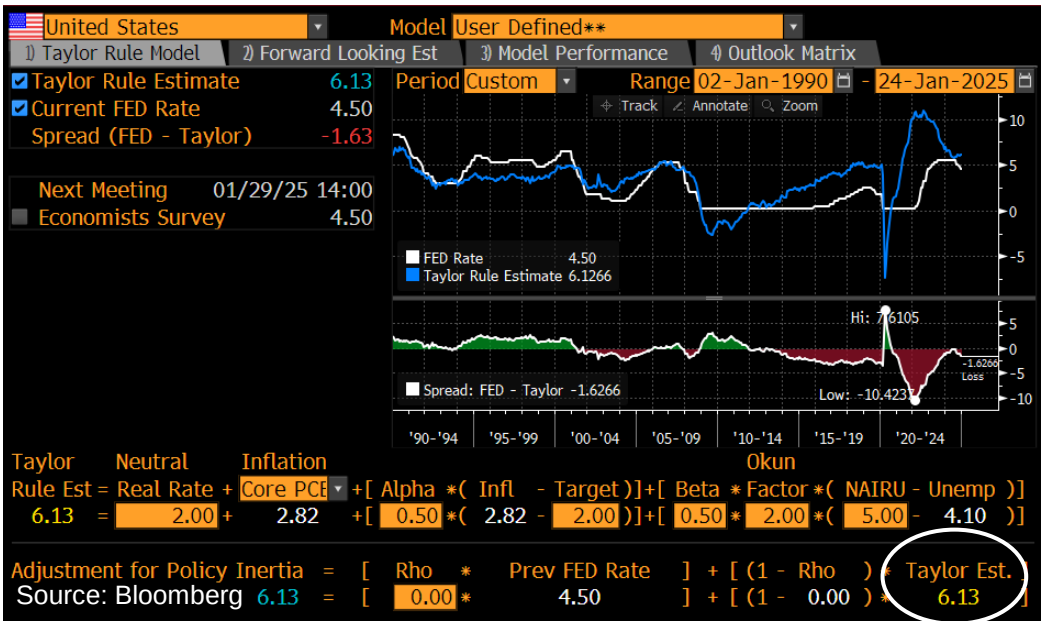


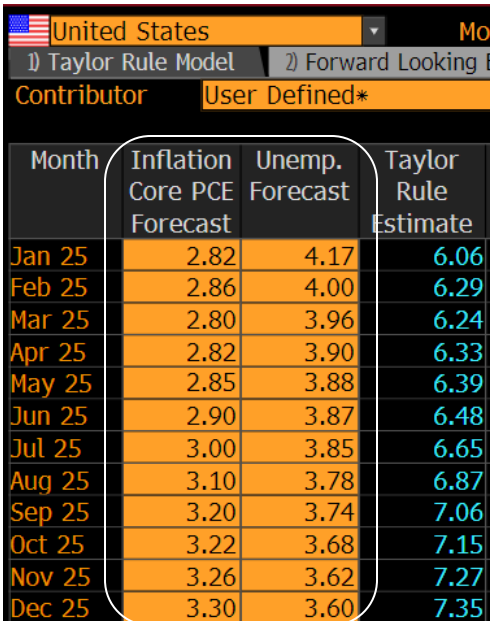
*Y/Y change in 2-Year Yield and Taylor Rule winsorized

Higher Short-Term Rates And Three Rate Hikes In 2025

Bloomberg provides a simplified tool for using the TR. It requires assumptions, of course, but it then quantifies what this does to the Fed's policy reaction function. The TR as of December of 2025 sat at about 6%. Again, it is directionally correlated with the FFR but rarely looks the same level-wise. We assume core PCE recovers slightly to 3.3% by the end of the year (mostly in H2'25) and the unemployment rate to move lower to 3.6%. This would lift the TR all the way to 7.35% by year end.

