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WEEKLY ECONOMIC COMMENTARY

IN THIS ISSUE:

- **Fed Preview: Be Quick, But Don't Hurry**

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The American coach John Wooden was famous for his "Pyramid of Success." International audiences became acquainted with its contents through the television series "Ted Lasso."

One of Wooden's bromides, borrowed for this commentary's title, encourages action rooted in firmness of conviction. It discourages rash movements that might be regretted later on. As the Federal Reserve gathers to contemplate American monetary policy next week, they will do well to keep Wooden in mind.

The September 18 decision is nearly certain to yield the first in a series of rate cuts, but the structure of the easing cycle is up for debate. Should the Fed move gradually, or front-load its actions to offer more rapid relief? Here is our analysis of the points of debate which may arise next Tuesday and Wednesday, and in meetings to follow.

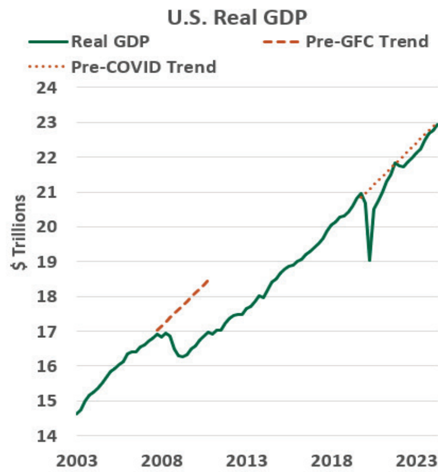
Economic Growth

Take Your Time	Hurry Up
The U.S. economy has returned to its pre-pandemic trend. Growth has remained remarkably strong and continues to defy expectations of a slowdown. Real Gross Domestic Product (GDP) grew at a hearty 3% annualized pace last quarter. Consumer spending continues to lead the gains, with both businesses and government playing a supporting role. Household and business sentiment readings are well above their lows of 2022-23. There is no need for the Fed to press the panic button.	The latest economic data point to slower growth, cautious consumption, and a softening labor market. Spending has moderated this year after accelerating in the second half of 2023. Some sectors are showing more visible signs of a slowdown at the hands of high interest rates. Nine of the 12 Federal Reserve districts reported flat or declining activity, according to the Beige Book survey. In many cycles, the recession came after the first rate cut, so the Fed should move more boldly.

The U.S. economy might appear to be on the brink of a recession, with an inverted Treasury yield curve and the Sahm Rule triggered by rising unemployment. But as we highlighted here, previously reliable recession indicators have not worked in this cycle.

Income, consumer spending and employment are all growing. None reflect signs of an imminent downturn. While there are pockets of concern, the perception that consumers are completely tapped-out is not accurate. Household balance sheets, in aggregate, are still very healthy.

All of that said, the economy is showing signs that it cannot withstand a sustained period of high rates. The longer monetary policy remains in restrictive territory, the higher the chances of a hard landing. A steady pace of easing should be enough to take a worst-case scenario off the table.

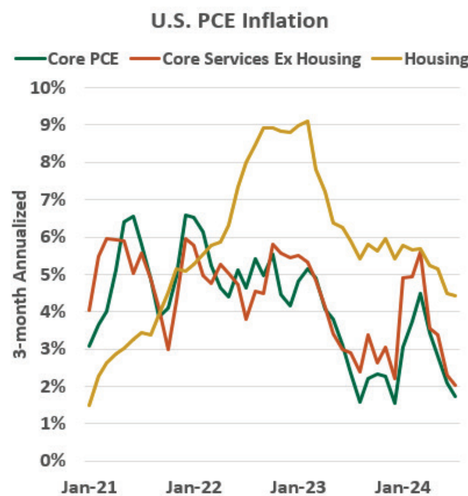


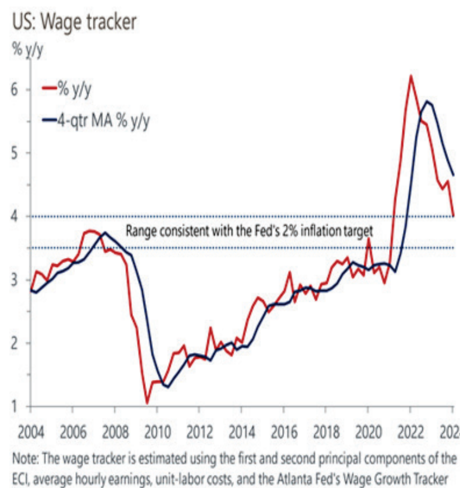
Sources: Haver Analytics, Oxford Economics

