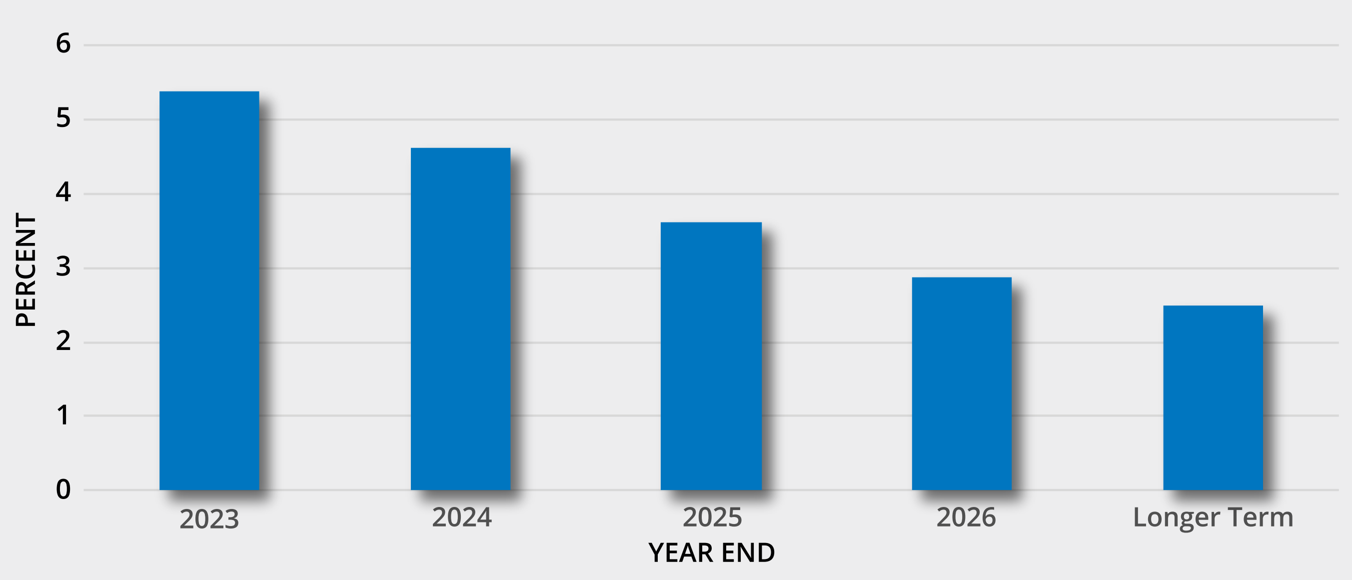
Pivot Party

Ever since the Fed began raising rates in March 2022, investors have been grappling with the question of when policymakers would conclude that enough was enough. This was the first step in a so-called "pivot" that would eventually lead to rate cuts. No issue has had more influence on asset prices over the past 21 months.

For its part, the Fed has been reticent about offering guidance on when it might relent, citing a high degree of uncertainty about what it would take in terms of monetary policy tightening to snuff out a burning inflation inferno. Outside of its quarterly Summary of Economic Projections (or "dot plot") that surveys the individual projections of officials, messaging from the Fed has been consistently non-committal in regards to a level of interest rates it felt was necessary to get the job done.

At the December meeting of the Federal Open Market Committee (FOMC), financial markets finally got some clarity. Without making a definitive declaration that no further rate hikes would be necessary, every indication pointed to the Fed's next move being a cut. The Fed's dot plot median projection expects 75 basis points of cuts next year – 50 basis points more than the September SEP.

FOMC Median Fed Funds Rate Projection (as of December 2023)



Source: Bloomberg, The Federal Reserve Board, 12/14/23

The very first question Powell fielded at the press conference zeroed in on the word "any" added to the statement's language on the need for additional firming. Powell affirmed the market's general perception that it was an acknowledgement policy rates had likely peaked – although he added that confidence in that outlook was not strong.