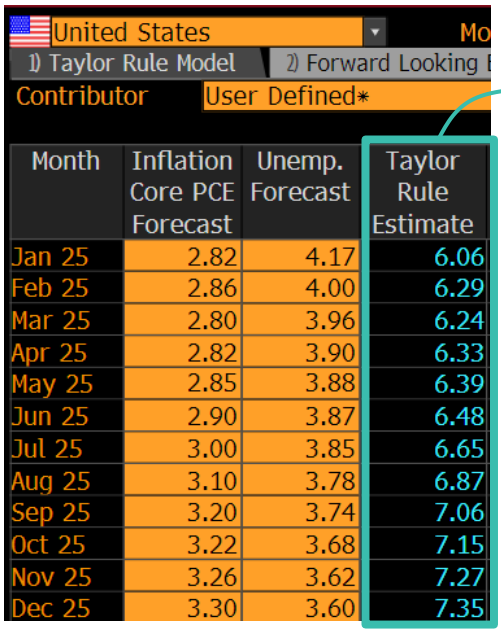
You Can Use Your Own Forecasts In The TR Using This Bloomberg Function: TAYL [GO]





Month	Inflation Core PCE Forecast	Unemp. Forecast	Taylor Rule Estimate
Jan 25	2.82	4.17	6.06
Feb 25	2.86	4.00	6.29
Mar 25	2.80	3.96	6.24
Apr 25	2.82	3.90	6.33
May 25	2.85	3.88	6.39
Jun 25	2.90	3.87	6.48
Jul 25	3.00	3.85	6.65
Aug 25	3.10	3.78	6.87
Sep 25	3.20	3.74	7.06
Oct 25	3.22	3.68	7.15
Nov 25	3.26	3.62	7.27
Dec 25	3.30	3.60	7.35

Again, it is the direction in the TR that can add value to the Fed's debate. If our forecast does come to fruition this would increase the TR by about 130 basis points over the course of the year (note that this is merely following the TR trend already in place). If we then take this change in the TR and plug it into the scatter plot from page 7 on the lower right, we can estimate what likely happens to the 2-year yield over the course of 2025. It would rise by close to 100 basis points. This would support our opinion that three rate hikes are likely to take place in the fall of this year. Plug in your own forecasts and see.



Month	Inflation Core PCE Forecast	Unemp. Forecast	Taylor Rule Estimate
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Mar 25	2.80	3.96	6.24
Apr 25	2.82	3.90	6.33
May 25	2.85	3.88	6.39
Jun 25	2.90	3.87	6.48
Jul 25	3.00	3.85	6.65
Aug 25	3.10	3.78	6.87
Sep 25	3.20	3.74	7.06
Oct 25	3.22	3.68	7.15
Nov 25	3.26	3.62	7.27
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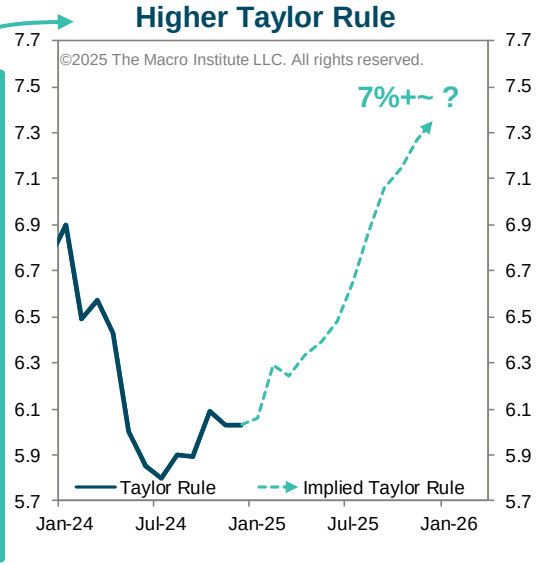
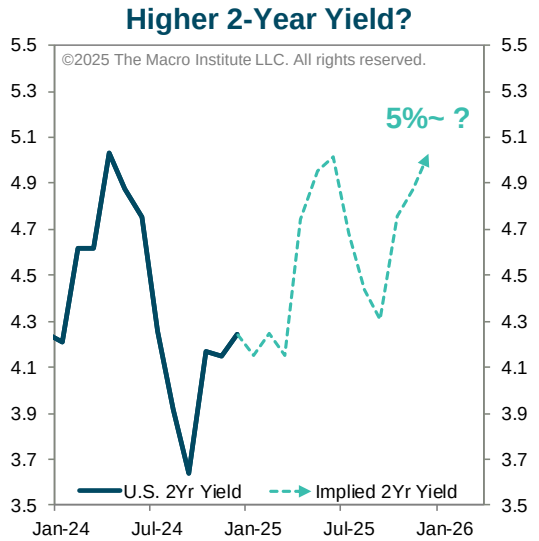
Lower UR (3.6%) + Higher Core Inflation (3.3%) Leads To This:

