US ECONOMICS WEEKLY

Fed hawks can't compete with plunging inflation

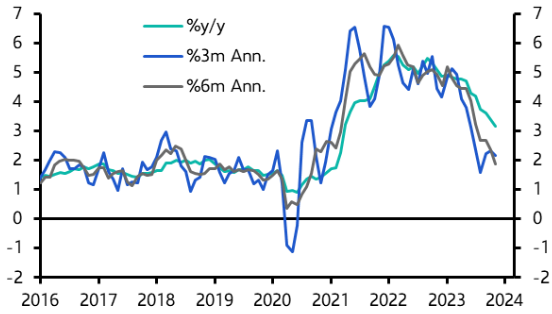
This week saw a renewed attempt from some Fed officials to push back against market expectations for interest rate cuts but, with core PCE inflation running at an annualised pace of *below* 2% over the past six months, this final flurry of hawkishness isn't fooling anyone. There is mounting evidence that the post-pandemic inflation scare is over and we expect interest rates to be cut significantly next year.

After NY Fed President John Williams pushed back last week on the markets' dovish reaction to the FOMC meeting, more officials followed suit at the start of this week. Atlanta Fed President Raphael Bostic, an FOMC voter next year, claimed there was no "urgency" for rate cuts and that he was expecting just two 25bp reductions in the second half of 2024. The Cleveland Fed's Loretta Mester, another 2024 voter albeit retiring in June, suggested markets had got "a little bit ahead" in pricing rate cuts. Even the usually dovish Mary Daly of San Francisco said she anticipated only 75bp of loosening, in line with the Fed's median projection but only half the amount that markets have been pricing in.

The trouble for those Fed officials is that their comments were ignored, with fed funds futures showing a slight fall in the implied odds of a March cut, but little change in the amount of loosening expected overall next year. Initially, that appeared to reflect investors taking more notice of global developments earlier this week, with yet more soft inflation data – this time from the UK – reinforcing the belief that nearly all DM central banks will be cutting rates significantly next year. More generally, it reinforces the idea that we're now at the stage where the economic data are far more important for the rate outlook than guidance from the Fed.

Indeed, the muted 0.06% m/m rise in the core PCE price index in November means that the six-month annualised rate of core PCE inflation is now running at just 1.9%. (See Chart 1.) The hawks can still point to the annual core inflation rate being elevated at 3.2% but, with more downward pressure in the pipeline, the 2% target for annual inflation is rapidly coming into view.

Chart 1: Core PCE



Source: Refinitiv

As we've previously highlighted, the Fed was always unlikely to seriously entertain talk of interest rate cuts until the last possible moment, for fear of stoking easier financial conditions before the inflation battle was won. That has been a consistent pattern in the lead-up to past easing cycles even when inflation was relatively low and stable. But if we're right that the annual core PCE inflation rate will fall rapidly towards 2% over the first half of next year, it will be increasingly untenable for the Fed to keep its nominal policy rate as high as 5.25%-5.50% – whether or not there is much sign of weakness in the real economy.

The upshot is that we think markets are right to focus on the inflation data rather than hawkish rhetoric from a remaining handful of Fed officials. Our previously below-consensus view that rates will be cut to 3.50%-3.75% by the end of next year, and to a terminal rate of just over 3% by mid-2025, is now broadly in line with market pricing.

The weeks ahead

2024 will begin with a flurry of key data releases, with the December ISM surveys likely to have been little changed at subdued levels, and the employment report showing a further softening in jobs and wage growth. Attention will also turn towards Congress as lawmakers look to thrash out a deal to avert a partial government shutdown on 19th January.

Andrew Hunter, Deputy Chief US Economist, +44 (0)20 7808 4071, andrew.hunter@capitaleconomics.com

Data Previews

Wed 3rd Jan. - ISM Manufacturing Index (Dec.)

