

# THE ECONOMIC OUTLOOK GROUP



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## ECONOMIC TALKING POINTS

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### **Is the Fed's strategy to contain inflation starting to unravel?**

Last November 13<sup>th</sup> I wrote about how forces are at work to hinder the Federal Reserve's efforts to quell inflation ("*Consumer Prices: The Fed is Now in a Real Quandary*"). That conclusion was based on early data. But more concrete evidence has emerged since to suggest the Fed now has genuine reasons to be concerned.

Two reports last week highlight that point. One was the December employment release, and the other from January's Survey of Consumer Sentiment.

Let's start with the latest jobs report since it shows the economy galloping into the new year with considerable momentum.

December's nonfarm payrolls surged by 256,000, the most since last March. (Consensus expectations was for a meeker 165,000). Private sector hiring jumped by 223,000, more than the same month a year ago!

Further reinforcing this upbeat trend was the household survey. Total employment soared by 478,000, the largest one month increase in more than a year!

Not only did the unemployment rate drop to 4.1%, but December also had the distinction where workers in every demographic group (age, ethnic background, level of education) enjoyed a decline in joblessness.

All this hiring suggests corporate leaders have made a two-bet wager.

**Bet #1.** President-elect Trump's push to cut taxes and promote more domestic production will result in stronger economic growth in 2025. To satisfy the increase in demand for goods and services, firms will need to ramp up production and that

**requires additional workers. Since the labor pool has been thinning, there is no time to waste. Hire now!**

**Bet #2. US business leaders seem to be undaunted if the Fed choose to keep rates higher for longer. First of all, just look at how well the economy performed the last two years even with higher real interest rates. Moreover, the Fed already lowered the cost of overnight borrowing a full percentage point since last fall. Monetary policy is still “restrictive,” according to the Fed, just slightly less so. But what has truly buoyed corporate optimism is they now see the arrival of a business-friendly White House that is intent on slashing regulations, bureaucracy and tax burdens. This mana from Washington should produce greater revenue and profits for companies ahead---even if the Fed does not lower rates this year.**

**That brings us to the report on Consumer Sentiment.**

**If the economy is gearing up for faster growth, aided by broad tax cuts, more consumer spending, greater business capital outlays, and tariffs designed to encourage more domestic production, well then, it probably will come at a cost, namely higher inflation.**

**And that is precisely what the University of Michigan’s Consumer Sentiment Survey has just warned. Inflation expectations now appear to be unmoored. One key index, which asks Americans where they see inflation a year from now, jumped to 3.3%, its highest level since May 2024! Let me point out that last May 2024, the Michigan survey came up with an identical one-year inflation outlook (3.3%), and the Fed back then was in no mood to even consider cutting rates!**

**To be fair, we do not know when the tariffs will be deployed, against whom and by how much. Nor do we have sense of what the new tax legislation will encompass or when it will take effect? Nevertheless, the latest Sentiment survey is a tip off that inflation is likely to accelerate early in Trump’s second term.**

**So where do matters stand at this point?**

**We know the President-elect has his eyes set on achieving a cornucopia of domestic and foreign policy goals. Listing them all in a single breath won’t be easy, but let’s try: Trump seeks to deploy universal tariffs, extend the 2017 tax legislation, revoke taxes on tips, overtime and on social security, lift the state & local tax (SALT) deduction, arrange for free in vitro fertilization, cut federal spending by \$2 trillion, accelerate deportation of undocumented workers, shut down or merge major government agencies, purchase the deed (...or else!!) to Greenland, grab back the Panama Canal, economically squeeze Canada until it surrenders to be part of the US, and quickly bring an end the wars in Ukraine and Middle East. I’m sure I have missed a few. (I would have added Taiwan to the list, but Trump has been reticent about the future of this island.)**

**There’s no way to know at this moment which from this gallimaufry will see daylight.**

**What is fair to say is that elected officials arrive in Washington with a certain amount of political capital to shape public policy. The President, of course, enters the Office with a magnum of such capital because he's the nation's top executive and Commander in Chief. Yet the Presidency is not immune to losing some leverage over time. Political capital can be fleeting, especially if used frivolously. If Trump over promises but fails to deliver, if he uses the power of his office promiscuously, if he incessantly demeans all who disagree with him, if he persistently intimidates his foreign allies or speaks long-windedly about grabbing lands that belongs to other nations --- if, to summarize, Trump's conduct and verbiage becomes manifestly solipsistic and tiresome, then he will unwittingly deplete his political capital in the US and on the world stage. His clout quickly crumbles. In that case, far less of his declared policy preferences comes to fruition.**

**We shall see. Trump has certainly not been shy telecasting his intentions.**

**For, now, however, the Fed faces a dilemma. If the Michigan survey on inflation expectations is to be believed, and it should, there is then a real danger Powell's long effort to contain prices is starting to unravel. That is why this week's scheduled release of economic indicators (Producer Prices, the CPI, Retail Sales and Industrial Production), may well determine the future course of monetary policy. One thing is clear: The very last the Fed wants to do is cut on January 29th, only to take it back later in the year.**

**Producer Prices – Tuesday, Jan. 14 (8:30 AM) BLS  
Consumer Prices - Wednesday, Jan. 15 (8:30 AM) BLS  
Retail Sales – Thursday, Jan. 16 (8:30 AM). Census  
Industrial Production – Friday, Jan. 17 (9:15 AM). Federal Reserve**