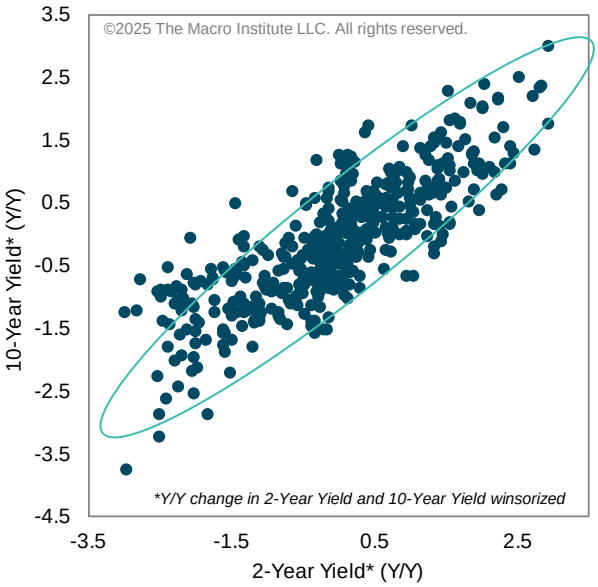




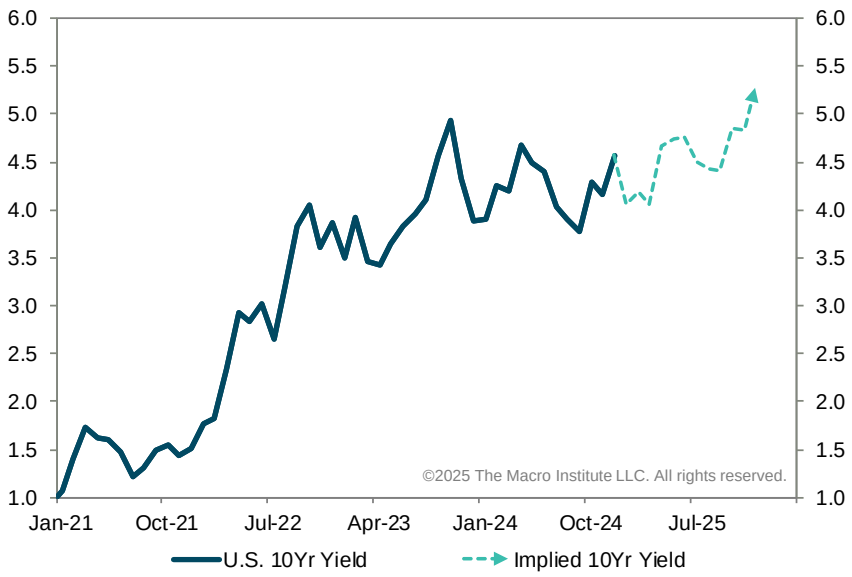
Fed Policy Sends Bond Yields Higher & Drives Stock Selection In 2025

The exercise thus far has been largely theoretical. The TR framework does allow us to quantify macro projections into an interest rate forecast. Still, humans trade these instruments and an overshoot or an undershoot is almost always part of the story when it comes to bond prices. Let's recap: prospects for higher inflation/lower unemployment argue for higher short-term rates and tighter Fed policy. The next step is to try and translate all of this into an outlook for the bond market. The rise in the TR from our assumptions would mathematically translate into a 100+ basis point increase in the 2-year yield which, using the scatter below left, would leave us with a 10-year bond yield around 5.25%/5.50% at year end.