Inflation

Take Your Time	Hurry Up
Inflation may not be the Fed's sole focus, but it remains a central concern for households. Actual inflation has still not reached its target. Underlying price pressures have proven to be much stickier than expected, led by shelter and core services like insurance. Housing costs perked up in July amid continued demand-supply imbalances. The last mile to price stability is often the most challenging, and surprises could still emerge. Lack of confidence that inflation will continue to decline to the 2% target would suggest a more gradual path of easing.	The disinflation trend appears to be firmly entrenched as the breadth of inflating categories continues to shrink. Extreme price movements have become much less common. Core services inflation is moderating with goods in deflationary territory, on a three-month annualized basis. Wage growth has moderated to a pace consistent with the inflation objective. Inflation expectations remain very well-anchored. Waiting for overall inflation to hit the 2% target could cause undue damage to employment and the economy.

Moderating inflation has allowed the Fed to turn attention to its employment mandate.





Sources: Haver Analytics, Oxford Economics

Inflation has been well-behaved over the past several months. The slowing labor market is contributing to gradual softening of price pressures across domestically-focused services. Shelter costs continue to escalate briskly, but increases in this category do not have to reach 2% for the overall inflation target to be satisfied. The benign readings have given Federal Reserve Chair Powell more confidence that inflation is on a sustainable path toward the 2% target and allowed him to turn attention to both sides of its dual mandate.

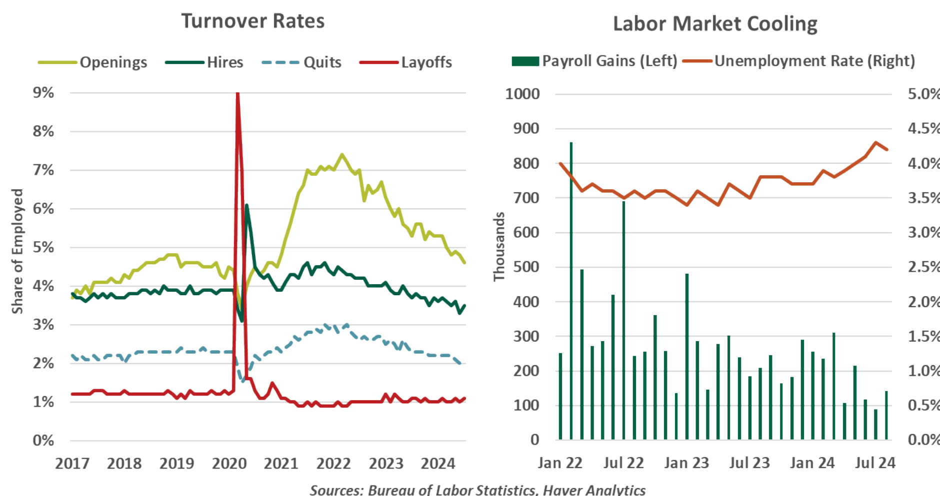
More cautious voices will note that the Fed was reasonably confident of reaching the inflation target coming in to 2024, only to see unwelcome increases in monthly readings. That series set back the start of the easing campaign, and argues for caution in reducing interest rates. We've had very good fortune with energy and goods prices, which may not persist. The dollar has lost some ground in currency markets, raising the potential for higher import costs. Cutting aggressively may risk rekindling inflation at a very unwelcome time.

Employment

Take Your Time	Hurry Up
Recent labor market readings are consistent with a sustainable level of activity. Unemployment claims have remained muted, and mass layoffs have been avoided. Increases in the unemployment rate have been driven more by population gains than job losses. Wage growth has exceeded inflation for more than a year, a moderate inflationary risk. The jobs market has shifted from overheated to normal, but is not in crisis.	The unemployment rate has risen a half a percentage point in the year to date. Rates of hiring and quitting are below their pre-pandemic level, and payroll gains are slowing. Pre-pandemic, the unemployment rate held below 4% without sparking inflation. Labor trends have strong momentum: rising unemployment and slower hiring will be hard to reverse. Decisive action can restore business confidence and support job creation.

Assessing the labor market is difficult, given a series of measurement challenges. The unemployment rate requires estimates of both the working population and the total population available to work; recent immigration has complicated the collection of these data. Falling survey response rates and funding constraints prevent a more fulsome assessment. The correction of some statistical problems led the Bureau of Labor Statistics to reduce the average monthly payroll gain for the year through March 2024 from a hot 243,000 to a still-healthy 175,000.

