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Timing the First Cut

The Federal Reserve started raising rates in March'22. If it was to have any credibility it really had no choice. Its official target for inflation is 2%; as measured by the Headline Personal Consumption Expenditure Index (PCE). Many Fed members put more stock in the Core PCE. Core excludes food and energy. Chairman Powell has gone a step further and indicated a preference for a "super-core" index which stresses "services" and excludes "shelter". Unfortunately, the Fed doesn't publish its "super-core" numbers so we have to estimate it. In less than 2 years the Fed has raised rates 11 times (0.25% to 5.50%). The progress is undeniable. Year-over-year Headline PCE is currently 2.6%.

As most of our clients know, we believe year-over-year numbers don't tell the whole story. Who really cares what happened 9, 10, or 11 months ago? What matters is what's happening now. Currently 1-month, 3-month and 6-month annualized inflation (Core PCE) is below the Fed's 2% target. Headline PCE's 3-month annualized rate is 1.2% and last month (Dec'23) was negative.

When will the Fed cut rates? We believe the odds favor March.

The Federal Reserve has 2 mandates: 2% inflation and maximum employment. This is why we pay so much attention to the monthly "Jobs" report. In December, we created 216,000 new jobs. Average monthly job creation in 2023 was 225,000, down from 399,000 in 2022 and 606,000 in 2021. Jobs gained in 2021 and 2022 mostly replaced the jobs we lost during COVID, so let's focus on the 225,000 jobs per month gained last year. In the 7 years prior to COVID, we averaged 200,000 jobs gained per month. 225,000 in 2023 looks good, especially when coupled with 3.7% unemployment. These statistics are missing something important. What they are missing is the shortened workweek. The number of jobs is important, but GDP output and the strength of the job market are also affected by how many hours workers are working. According to the Bureau of Labor Statistics, there are 132 million workers in the US and 55% of them are paid by the hour. According to Conner Sen and reported by Bloomberg average weekly hours worked dropped to 34.3 in December, down from the pre-pandemic high of 35. He went on to say "Total hours worked in the US did not grow at all in the fourth quarter of 2023 despite the economy adding 494,000 jobs. In fact, the shorter workweek means we've seen only a 0.4% uptick in total hours worked since last January, which would be as if the economy had been adding only about 50,000 jobs per month rather than the 200,000 actually added."

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It's possible the jobs market isn't quite as tight as the Fed thinks.

Is the Fed going to wait until year-over-year inflation falls to the 2% target before it cuts rates? Chairman Powel was asked this very question at his last press conference. His answer was:

> "I mean, the reason you wouldn't wait to get to 2 percent to cut rates is that policy would be, it would be too late. I mean, you'd want to be reducing restriction on the economy well before 2 percent because- or before you get to 2 percent so you don't overshoot, if we think, think of restrictive policy as weighing on economic activity. You know, it takes-it takes a while for policy to get into the economy, affect economic activity, and affect inflation."

The next Federal Reserve meeting starts next week, January 30th. It's very possible they will hint strongly that a rate cut could happen sooner rather than later. If they continue the "higher for longer" message and then are forced to cut rates, more credibility will be lost.

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