Short/Long Rates Correlated

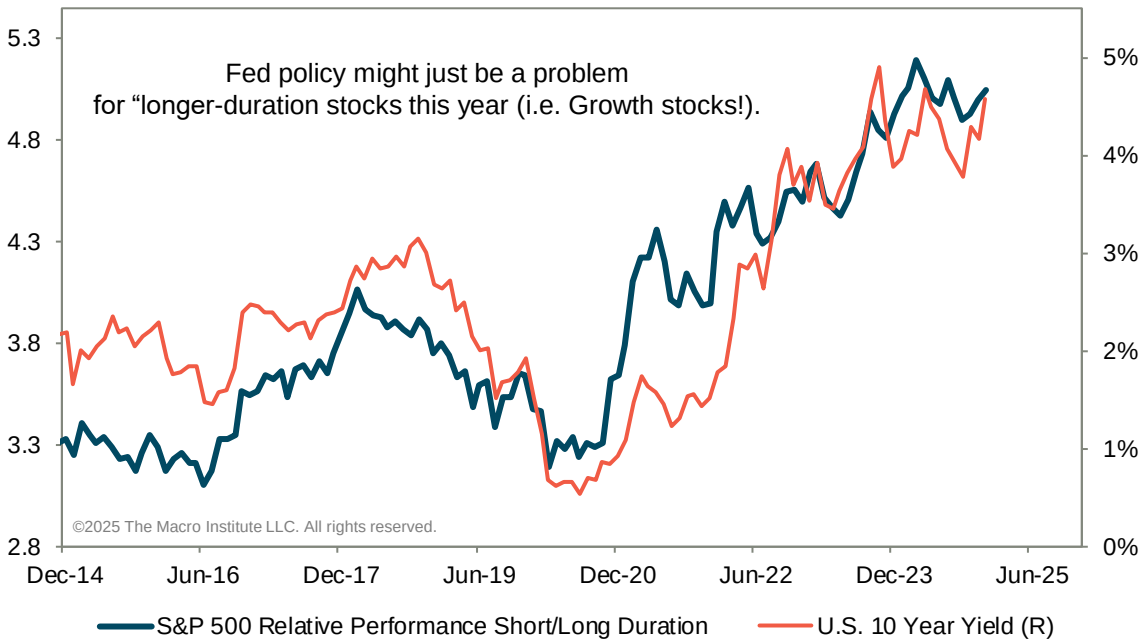


10 Year Yield Headed To "5% And Change" In 2025?



One thing we know from the pandemic recovery is that bond yields have been more influential for equity markets than most investors have been accustomed to. Surely, there is the P/E compression effect from higher yields. That said, there is also the influence that this brings to stock selection. It's easy to look at 2022 and see that longer-duration stocks (i.e. growth stocks) were impacted the most by the rise in interest rates. Think of what lies ahead as a milder version of the dynamic seen in 2021/22.

Bond Yields' ENORMOUS Influence On Stock Selection



The "Resumption Of Monetary Tightening" Trade Gets a Little Murky

We expect some things this year to feel familiar or look similar to the 2021/22 period but it is not exactly a perfect comp either. Still, a look at what would comprise the lowest quintile of equity duration in the S&P 500 makes it very clear that this backdrop favors Value over Growth when it comes to style investing. In other words, there is a lot of overlap between the extremes of equity duration and the style universes. This also fits the other part of the story since LEIs look set to trend higher this year. After all, Value tends to be much more exposed to cyclicality.

