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ECONOMIC TALKING POINTS

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The Fed Turns More Hawkish; A Bizarre Policy Shift That Puts the 2024 Economy at Risk

Let's begin by giving credit where credit is due. The Federal Reserve has so far managed to significantly lower inflation without suppressing economic growth or kicking up unemployment. That is a hellishly difficult trifecta to accomplish, so much so that only a few economists thought the Fed could pull it off without triggering a recession (and we were among them).

And then came Fed's September FOMC meeting, which suddenly raises grave concerns. Policymakers decided to keep the benchmark rate at 5.25% to 5.50% --- but then signaled the likelihood of one more rate hike this year! And if that wasn't enough, instead of their earlier plan to cut fed funds by 100 basis points in 2024, they decided to allow only half as many cuts next year.

So one has to ask: Why, if everything was going so well in terms of disinflation and the ability to avoid recession, would the Fed suddenly feel it necessary to turn more hawkish? Why tinker with success? Of course, if inflation begins to re-accelerate, we would understand why the Fed would lift rates further. But that is clearly not the case now, and anyone with a minimum of foresight can find reasons why the economy is destined to slow in the coming quarters and further cool inflation pressures.

Here are a few. Consumers are now holding a record amount of debt (in excess $17 trillion), and this includes the largest credit card balances ever (above $1 trillion for the first time). These massive household liabilities are being carried at a time when interest rates are at their highest levels in

about two decades! The Federal Reserve Bank of New York even noted that credit card delinquencies beyond 90 days have spiked, and they have done so across every age group!

That massive debt burden, in conjunction with sharply higher interest rates and costlier gasoline are certain to dampen consumer spending the next few quarters. We're not talking about a total shut down in shopping, only that American are entering the next phase of spending, one where they are far more cautious and selective in what they purchase.

Then there is the resumption of student debt payments. Some 45 million Americans are going to have to allocate an average of $300 a month to service $1.75 trillion in college loans. That will also leave less available for discretionary spending and act to depress overall consumption.

Finally, there are political risks that loom larger each day that can do additional harm to the economy. Would the Fed really be inclined to hike rates in a prolonged government shutdown --- or even if Congress manages to pass short term funding through multiple Continuing Resolutions to keep Washington open? And how do we quantify the effects on consumers and business if the Presidential election campaign degenerates into political gang warfare where absolutely nothing gets done on Capitol Hill?

You would think the Fed would be more mindful of all these obstacles to growth over the next 12 to 18 months. Instead, policymakers there ignored it all. The FOMC statement and Jerome Powell's comments during his press conference voiced a concern that the economy was still too hot and that labor market conditions too tight, and that these reasons justify a more aggressive tone regarding future monetary policy.

Such a stance, however, is unwarranted and actually poses considerable risks.

It is true the economy performed very well in the 3Q. The Atlanta Federal Reserve's GDPNow model estimates it grew a strong 4.9% annual pace during the summer. While I have reservations about their GDPNow model in the first place, the more relevant issue is that the 3Q is nearly over and there is every indication the next 3 quarters will be substantially weaker.

Yet the Fed felt the need to act tough and for reasons, I believe, defy economic logic.

Here's what I mean. In their latest Summary of Economic Projections, the Fed acknowledged that inflation is in clear retreat. Last June, they expected core PCE inflation to fall to 3.9% by the end of this year. Now it sees it drop faster, to 3.7% by end of 2023, followed by another slide to 2.6% in 2024. Great news, you would think! This is precisely the kind of disinflation the Fed hoped to achieve, given that the REAL fed funds rate (nominal fed funds minus

inflation) has been at a highly restrictive level of 1.5% to 2%. As a point of reference, I believe the neutral REAL federal funds rate at this point in the business cycle is in the vicinity of 0.5%. (A neutral fed funds rate neither stimulates nor constricts economic activity.) The larger the positive spread between the REAL fed funds rate and the neutral rate, the firmer Fed's foot is on the economic brakes. So, again, why threaten to slam on those brakes harder when inflation is in decline and the economy is about to weaken?

Their rationale is strange. Back in June, they projected GDP growth this year to be 1.0%, but this week they doubled it to 2.1%. Let's be serious. That's hardly blazing speed. Perhaps there was another factor under consideration. The unemployment rate would not climb as much as previously forecast. That, too, may have spooked the Fed.

