ECONOMIC AND MARKET COMMENTARY

Fed Policy: One Month of Good Data Is Not Enough

13/06/2024 Tiffany Wilding, Allison Boxer

Good news on U.S. inflation in May did not sway the Federal Reserve to signal interest rate cuts could come sooner.

One softer-than-expected monthly inflation reading didn't stop Federal Reserve officials from delaying the expected start of interest rate cuts.

On the same day that core consumer price index (CPI) inflation registered its softest monthly reading in almost three years, the Fed adjusted higher its estimate for where its policy rate would land at year-end. The new median rate projection is 5.1%, implying one 25-basis-point (bp) rate cut in 2024, instead of the three 25-bp cuts estimated in the previous projections back in March.

Overall, the CPI and Fed news did not bring much to change our near-term U.S. outlook: slowing but still solid growth, above-target inflation, and a patient Fed.

The Fed's latest move came after core personal consumption expenditures (PCE) inflation – the Fed's preferred gauge – dramatically reaccelerated in the first quarter, and trends suggested it would remain above target in the second quarter and beyond.

After these surprisingly firm core PCE readings earlier this year, Fed officials confirmed that they need to see a string of softer monthly inflation reports before they'll become confident that inflation is moving sustainably back to 2%.

Even if inflation cools notably over the next several months, the annualized core PCE rate could still end 2024 at 3% (above the median Fed projection of 2.8%). This is due to base effects: Over time, as the very soft 2% inflation readings from the third and fourth quarters of 2023 fall out of the calculation, annualized core PCE inflation will tend to move higher. Core PCE at or near 3% would make the optics of rate cuts in the context of an otherwise pretty solid U.S. economy difficult, in our view. It's likely a key reason why many Fed officials signaled a delay.

Nevertheless, we view the broader set of recent U.S. economic indicators as consistent with the Fed delaying cuts, not canceling them altogether. Indicators of real GDP growth appear to be slowing (but not crashing) to a potentially below-trend pace as last year's boost from immigration and government spending fades. Shifting immigration trends could even become an outright drag if the Biden administration's recent executive order on the southern border is fully implemented. Labor market indicators have been mixed, but falling job openings along with a modest tick higher in the unemployment rate suggest that labor markets are closer to balanced, even if monthly job growth has remained strong. There is some evidence that labor market matching efficiencies may have declined a bit post-pandemic.

May inflation data show improvements, but one month is not a clear trend

May core CPI marked the weakest reading since 2021, a significant surprise to the downside. Much of the cooling came in the core services ex shelter categories – welcome news for Fed officials who have been concerned that sticky wage inflation could re-anchor inflation somewhat above target. Still, the CPI report wasn't without caveats. Within core services ex shelter, the volatile travel services categories unexpectedly fell, while rental inflation remained firm.

Overall, we believe the May CPI report is a good start on the journey toward the Fed gaining greater confidence that its target is in sight, but we wouldn't place too much weight on any one report.

Fed is ready to be patient for longer

Higher first quarter inflation was the catalyst to the Fed delaying when it expects to begin normalizing policy. After projecting a likely June start for rate cuts in the March Summary of Economic Projections (SEP), the latest "dot plot" in the Fed's June SEP now implies December is the most likely timing, although there is still a dispersion of views. The new projections reveal a majority of committee participants (11) are now expecting rate cuts to commence near the end of this year (or later), versus a still sizable minority (8) who anticipate cutting twice by year-end. The median path for 2025 edged higher as well, by 25 bps.

The median core PCE inflation forecast for year-end 2024 was also revised higher to 2.8% annualized from the prior projection of 2.6%. We see some room for further upward revisions to that forecast in future meetings – especially if the U.S. economy remains solid as Fed officials project. This new PCE projection assumes a notable decline in the monthly average inflation data between now and December: We would need to see core PCE inflation print at 2.2% annualized in both the third and fourth quarters, effectively a repeat of last year.

Fed Chair Jerome Powell's comments during the press conference balanced the morning's unexpectedly good news on inflation with the notable policy outlook revisions from the SEP. Powell reinforced that monetary policy is restrictive and that gradual cooling in demand is helping make progress on inflation. Similar to the March press conference, he emphasized the Fed is alert to any unexpected weakening in the labor market and is prepared to cut in response. Powell also tempered expectations on extrapolating the May CPI report – echoing his messages of caution following the strong CPI reading in January – reiterating how policymakers would be focused on the trend rather than any one data print.

Market reaction

Overall, the May CPI data and the June Fed announcements didn't materially change our near-term outlook for the economy, inflation, or monetary policy. We expect the Fed to begin easing rates later this year. If inflation remains sticky, Fed officials will probably further delay the start of easing. On the other hand, if labor markets materially deteriorate, the Fed could cut sooner and faster.

Markets appear to be largely pricing in expectations in line with the Fed's dot plot and the balance of risks that the economy faces. However, looking further out the yield curve, we believe intermediate maturity government bond yields still look attractive relative to where we expect the Fed will eventually land. The 5-year, 5-year forward real rate (implied by the market for U.S. Treasury Inflation-Protected Securities (TIPS)) is currently around 2%, according to Bloomberg, potentially offering what we see as a good yield cushion versus our 0%–1% range estimate of real neutral policy rate.

Featured Participants

Tiffany Wilding
Economist

Allison Boxer
Economist

Disclosures

Statements concerning financial market trends or portfolio strategies are based on current market conditions, which will fluctuate. There is no guarantee that these investment strategies will work under all market conditions or are appropriate for all investors and each investor should evaluate their ability to invest for the long term, especially during periods of downturn in the market. Outlook and strategies are subject to change without notice.

PIMCO as a general matter provides services to qualified institutions, financial intermediaries and institutional investors. Individual investors should contact their own financial professional to determine the most appropriate investment options for their financial situation. This material contains the opinions of the author and such opinions are subject to change without notice. This material has been distributed for informational purposes only and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed. No part of this material may be reproduced in any form, or referred to in any other publication, without express written permission. PIMCO is a trademark of Allianz Asset Management of America LLC in the United States and throughout the world.

CMR2024-0613-3643190