Fed Watch

Fed likely remains confident enough to keep cutting rates at a 25bp pace

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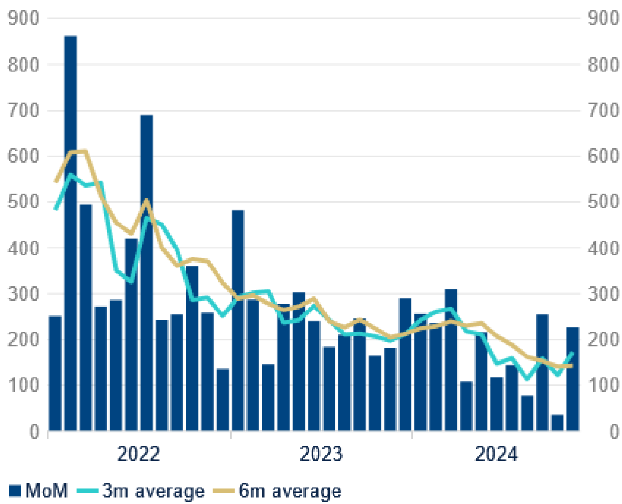
There is a good chance that the recent inflation bump is transitory, echoing the short-lived inflationary episode from the first quarter

- **Economic activity continues to exhibit signs of a soft landing, with consumer spending remaining a key driver of growth despite the transitory shocks faced by the manufacturing sector.** Data revisions during the intermeeting period did not materially alter the view of underlying economic strength. The second estimate for 3Q24 real GDP growth remained unchanged at 2.8% (SAAR), and consumption growth was revised only marginally down to 3.5% from 3.7%. Besides, early 4Q data indicate the outlook is unlikely to be at risk of a sudden deterioration: the Atlanta Fed's 4Q GDP nowcast points to 3.3% SAAR growth. Retail sales increased by a healthy 0.4% MoM in October, underpinned by the strength of motor vehicle (1.6%), food services (0.7%), and building materials (0.5%) sales. It is true that control group sales fell by 0.1% MoM, but the notable upward revision to September's headline figure to 0.8% from 0.4% suggests little cause for concern. On the other hand, industrial production fell 0.3% MoM in October amid the Boeing strike and hurricanes Helene and Milton. While these shocks have faded since early November, they may still weigh on 4Q GDP. The most timelier survey-based activity data continues to signal a healthy slowdown: the ISM manufacturing index rose only slightly to 46.8, remaining in contractionary territory, while the ISM services index declined to 52.1, partly due to a fall in the employment index (to 51.5 from 53.0) amid a cooling labor market. In this context of mixed signals, we think the strong performance of the economy is unlikely to spark inflationary fears among most Fed members.
- **Employment data painted a mixed picture of the labor market, which "appears finally to be in balance": both jobs and wage growth remain healthy, but the unemployment rate edged up slightly.** The rebound of new nonfarm payrolls in November was broadly expected following the dissipation of the temporary disruptions that weighed on hiring in October, particularly in the manufacturing sector. Indeed, the solid 227,000 jobs gain suggests that more than a simple reversal from the previous month's weakness was behind November's strength, since the headline figure was accompanied by upward revisions to both September (+30,000) and October's (+24,000) data (Figure 1). Overall, employment has grown c. 150,000 per month in the second half of the year, a healthy pace but somewhat below the c. 200,000 pace of 1H24. The sticky 0.4% MoM (4.0% YoY) gain in average hourly earnings might make some at the Fed a little uncomfortable. However, wage growth is still on track to slow further, as suggested by the private quits rate (Figure 2). In any case, the wage growth trend warrants close monitoring by the Fed, as Trump's potential immigration policies could contribute to broader inflationary pressures in 2H25. On the other hand, the unemployment rate ticked up to 4.2% (from 4.1%) amid a less vibrant labor force, indicating a low but non-negligible risk of a sudden labor market downturn. Overall, we believe labor market conditions are stabilizing at a healthy level and pose little inflationary risk, which is likely to be a shared view among several FOMC members, such as Governor Waller who noted recently that "the labor market appears finally to be in balance," a welcome development.