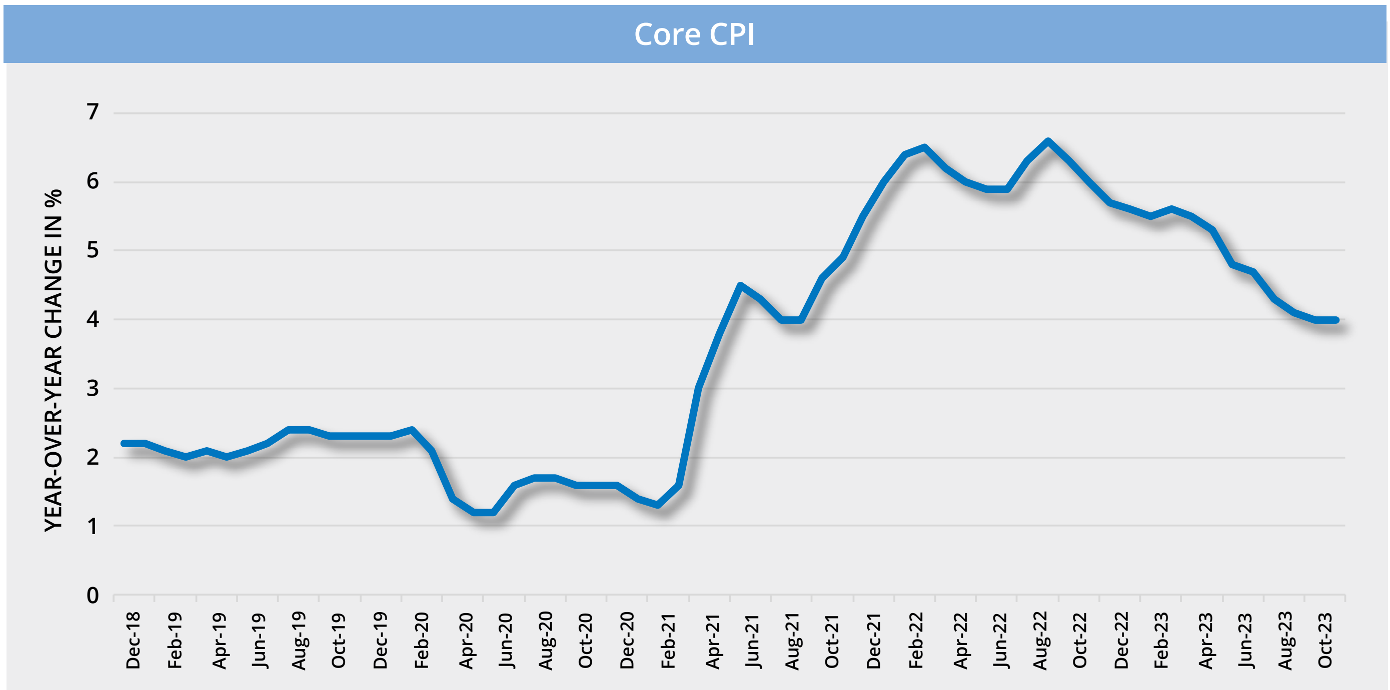
Of course, by suggesting that the Fed was done hiking, it naturally turned the conversation to when policy would begin to ease. This caught many off guard, because – less than two weeks earlier – he sounded far more hawkish when he remarked that speculation about future rate cuts would be premature.

During the post-meeting press conference, Powell offered little pushback to this dovish direction outside of highlighting inherent uncertainty emanating from pandemic-related distortions this cycle. He also qualified the dovish outlook in the SEP as simply a forecast that the FOMC was not obligated to follow.

Perhaps most surprisingly, Powell didn't indicate concern about the role financial markets were playing in loosening financial conditions in anticipation of the Fed's next move. At past meetings, he has attempted more actively to quell that type of speculation by market participants, seemingly out of concern it could work against the Fed's inflation-fighting cause.

Best of Both Worlds

Evidence of cooling inflation has begun to calm the nerves of anxious policymakers who were willing to do whatever it took to restore price stability. November's CPI report, released just before the FOMC meeting began, supported the case that a disinflationary trend was underway. Core CPI has declined to 4% on a year-over-year basis from a peak of 6.6% in September 2022.

