

THE ECONOMIC OUTLOOK GROUP



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ECONOMIC TALKING POINTS

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Quick note:

Inflation is marching higher...so traders expect the Fed to cut rates?

When discussing future monetary policy, there's always a distinction to be made between what one thinks the Fed *ought to do*...and what you *expect they will do*. This dichotomy is especially apparent now.

Here is what I mean. November's CPI rose at the fastest pace in seven months, up 0.3% from October. On annual basis, consumer prices just increased for two consecutive months, with the latest a rise of 2.7%. It is clearly on a path moving further away from the 2% target.

By the way, this upward trend mimics the Federal Reserve's favorite inflation metric, the PCE price index. So the data on prices have been consistent; inflation pressures are building again and this should be concerning. At the very least, you would expect the Fed to pause next week and reassess the dynamics on what's causing prices to climb back up.

Yet traders are assigning a 95% chance the Fed will nevertheless reduce the fed funds rate by another quarter point at next week's meeting.

How does one make sense of this inherent inconsistency? Remember, Jerome Powell firmly repeated countless times over the past year that he and his colleagues have to be “*confident*” that inflation is moving in the right direction and nearing 2% before they ease up on the monetary brakes. Frankly, had these same inflation numbers been published earlier this fall, I doubt the Fed would have lowered rates as they did in September and November.

So why do so now?

If, in fact, the Fed does cut rates next week, Powell will have to work hard at the press conference to explain (better word is “rationalize”) this latest action. My sense is he may want to slip in one more quarter-point cut (bringing fed funds to 4.25% to 4.5%) before the Trump Administration takes over in January and starts to follow through on its promise to lift tariffs and slash corporate and personal income taxes.

If that is the plan, fine. But we cannot ignore another potential risk to the economy, which is that markets get confused whenever there’s a divergence between Powell’s words and his deeds. I think a rate cut next week will prove to be a mistake because (a) it isn’t warranted --- and (b) it risks eroding Fed credibility.