Low-Duration Portfolio Vs S&P 500 – Style Breakdown

Style	Low Duration	S&P 500	Spread
Pure Value	50%	22%	28%
Pure Growth	13%	18%	-4%

A similar analysis of the lowest quintile of equity duration also allows us to see how sector positioning skews around that factor. Knowing that Value is overrepresented does give us a sense of what to expect. Indeed, cyclical sectors like Financials and Energy showed up at the top of the list. Unsurprisingly, rate-sensitives like Utilities and REITs were at the bottom of the list along with the Technology sector. Industrials looks a little odd at the bottom of the list but there is less dispersion in duration with the sector.

Low-Duration Portfolio – Sector Breakdown

Sector	Low Duration	S&P 500	Spread
Financials	30%	15%	15%
Energy	12%	4%	8%
Communication Services	7%	4%	3%
Consumer Staples	9%	8%	1%
Materials	7%	6%	1%
Consumer Discretionary	10%	10%	0%
Health Care	9%	12%	-3%
Information Technology	9%	14%	-5%
Real Estate	1%	6%	-5%
Utilities	0%	6%	-6%
Industrials	7%	16%	-9%

Short-Duration Portfolio – Factor Breakdown

Factors	Low Duration	High Duration
Earnings		
EPS LTM Y/Y	9.9%	15.3%
EPS Dispersion	2.6%	4.0%
Efficiency		
Operating Margin	15.4	21.1
ROIC	12.3	13.2
Other		
Price/Sales	2.1	5.4
Debt To Assets	21.9	49.4

The table on the left is more informative than anything else but it shows how some characteristics differ between the extreme ends of equity duration within the S&P 500. Truth be told, the table would probably not look all that different if it was instead plotting the characteristics of Pure Value and Pure Growth. The former has slower EPS growth with more leverage to an improving economy. Value or Lower Duration clearly exhibit cyclical traits.

Where Will Rates Have The Biggest Impact On Stock Selection?

We know which sectors have the most exposure to lower-duration stocks. This is helpful when thinking about opportunities this year. That is not the entire story, however. There are some sectors where the differential between lower-duration and higher-duration names matters more than others. We saw on the prior page that the Energy sector has a lot to offer when it comes to lower duration. What the table below illustrates, though, is that duration is not a great differentiator within the Energy space when it comes to stock selection. It is for Consumer Discretionary and a host of other sectors, however.

The Influence Of Yields On Stock Picking

Short/Long Duration & U.S. 10YR	
Sector	Correlation
Pure Growth	0.80
Pure Value	0.51

73% of the S&P 500's market cap has an Equity Duration **greater than the index median**.

Short/Long Duration & U.S. 10YR	
Sector	Correlation
Discretionary	**0.87**
Real Estate	**0.82**
Financials	**0.78**
Industrials	**0.74**
S&P 500	0.65
Tech	**0.55**
Staples	**0.41**
Telecom	**0.29**
Utilities	**0.25**
Materials	**0.02**
Health Care	**-0.47**
Energy	**-0.58**

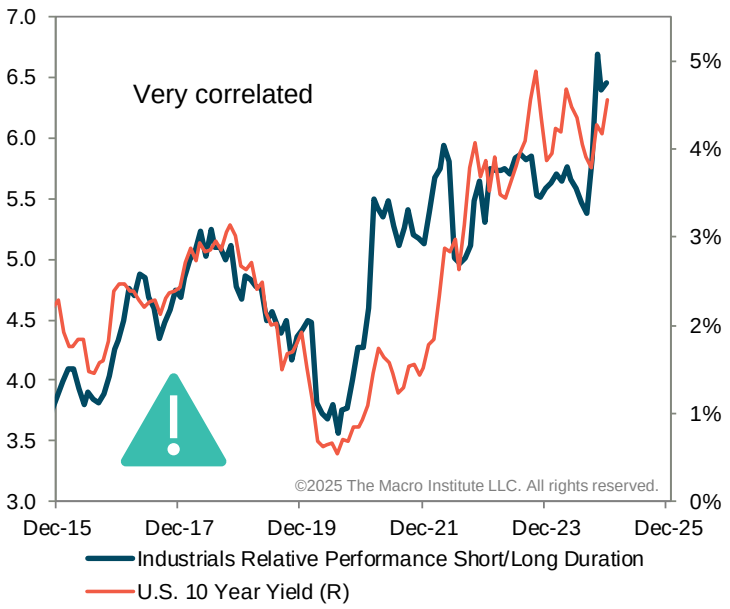
Bond yields a CRITICAL variable for stock selection in these sectors

