Macroeconomic Update

Fed Needs to Act to Prevent Normalization Turning into a Downturn

Signs are growing that the Fed is behind the curve.

The U.S. has returned to conditions that look more like "normal." The overheated labor market of 2021–2023 has seen demand for workers cool alongside expansion of available labor supply, causing the unemployment rate to drift upward from 3.4 percent to 4.3 percent over the past year and a half. Fed officials now describe the labor market as in "rough balance" and back to conditions seen before the pandemic.

Meanwhile, substantial progress has been made in bringing inflation back down to the Fed's 2 percent target. Following a hot first quarter, recent months have seen renewed progress in the inflation fight, bringing core personal consumption expenditures (PCE) inflation down to 2.6 percent in year-over-year terms and 2.3 percent annualized in the three months through June. This inflation progress looks to be durable for two key reasons: First is the rebalanced labor market and associated cooling in wage growth. Second is the slowdown underway in shelter inflation, which has been the biggest contributor to above target inflation but which finally saw a long-awaited slowdown in the June inflation data. Leading indicators of rent inflation, particularly prices for newly signed leases, suggest this slowdown should stick and help inflation remain low for at least the next few quarters.

With the economy getting back to normal, the Fed should soon follow suit with its rate policy. Fed officials are increasingly acknowledging that if they wait too long to bring interest rates down, they risk turning this normalization into more of a slowdown, or even recession. The July employment report seemed to validate those fears just days after the Fed decided to hold rates steady at the July meeting, with the unemployment rate rising 20 basis points and job growth outside healthcare and government up just 33,000. Compounding downside risks, recession fears, questions around AI, and foreign spillovers have highlighted vulnerability to an equity-led tightening in financial conditions.

The emergence of these downside risks, which we have previously flagged, raises the risk that the normalization the Fed has been seeking turns into a slowdown, or even recession. We expect the Fed will respond by cutting rates faster than previously expected, with at least three 25 basis point rate cuts this year, and the potential for larger cuts if the labor market data continues to weaken. More importantly, we see downside risk to the terminal fed funds rate from what is priced into the market, which is conditional on a soft landing. Easing cycles are usually faster than tightening cycles, and this tightening cycle was historically fast. There is risk around market expectations of a ladder step easing.

By Matt Bush and Maria Giraldo

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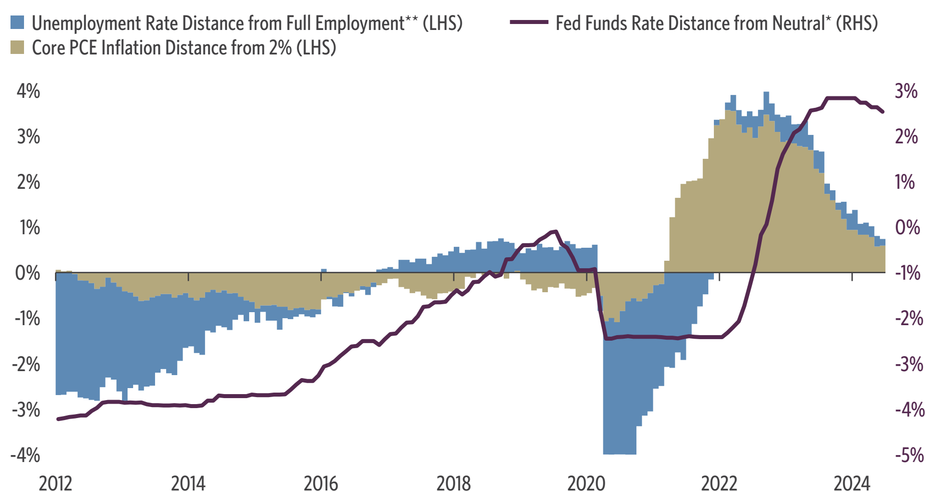
Rebalanced Labor Market and Falling Inflation Should Lead to Fed Rate Cuts



Source: Guggenheim Investments, Haver Analytics. Data as of 6.30.2024. *Neutral is FOMC Median Longer Run estimate in the Summary of Economic Projections. ** Full Employment is FOMC median Longer run estimate.

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