- **The disappointing inflation data from recent months is likely suggesting just a temporary halt of significant disinflation progress rather than a resurgence of inflationary pressures.** Core CPI prices have been increasing by 0.3% MoM since September, leaving the annual core inflation rate unchanged at 3.3% for four months in a row, driving the 3Mo3M and 6Mo6M annualized rates to their highest since April and June of this year, respectively (Figure 3). However, broad-based inflationary developments are hard to square. For instance, used vehicle prices have jumped at an average 2.4% MoM pace over the last two months, probably influenced by strong demand after the insurance claims in the aftermath of the hurricanes, but both owners' equivalent rent and rent prices slowed down to 0.23 and 0.21% MoM in November, which could be the first indication that housing services inflation is finally on track to decelerate more markedly, a development that we have been expecting for a long time based on timelier measures of market rents. The single PCE inflation figure from the intermeeting period also showed that core prices increased at a 0.3% above-target pace in October, but last week's producer prices (PPI) report suggests that core PCE inflation is on track to score a much weaker print in November. We believe this is enough to dissuade most Fed members from advocating for a pause in rate cuts this week, since chances are that these recent developments are from the same short-lived nature as those of the disinflation bump from 1Q earlier this year.
- **The Fed's tone will remain cautious as long as inflation remains above 2% and the economy continues to perform well, but a pause in the rate-cutting cycle this week seems hardly justified.** November's FOMC meeting minutes suggested that the risk that more than one FOMC participant (or even a voting member) supports a pause in the next meeting is not negligible, since "a couple [of participants] noted the possibility that the process [of disinflation] could take longer than previously expected." However, having learned from the data bumpiness earlier in the year, there were also "many" others who "noted the volatility of recent economic data and highlighted the importance of focusing on underlying economic trends." Chair Powell echoed this view by commenting that even if inflation has recently been "slightly more of an upward bump than than [they] had expected, [...] the broader trend [...] is still intact," even as he has also acknowledged the fact that "the economy is not sending any signals that [they] need to be in a hurry to lower rates" following September's big 50bp rate cut. Financial markets priced in the risk that inflation could remain elevated for longer than previously expected, as shown by the upward shift of mid- and long-term Treasury yields from their mid-September lows (Figure 4), which is also partially explained by greater uncertainty around the US inflation and fiscal outlook in the following years amid Trump's potential trade, tax and immigration policies (see here for more on the recent evolution of US interest rates). But in the very short term, and following last week's more encouraging disinflation signals, the futures market prices in a 93% probability of a 25bp cut this week.
- **All eyes will be on the updated "dot plot" and SEP, which could give us an idea of how the Trump 2.0 scenario is influencing the thinking of Fed members.** Although the Fed will continue to formally stay out of the debate around the probable economic policies of newly elected power bodies, it is likely that several FOMC participants have begun to incorporate into their thinking some of the obvious effects of Trump's potential trade, fiscal and immigration policies. Even though the median forecast of the path of the policy rate for 2025 is unlikely to be materially changed, some members could point with their new forecasts that they are rethinking the number of rate cuts for next year amid the risks to inflation that could arise if broad-based tariffs are imposed and there are signs that mass deportations are possible. Under this backdrop, some members could (now) predict a slower easing pace and think as Cleveland Fed's president Mester that two or three cuts are right, while others will rather not incorporate on their forecasts the effects of policies that have not yet changed and will continue to project four cuts. As of now, although the recent core inflation stickiness is frustrating, it is not concerning taking into account the recent encouraging signs on housing inflation and all the disinflation in the pipeline. This positive development could reaffirm the Fed's view that, after the past few months with little to no progress, core inflation has (much) more room to slow, so we think they are likely to agree to further normalize the monetary policy stance with a 25bp rate cut this week.