The labor market has cooled, not crashed.



Sources: Bureau of Labor Statistics, Haver Analytics

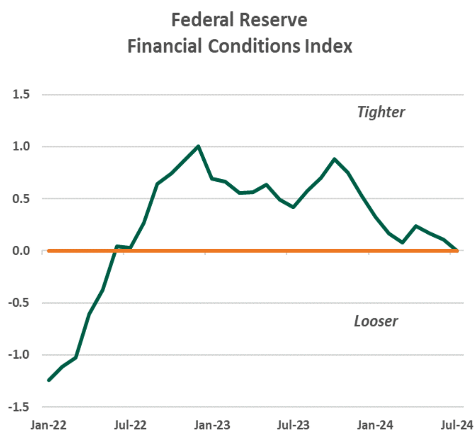
Unlike inflation, the Fed does not have a target unemployment rate, with a less distinct goal of "maximum employment." Even if the figures and targets are imprecise, the labor market is unmistakably cooler today than it was a year ago. The challenge for the Fed will be to see these trends reach a steady state around the current readings. Chair Powell stated clearly in his Jackson Hole comments: "We do not seek or welcome further cooling in labor market conditions." Easier policy may help bring back demand and support more investment that creates jobs, but there is no need to rush.

Financial Conditions

Take Your Time	Hurry Up
Credit remains widely available, and its cost is moderating After a brief spike in early August, market-based measures of financial conditions have fallen back into very easy territory. Long-term interest rates are down, and bank lending conditions are easing. Outside of traditional channels, private credit pools are making loans to a widening cross-section of borrowers. From these perspectives, monetary policy does not appear to be hindering access to capital.	Interest payments are becoming more burdensome for firms and households. A substantial amount of corporate borrowing, issued at low rates in 2020, will come up for refinancing next year. As households deplete their savings, their use of credit and the costs to service it will increase. Lower mortgage rates might reduce "house-lock," enticing current homeowners to put their properties on the market at a time that such supply is desperately needed.

Access to credit is ample, and costs are reasonable.

We've been watching closely for signs of credit distress across the economy, but nothing stands out. Commercial real estate loans bear watching, but may not be as threatening as some fear. Household finances for the lower deciles of the income distribution are not as comfortable as they were two years ago, but aggregate debt ratios remain in comfortable ranges.



Sources: Bloomberg, Federal Reserve, Haver Analytics

The financial system had a wobble at the beginning of August, but righted itself quickly. Happily, there hasn't been a recurrence of the banking stress of early last year.

The Federal Reserve has reduced its balance sheet by almost $2 trillion without attracting much notice. Levels of liquidity in markets are no longer abundant, but they are still ample. The pace of quantitative tightening has been reduced, to avoid the potential for a policy mistake.

Our View

The Federal Reserve has been accused of being behind the curve on several occasions this year. But results have justified their patient stance. Despite that history, some are pressing for a 50 basis point cut next week.

We don't think that a move of that magnitude is warranted. Instead, we expect **a cut of 25 basis points** to be accompanied by guidance that more of the same are on the way. Our latest forecast calls for a steady string of quarter-point reductions until rates get close to their neutral level (which we think is somewhere just north of 3%). The decision will be driven by the data, not the election.

A large opening gambit could be interpreted as a signal that the Fed is panicking or acted too late, which could add to volatility and dent investor confidence. The Federal Open Market Committee (FOMC) will communicate that it remains data dependent, and the policy path could be recalibrated if incoming information warrants.

The next meeting will include a quarterly Summary of Economic Projections (SEP), including the "dot plot" of rate expectations. In the June SEP, FOMC members coalesced around a pace of reducing by a percentage point per year, implying a cut of 25 basis points at every other meeting. We expect the September SEP will show a faster pace of easing, and a greater degree of dispersion.

Longer term, we expect the Fed to steer overnight interest rates towards their "neutral" level, which we think is just over 3%. Getting there will require cuts totaling more than 2%. Sticking to a cadence of a quarter-point per meeting will reach that objective late next summer.

The easing cycle ahead of us has no close precedent. Central banks typically reduce rates when they need to support the economy through some sort of stress event. Cutting rates to secure a soft landing will create unique challenges for both deciding and communicating changes to policy.

Uncertainty surrounding the outlook has increased, and the Fed will need to adapt if needed. As Wooden famously said, "Failing to prepare is preparing to fail."

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