Fed Watch

Fed takes “another step in reducing the degree of policy restraint”

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The Fed will likely end the cycle sooner than previously thought on greater inflationary challenges under Trump’s potential policies

- **As widely expected, the Fed cut the policy rate by 25 bps to a 4.50-4.75% target range and continued to signal that their plan points towards a further gradual reduction of policy restraint.** FOMC members remain hesitant to declare victory since the policy statement continues to note that inflation “remains somewhat elevated.” While their attention is still on “the risks to both sides of their dual mandate,” today’s second consecutive rate cut reflects the Fed’s commitment to supporting maximum employment as “labor market conditions have generally eased” since earlier in the year. The stronger-than-expected activity data for 3Q coupled with some stickiness in core services prices in September drove the Fed to remove the “further” adverb from the last meeting’s “inflation has made further progress” sentence. The phrase regarding the long-held needed “greater confidence that inflation is moving sustainably toward 2%” was also removed because, in Chair Powell’s words, “further confidence was [their] test for the first rate cut,” i.e., the confidence had been gained ahead of the previous meeting. Powell downplayed both tweaks to the wording, explaining that they neither hint that the Fed has fresh concerns about inflation, nor intent to signal an upcoming pause in the rate-cut cycle.
- **The Fed remains confident in the soft landing and rules out risks (for now?) from tighter financial conditions stemming from recently higher long-term Treasury yields.** Chair Powell continued to stress that they “continue to be confident that with an appropriate recalibration of [their] policy stance, strength in the economy and the labor market can be maintained with inflation moving sustainably down to 2%.” There were no signals that the rate cut cycle is at risk of halting or even reversing in the short term, as the Fed’s goal is to keep moving “toward a more neutral stance over time.” This was further supported by Powell, who suggested that the outlook for inflation, though likely “continuing to come down on a bumpy path,” calls for further restriction removal. Despite ongoing doubts regarding the neutral rate level, FOMC members “think that, even with today’s cut, policy is still restrictive.” As Chair Powell pointed out, “we understand it’s not possible to say precisely how restrictive, but we feel that it is still restrictive.” When asked about the drivers behind recently higher long-term yields, Powell’s opinion was that “the moves are not principally about higher inflation expectations [but rather] about a sense of more likelihood of stronger growth and perhaps less in the way of downside risks.” He downplayed the effect of those recently higher long-term rate on broad financial conditions by stating that “it is material changes in financial conditions that last [...] that really matter, and we don't know that about these [...] so far.”
- **As expected, Powell ignored the elephant in the room and avoided commenting on any issues related to this week's presidential election and the likely effects of Trump’s potential policies.** Although it is most likely that the Fed staff is already feeding their economic models with the scenarios of a second Trump term, Powell avoided entering the debate by categorically stating that: “we don't guess, we don't speculate, and we

don't assume." The Fed will likely remain on this line until Trump's policies are better outlined and become law, but in general the sense among market participants and analysts (us included) is already pointing to greater inflationary challenges under Trump's potential trade and immigration policies, which at first glance may result in fewer rate cuts next year. In our view, this is part of the reasons behind the upward shift of the middle and long ends of the Treasury yield curve in recent weeks.

- **We continue to think that the rate cut cycle still has legs, but following the outcome of the election the Fed will likely end the cycle sooner than previously thought.** As we argued earlier this week (see), recent evidence of economic activity and employment strength coupled with more disinflation in the pipeline suggest that the path to a soft landing is proving to be not as narrow as initially thought. With that backdrop, it made sense that the Fed was going to slow the pace of rate cuts. Although Powell was non-committal on future rate cuts, and argued that the Fed does not know "the right pace of the destination," he also said that the policy is still restrictive, risks remain two-sided, and the plan is still to reduce the policy restraint going forward.

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