More than a simple reversal from Oct's weakness was likely behind Nov's labor market strength

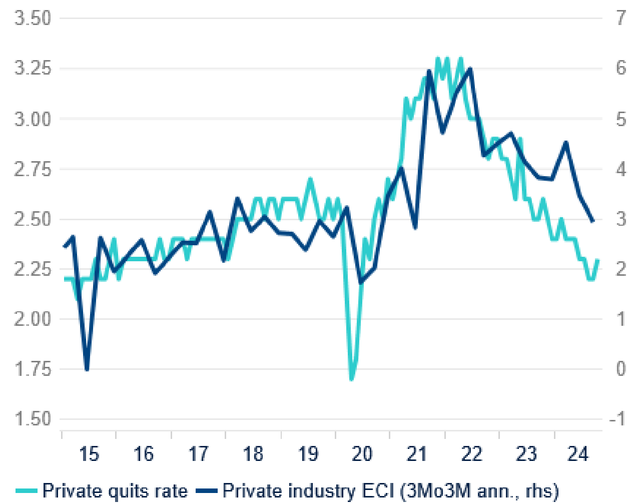
Figure 1. **CHANGE IN NONFARM PAYROLL EMPLOYMENT** (THOUSANDS)



Source: BBVA Research / BLS

Wage growth is still on track to slow further, as suggested by the private quits rate

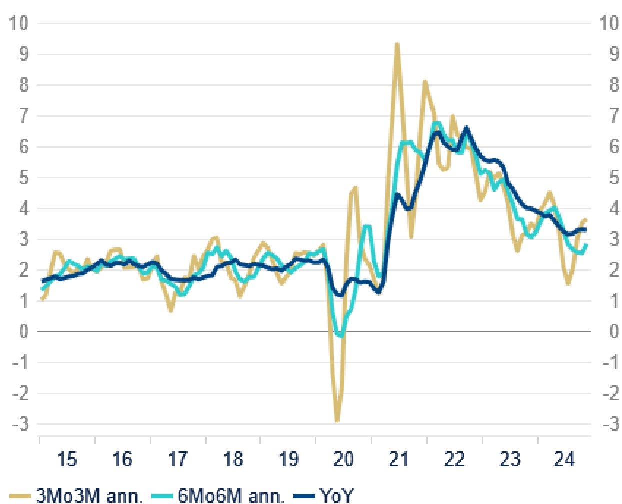
Figure 2. **PRIVATE QUITS RATE AND PRIVATE INDUSTRY EMPLOYMENT COST INDEX** (%)



Source: BBVA Research / BLS

Core CPI prices have been increasing by 0.3% MoM since September

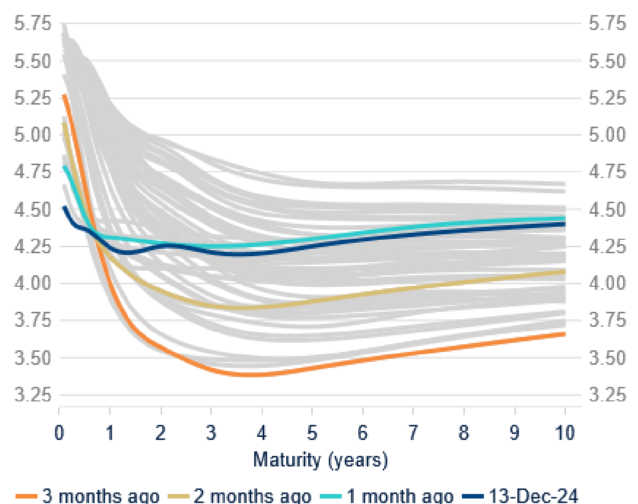
Figure 3. **CORE CPI INFLATION** (%)



Source: BBVA Research / BLS

Markets priced in the risk that inflation could remain high for longer than previously thought

Figure 4. **TREASURY YIELD CURVE** (%)



The gray lines indicate weekly curves over the past year; intermediate rates calculated with natural cubic spline interpolation. Source: BBVA Research / Treasury

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