So here we are in a rather strange place where it's not enough to actually see disinflation. It's not sufficient that the Fed is making sustained progress toward achieving its mandate. Instead, it appears they are behaving as if the US cannot possibly have a sustained period of declining inflation AND simultaneously enjoy healthy economic growth with low unemployment. Yet, that is precisely what we experienced in the years prior to the pandemic,

The danger is that a hawkish posture NOW increases the risk that the REAL fed funds rate will jump above 2% and possibly trigger an economic downturn. Tighten the noose enough and the economy ceases to move.

Simply put, the Fed's latest comments seems inconsistent with their mandates. Monetary policy should focus on inflation. Full stop! They already achieved their other mandate of maximizing employment. There is thus no justification for the Fed to turn more hawkish just because the economy is doing well (...a blistering 2.1%?) and/or the unemployment rate remains too low.

Should the Fed proceed later this year with another 25 bp rate increase and then keeps rates high for longer next year, we would have to increase the probability of recession from 25% to 40% in 2024.

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Charts Below

United States

	I 2022	II 2022	III 2022	IV 2022	I 2023	II 2023	III 2023	IV 2023	I 2024	II 2024	III 2024	IV 2024	I 2025	II 2025	III 2025	IV 2025
Real Gross Domestic Product (GDP):																
%	-1.6	-0.6	3.2	2.6	2.0	2.1	3.2	1.9	0.9	1.6	2.2	2.9	1.7	2.5	3.0	2.6
Personal Consumption Expenditures:																
PCE %	1.3	2.0	2.3	1.0	4.2	1.7	3.7	2.0	1.0	1.9	2.7	2.6	1.7	2.8	3.1	2.9
Inflation, end of period, year-over-year:																
CPI %	8.5	9.1	8.2	6.5	5.0	3.0	3.5	3.1	2.8	2.6	2.5	2.8	2.6	2.7	2.8	2.8
Unemployment Rate (end of period):																
%	3.6	3.6	3.5	3.5	3.5	3.6	3.7	3.8	3.9	4.0	4.1	3.8	3.8	3.7	3.5	3.5
Non-farm Payrolls, monthly avg. thousand:																
	561	329	423	291	297	201	165	180	155	185	235	230	200	235	240	240
Treasury 10-yr Note Yield % (end of period):																
	2.32	2.97	3.80	3.83	3.47	3.82	4.20	3.95	3.70	3.70	3.60	3.65	3.70	3.75	3.80	3.80
Federal funds rate % (end of period):																
	0.38	1.63	3.13	4.38	4.88	5.13	5.38	5.38	5.38	5.38	4.88	4.38	3.88	3.63	3.13	3.38

GDP Growth - Global Economy - Year over Year

Country	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
US	2.6	1.6	2.2	1.8	2.3	2.7	1.7	2.2	2.9	2.3	-2.8	5.9	2.1	2.2	1.8	2.5
Eurozone	1.7	1.4	-0.9	-0.2	1.4	2.1	1.9	2.5	1.8	1.6	-6.2	5.3	3.5	0.8	1.3	1.7
United Kingdom	1.7	0.7	0.3	1.8	2.9	2.2	1.9	1.9	1.7	1.7	-9.3	7.6	4.1	0.3	1.0	1.3
Japan	4.6	-0.4	1.6	1.5	-0.1	1.1	0.5	1.7	0.6	-0.2	-4.6	1.7	1.0	1.2	0.9	1.6
Canada	3.1	3.1	1.8	2.3	2.9	0.7	1.0	3.2	2.8	1.9	-5.1	5.0	3.4	1.6	1.4	1.8
India	8.4	8.6	6.7	4.9	7.4	8.0	8.1	7.2	6.4	3.8	-6.6	8.7	6.7	5.6	6.1	6.6
China	10.5	9.5	7.8	7.7	7.3	6.9	6.7	6.8	6.7	6.0	2.2	8.1	3.0	5.0	4.6	4.8
Brazil	7.5	2.7	0.9	2.3	0.1	-3.5	-3.5	1.2	1.2	1.7	-3.6	5.3	3.0	2.3	2.2	3.1
Mexico	5.2	4.0	3.9	1.4	2.3	2.7	2.7	2.4	2.2	-0.2	-8.2	4.9	3.0	2.5	2.2	2.7
Australia	2.8	2.6	3.6	2.4	2.6	2.5	2.4	2.4	2.7	1.8	-1.1	4.7	3.7	1.3	1.7	2.8
Russia	4.0	4.3	3.4	1.3	0.6	-2.8	-0.2	1.6	2.8	2.2	-2.7	5.6	-2.1	0.9	1.2	1.7
World	4.2	3.1	2.5	2.6	2.8	2.8	2.6	3.4	3.2	2.6	--3.1	6.0	3.1	2.3	2.0	2.9

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