Why the Fed is likely to cut interest rates again despite inflation uptick, solid economy

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Despite stubbornly high inflation recently and a sturdy economy and job market, the Federal Reserve is expected to cut interest rates this week for the third straight meeting.

What gives?

Some economists say Fed officials could be making a blunder that risks reigniting inflation and undercutting their pledge to rely on the latest data when making rate decisions.

"I think a rate cut next week will prove to be a mistake because (a) it isn't warranted and may backfire and fuel more inflation, and (b) it risks eroding Fed credibility," **Bernard Baumohl**, chief global economist of the Economic Outlook Group, wrote in a note to clients.

Others, however, say that despite the worrisome headline numbers, there's evidence inflation is still heading lower and the Fed should stay on course to gradually bring rates back to normal levels.

Who benefits from Fed rate cuts?

The Fed raises rates to reduce inflation by making borrowing more expensive and cooling the economy. It lowers rates to boost a flagging economy and job market or bring rates closer to a "neutral" level – that neither stimulates nor dampens growth – as inflation eases. Rate cuts also typically juice stocks.

Is the Fed going to cut rates again?

Futures markets say there's 97% chance the Fed will trim its key short-term rate by another quarter percentage point Wednesday after a two-day meeting, but pause in January and slow the pace of decreases next year to just two quarter-point cuts. That would be half the four reductions Fed officials predicted in September. And it's consistent with officials' recent comments about slowing the cuts in 2025 to judge their effects, especially with the economy on solid footing.

Why did the Fed increase the interest rate?

In 2022 and 2023, the central bank hiked its key rate from near zero to a range of 5.25% to 5.5% to wrestle down a pandemic-related price spike that propelled annual inflation to a 40-year high of 9.1%.

Inflation has fallen below 3% this year, close to the Fed's 2% goal, leading officials to chop the benchmark rate by three-quarters of a percentage point since September.

What is the inflation rate right now?

But average price gains have stayed elevated in recent months. In November, overall inflation rose for the second straight month to 2.7%, based on the consumer price index, the Labor Department said last week. And core prices - which exclude volatile food and energy items and the Fed watches more closely – increased sharply for a fourth straight month, keeping yearly core inflation at 3.3% for a third month.

Those core price changes are more sustainable because they're affected by consumer demand, which the Fed can control with rates, rather than global commodity prices.

Wholesale costs, which typically feed into consumer prices, also jumped a hefty 0.4% last month, though much of that was due to a bird flu-related surge in egg prices.

How is the economy doing right now?

Meanwhile, the economy has been resilient despite high prices and interest rates that have especially hurt lower-income households. It grew at a healthy 2.8% annual rate in the third quarter and the Federal Reserve Bank of Atlanta forecasts a 3.3% rise in the current quarter. And job growth bounced back smartly in November after hurricanes and strikes suppressed payroll totals the previous month, with 227,000 gains.

In a recent speech, Fed Governor Christopher Waller said he was leaning toward a December rate decrease but the Fed's decision would depend on coming reports. Those reports, which have since been released, show inflation and the job market have been hotter than projected.

So why is the Fed still planning to slice rates this week?

Lowering interest rates from high to normal

Fed officials have said the key rate is too high and they're trying to slowly bring it to a neutral level of about 3%. The rate is now 4.5% to 4.75%.

In his speech, Waller said the rate is still "significantly restrictive" considering the drop-off in price increases so far, meaning it could be unnecessarily constricting the economy. "Cutting again," he added, "will only mean that we aren't pressing on the brake pedal quite as hard." Barclays economist Marc Giannoni said the Fed would like to push down the rate closer to neutral as soon as possible so it doesn't further hamper the economy and possibly risk a recession. Then in January, after total rate cuts of a percentage point, officials can pause to assess their impact, he said.

Trump's tariffs

Fed Chair Jerome Powell also “may want to slip in one more quarter-point cut before” President-elect Trump begins making good on threats to impose tariffs on imports from Canada, Mexico and China as soon as his first day in office that are expected to intensify inflation, **Baumohl** said. Tariffs could force the Fed to hold rates steady or lower them more slowly than planned.

Powell, though, has said officials aren’t yet factoring Trump’s uncertain trade policies into their decisions. Giannoni expects the tariffs to increase inflation but not until the second half of the year.

Under the hood, inflation is slowing

Although overall inflation has picked up, the details have been more encouraging for Fed officials looking for a pullback.

Rent, the biggest contributor to inflation, increased just 0.2% in November, the smallest monthly rise since July 2021.

Other persistent inflation drivers, such as auto repairs and car insurance, also crept up modestly in November. The pullback in services inflation broadly “should provide much comfort to the Fed,” Nationwide Chief Economist Kathy Bostjancic wrote to clients.

At the same time, items whose prices surged last month and fueled inflation, such as hotel rates and cars, are volatile, said Samuel Tombs, chief U.S. economist of Pantheon Macroeconomics. In other words, they’ll likely cool down soon enough. New and used car prices were juiced by a burst of demand after two Southeast hurricanes damaged thousands of vehicles in early fall, forcing owners to replace them, Tombs said.

Another inflation measure looks tamer

Although the consumer price index has run hot lately, another inflation gauge the Fed follows more closely – called the personal consumption expenditures index - is expected to show smaller cost increases.

A report next week is likely to reveal the PCE index edged up just 0.1% on a monthly basis in November, Barclays said. Items such as vehicles and hotel rates that weigh heavily in the CPI contribute far less to the PCE measure, Tombs said.

The labor market is cooling

While job growth has been solid, the labor market is cooling. The unemployment rate rose from 4.1% to 4.2% last month, Barclays noted. And average yearly wage growth held firm at 4%, down from 5.9% in early 2022. Strong growth in productivity - or output per worker - should let companies give large raises without passing the higher costs to consumers through price increases, Oxford Economics said.

More cautious interest rate forecasts

Wednesday, Fed officials are expected to predict just two or three rate cuts next year, Barclays said.

Since such forecasts can affect the public's inflation expectations, which can impact inflation itself, estimates of fewer cuts would send a more cautious signal and partly offset the effects of a rate drop, Giannoni said.

Futures markets expect a rate cut

Futures markets that bet on the movements of the Fed's rate, along with the stock market, believe a rate cut Wednesday is nearly certain. If last week's inflation numbers caused officials to waver, they had no chance to convey that message to the public.

While Fed officials formally insist markets don't sway their decisions, economists say the central bank doesn't like to rattle them. "They don't want to push back on market expectations," Giannoni said.