US interest rates

Jay Powell pushes back on investor bets on imminent rate cuts

The US Federal Reserve is set to err on the side of caution in its quest to bring inflation under control

Jay Powell's comments on Wednesday all but ruled out an early spring interest rate cut © Bloomberg

Claire Jones in Washington FEBRUARY 1 2024

The Federal Reserve made two things clear at its meeting on Wednesday — interest rate cuts are coming, but not as soon as many investors might like.

After two years of turbulence, including a bout of rampant inflation that caught the central bank's officials off guard, the Fed has called time on one of the most dramatic cycles of rate rises in decades.

Gone from the official statement was any mention of "additional policy firming" — that is, more rate rises — if the Fed deemed it appropriate. Instead, there came a hint of triumph, with the central bank noting that risks to full employment and low inflation were now "moving into better balance".

Fed watchers read through the jargon: a punishing period in which borrowing costs rose by 525 basis points in just 18 months is as good as officially over.

Just don't think that means new cuts are imminent. Like it had for the previous three meetings, the Fed on Wednesday held rates deep in restrictive territory, at a 23-year high of between 5.25 per cent and 5.5 per cent. And while the bias towards further rises has gone, the Fed is not ready to slash them just yet.

The cause of the delay? Officials want "greater confidence" that inflation will be beaten down to the Fed's 2 per cent goal.

That need for surety is bemusing some economists and investors. Measured over the second half of 2023, the inflation gauge Fed officials watch most closely — the personal consumption expenditures index — was just 1.9 per cent.

That marked six months of "good news" on inflation, Fed chair Jay Powell acknowledged. But the central bank wants even more data, and even more certainty. So he was adamant that market bets of a cut as soon as the next meeting, in March, were overeager — not his "base case".

Fed watchers said that, barring an economic catastrophe between now and March 20, Powell's comments on Wednesday all but ruled out an early spring cut. The market move after the meeting reflected that too, as stocks fell, Treasuries rallied and traders reduced the odds of a March rate cut, which fell from 60 per cent to about a third.

Powell's pushback against investors' bets marked a contrast to the Fed chair's remarks in mid-December, when his dovish rhetoric raised some market expectations for as many as six quarter-point cuts beginning in early spring.

On Wednesday, Powell was in a more Eeyorish mood, reining in the optimism on the economy — and refusing to join the chorus of cheerleaders claiming rate-setters had pulled off a soft landing, by quelling inflation without inducing widespread job losses.

The US performed better than other advanced economies last year, expanding by 3.1 per cent even while unemployment remained historically low, at just 3.7 per cent in December. And yet, Powell said, there was still "a way to go" before victory could be declared.

In fact, it is that strong growth that has given rate-setters leeway in deciding when, and by how much, to begin easing monetary policy, noted Christopher Waller, a governor at the Fed, last month.

"The Fed clearly doesn't want to jinx its run of good luck by prematurely advertising any rate cuts," said Eswar Prasad, a professor at Cornell University. "Nevertheless, the Fed is sending an unambiguous signal that rate cuts will be forthcoming if the news on inflation continues to be good."

US inflation is under control

December 2023 annualised PCE inflation for different categories and various time horizons

	1m	3m	6m	12m	PCE Weight
Headline	2.0	0.5	2.0	2.6	100
Core	2.0	1.5	1.9	2.9	88
Market based core	1.5	1.7	2.0	3.0	76
Core ex housing	1.0	0.3	1.0	2.2	73
Core services ex housing	3.0	2.0	2.7	3.3	50 50
Median PCE	2.6	2.8	3.1	3.8	
Trimmed mean PCE	2.6	2.3	2.6	3.3	
Median of measures	2.0	1.7	2.0	3.0	

But holding off rate cuts until later in the year was not without some jeopardy, said some economists. The central bank had originally been too slow to respond to high inflation — and now risked cutting too late.

"We have the right ingredients to continue with the last mile of disinflation," said Greg Daco, chief economist at EY. Companies had lost some ability to keep pushing up prices, Daco said, and there were signs that wage inflation was also easing.

"Any external observer will tell you that easing in March would most likely be optimal," he added. "But Fed officials want to have that extra confidence cushion, so they will probably wait until May."

Some analysts shared Powell's concerns that inflation could yet prove sticky — and beyond the 2 per cent target.

Vincent Reinhart, a Fed veteran who is now at Dreyfus and Mellon, pointed to a rise in the consumer price index — another inflation gauge monitored by the Fed — from 3.1 per cent in November to 3.4 per cent in December. The uptick was another reason not to signal a March cut.

"That beneficial drag on prices from the easing of supply chain pressures and the lower cost of goods has certainly stopped and has probably turned around," Reinhart said.

Investors were already doing some of the Fed's job, he pointed out, as they priced in rate cuts, driving down bond yields and helping to lower the cost of capital for businesses. That market outcome, coupled with the economy's strong health, favoured the Fed taking its time.

"What happens if inflation doesn't keep falling, or even rebounds? If you ease too soon, markets are just going to reinforce your mistake. As a central bank, you're better off being too conservative right now."