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A Lower Hurdle for Rate Cuts

We have been bearish on the economy and bullish on treasuries for a handful of reasons. The Index of Leading Economic Indicators (LEI) is in freefall, the Treasury yield curve is deeply inverted, commercial banks continue to tighten lending standards, consumer goods spending is well above its pre-covid trend, construction payrolls are massively outsized relative to underlying housing activity, and finally, inflation continues to collapse after having peaked just three months after the Fed began raising interest rates.

The LEI is down 19 consecutive months and declining at a near 8% annual rate. The slope of the yield curve has been negative for 17 consecutive months after a record sized inversion earlier this year. Senior loan officers continue to tighten credit for businesses and households at levels consistent with past recessions.

Real consumer goods spending, as a share of GDP, is over 9% which is one and half percentage points above its pre-pandemic trend. Based on the level of residential investment, as well as current readings on homebuilders' sentiment and mortgage applications, we calculate that there is anywhere between 700k to 1 million too many construction jobs relative to demand.

Lastly, the consumer price index is up 3.1% over the last 12 months, down from its 9.1% cyclical peak and on track to hit 2% around the middle of next year. Inflation having peaked a record-long 13 months before the peak in the funds rate means there is a lot of policy tightening in train.

Against this backdrop, **we have long argued the Fed needs to cut interest rates by at least 250 basis points (bps) over the next 18-to-24 months to properly recalibrate the overnight night borrowing rate with the term structure of interest rates**. The fed funds futures market is almost there, discounting about 200 bps in cuts over the next 18 months. If there is a recession, the funds rate is likely to go much lower. That is the chief risk.

But **what is surprising to us, is the timing of the Fed pivot because the factors we cite above have been known for some time, and the latest data while softening, have still been decent**. Even the FOMC's updated forecasts do not explain the dovish shift. For example, the median estimate of the core PCE was lowered only a couple of tenths from where it was in September to 2.4%. Headline inflation and real GDP were trimmed just a tenth to 2.4% and 1.4%, respectively. And the unemployment rate was unrevised at 4.1%. Yet, the median 2024 Fed dot is 50 bps lower than where it was in September.

Furthermore, consider what Chair Powell said just two weeks ago at Spelman College. "It would be premature to conclude with confidence that we have achieved a sufficiently restrictive stance, or to speculate on when policy might ease. *We are prepared to tighten policy further if it becomes appropriate to do so*." Clearly this was not the message that Chair Powell delivered this week when he stated the FOMC discussed rate cuts! What changed in such a brief period?

Regarding the outlook for official interest rates, **the abrupt change in Fed tone means the hurdle for a Q1 rate cut is much lower than before**. We will not need negative employment for the Fed to cut. Instead, any variety of mildly weaker economic data could initiate rate cuts.

For example, the Fed could now lower rates on any combination of sub-100k nonfarm payrolls, near 4% unemployment, only modest increases in core inflation, flat-to-modestly negative retail sales, and even a weaker than expected ISM manufacturing survey. Notably, we would not have made this argument before the December FOMC meeting. Stay tuned.

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