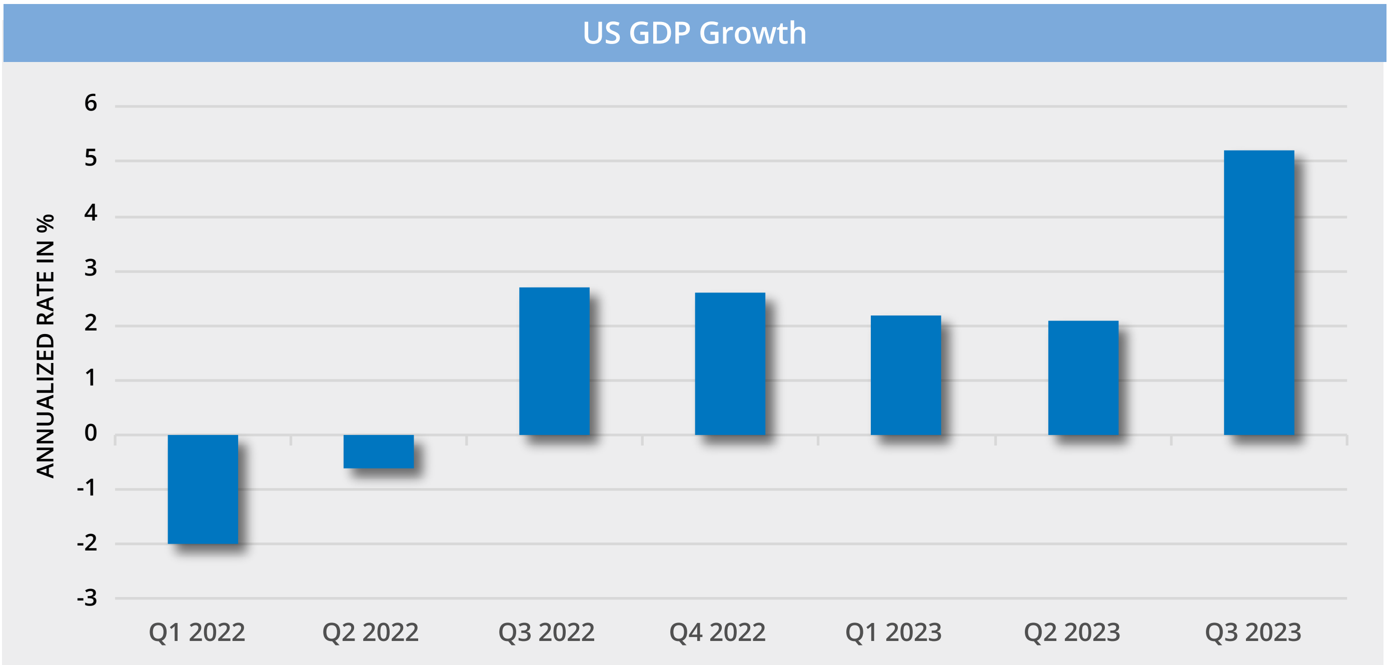


Source: Bloomberg BLS, 12/14/23

Cognizant of the inherent lags in monetary policy, the Fed acknowledges that waiting for inflation to return to its stated 2% target before cutting rates would likely result in an "overshoot." When Powell was asked how much closer inflation would have to get to 2% before he would consider cutting rates, he responded by saying "I can't give you a precise answer." He then suggested the dot plot, now projecting 75 basis points of cuts next year with inflation falling further to 2.4% (Core PCE), was "a good estimate."

During Powell's Jackson Hole speech in August 2022, he warned that higher interest rates in pursuit of lowering inflation "will also bring some pain to businesses and households." More than a year later, the Fed can celebrate its progress on moderating inflation pressure, while not lamenting over mounting job losses – a feat that once seemed improbable in the eyes of many, including the Fed itself. Indeed, many forecasters expected bringing inflation back in check would require sacrificing economic growth to the point of contraction.

A recession has yet to materialize, and there are few signs one is brewing over the near-term horizon. The U.S. economy grew at an astounding 5.2% annualized rate during the third quarter and is on track to deliver above-trend growth of 2.6% for 2023 according to the Fed's latest projection. A year ago, the projection was just 0.5%.



Source: Bloomberg BEA, 12/14/23

The unexpected durability of economic momentum in the face of higher interest rates may be attributable to a number of atypical circumstances. Excess savings on consumer balance sheets and an exceptionally tight labor market are two of the most common explanations. However, it should not be taken for granted that either of these conditions will last. If the Fed wants a chance at 'having its cake and eating it too,' it knows it must be mindful of not letting an opportunity for a soft landing slip through its fingers by staying overly hawkish.

Take-Away

As long as disinflationary trends persist, the Fed can afford to shoot for the win-win of restoring price stability without sacrificing economic growth. Such an outcome has become the base case in financial markets driving bullish sentiment for both stocks and bonds. However, if inflation progress were to stall, the Fed would be forced to pivot back to its hawkish leanings. In our view, this scenario has a non-trivial probability of occurring given the unusual circumstances of this cycle and inherent challenges of wringing out the so-called 'last mile' of inflation. Our concern is that investors may be prematurely celebrating success by assuming the prevailing base case is a foregone conclusion.

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