Bond yields a KEY influence for stock selection in these sectors

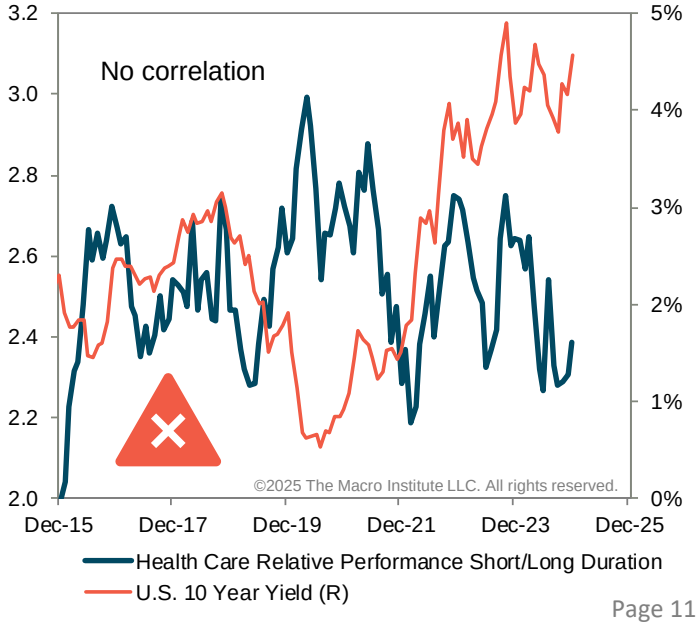
Bond yields an INCONSISTENT factor for stock selection in these sectors

The best way to show this concept is by looking at two extremes. On the left, we see that equity duration is actually a very important distinction when it comes to alpha generation within the Industrials sector. Conversely, equity duration has not been a good factor for separating winners from losers within the Healthcare sector. In summary, if you are stock picking within Consumer Discretionary, REITs, Financials and Industrials then the inflation story and its implications for the Fed are of critical importance. We expect the Fed to be a key variable this year but admittedly it matters more in some sectors than others.

Rates Matter MORE Within Industrials

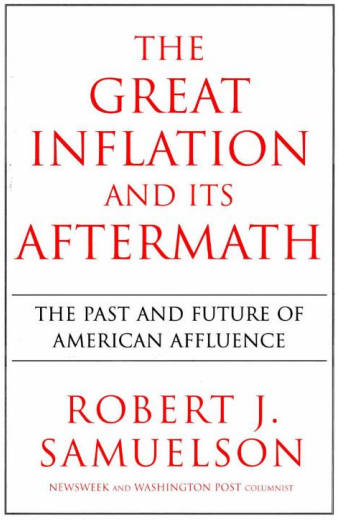


Rates Do NOT Matter Within Health Care

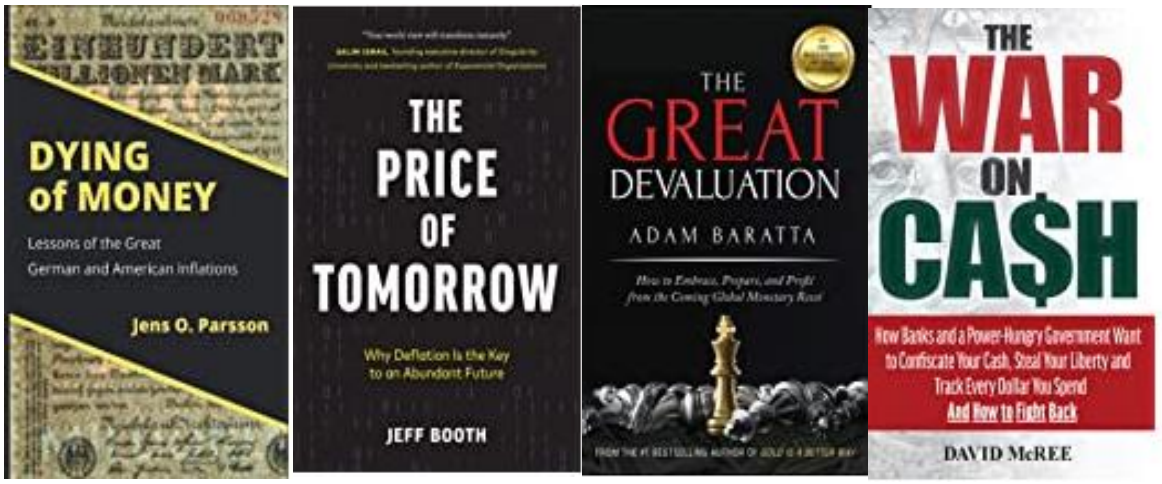


Annex: Some Interesting Resources Regarding Inflation Across History

I must admit that I felt largely unprepared back in 2021 when inflation started to become a problem. At the end of the day, most economists of my generation are not well trained in the topic largely because inflation had not been a real problem in almost four decades up to that point. We understood how to forecast inflation but were neophytes on all the implications it would bring for markets and the overall economy.



Top-Selling Books On Economic Inflation



If you are interested, the books above are among those that come up in a search of "inflation" on Amazon. The most helpful in our opinion is Samuelson's "The Great Inflation And Its Aftermath." We list below some of the main conclusions from Chapter 2 entitled "The Full Employment Obsession." The "employment" side of the Fed's mandate is generally seen as the starting point to the 1970s issues. Emphasizing employment at the expense of inflation eventually works against the economy's interest. This was not well understood at the time but became clearer and clearer as the decade unfolded. The vicious forces of inflation were eventually brought to a halt by Volcker in the early 1980s.

Chapter 2: The "Full Employment" Obsession	Lessons From 1970s Period Applicable Today
Conditioned by the Depression, the Kennedy-Johnson economists didn't worry much about inflation … Joblessness seemed the pressing problem."	This is a prime example of Familiarity Bias in which individuals have a preference to remain confined to what is familiar to them (i.e., low-inflation backdrop). *See top of page 2 in this report*
Government wouldn't tolerate substantial unemployment; that was its promise. The result was a stubborn wage-price spiral. Wages chased prices, which chased wages.	Similar dynamic to today in which labor market tightness pushes up wages, and historically leads to higher core inflation. *See top of page 3 in this report*
"Inconvenient bursts of inflation were blamed on onetime events: spending for the Vietnam War or global surges in oil prices … Unfortunately, most inflation did not stem from temporary causes."	Supply-chain issues and government benefits come to mind. *Please see report dated June 10, 2021:* What Happens To Equities If The Fed Is Wrong About Inflation?
"The result of this mind-set was that the same mistakes were repeated for fifteen years: Inflation was underestimated; policies to "stimulate" the economy (tax cuts, budget deficits, easy money) were overused; … as a reasonable way to reconcile "full employment" with low inflation."	The government's response to the pandemic has been nothing short of stimulative: two rate cuts, the re-starting of QE, over $4.2 billion in stimulus checks, and an upcoming infrastructure bill.
"The impatience to get unemployment as low as possible was fatal. Politicians would demand policies that would promote job creation until there was a reason to stop—the outbreak of serious inflation being the only obvious limit."	"…I think we now realize that unemployment can go low for quite a long time without inflation being a problem…" *Jerome Powell, April 2021*