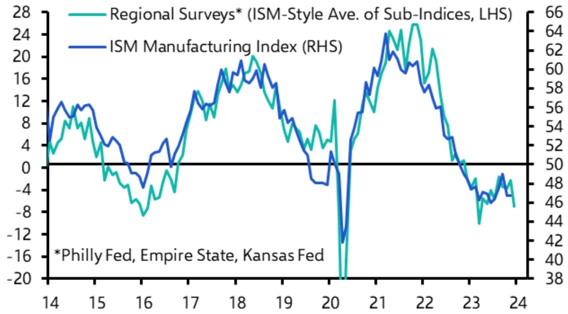
Forecasts	Time (EST)	Previous	Median	Capital Economics
Headline index	10.00	46.7	47.1	46.0

Manufacturing slump continues

We expect the December data to confirm that the ISM manufacturing index spent the whole of 2023 below 50, for the first time since 2001.

The unchanged reading of 46.7 in November may have been a sign of the ongoing disruption in the autos sector from the UAW strike, which wasn't resolved until late in October. But that can't explain the renewed weakness in the early regional surveys for December, with the Empire State and Philly Fed indices falling quite sharply and the Kansas Fed's survey remaining in contractionary territory. (See Chart 2.) Alongside the further fall in the S&P US manufacturing PMI, that all points to a renewed decline in the ISM index. We expect it to have fallen to 46.0 in December, suggesting that output growth in the sector will continue to struggle. With global demand likely to remain weak in the near term and domestic growth cooling, the manufacturing downturn probably still has a bit further to run. So far, however, there isn't much sign of that manufacturing weakness filtering through to the wider economy.

Chart 2: Regional Surveys & ISM Manufacturing Index



Source: Refinitiv

Wed 3rd Jan. - Fed FOMC Minutes (12th - 13th December Meeting)

Hawkish minutes would probably be ignored by markets

Recent comments from Fed officials suggest that the minutes from the mid-December meeting could present a somewhat more hawkish tone than Chair Jerome Powell did in his press conference last week. But that is unlikely on its own to dent market hopes for interest rate cuts next year.

The initial market reaction to last week's Fed statement and revised economic projections, which showed a 50bp reduction in the median interest rate projection for the end of 2024, was arguably a little overblown. But the more dovish tone from Powell, where he acknowledged the growing risk that the Fed might keep rates high for too long, and generally made no attempt to push back against the idea that the Fed will be cutting rates soon, appeared to provide a bit more justification for the sharp fall in market rate expectations.

Other officials still seem to want to maintain a more hawkish line, with some even still suggesting a prospect of further rate *hikes*, and that apparent divide may be reflected in the minutes. They should also clarify the extent of any discussion of the prospect of lowering rates next year - which Powell suggested was a topic of debate last week, but other officials have subsequently claimed wasn't yet a big part of the agenda.

Regardless, the minutes are unlikely to do much to shift the interest rate outlook when inflation appears to be rapidly closing in on the 2% target.

Fri. 5th January - Employment Report (Dec.)

Forecasts	Time (EST)	Previous	Median	Capital Economics
Chg. in Non-Farm Payrolls	08.30	+199,000	+150,000	+150,000
Unemployment Rate	08.30	3.7%	3.8%	3.8%
Average Hourly Earnings	08.30	+0.4%(+4.0%)	+0.3%(+3.9%)	+0.2%(+3.8%)
Average Weekly Hours	08.30	34.4	-	34.4

Trend of softer labour data continues

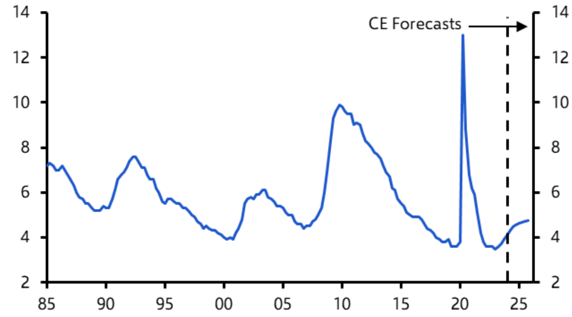
With the distortions from previous strike action now passed, we think non-farm payrolls rose by a softer 150,000 in December.

November's 199,000 increase in non-farm payrolls was flattered by the return of 47,000 workers from strikes. The mixed survey evidence and relative stability of jobless claims suggest that payroll growth in December was similar to the underlying trend last month. We are provisionally forecasting a 150,000 increase in non-farm payrolls and will publish our usual detailed *Employment Report Preview* in early January.

Household employment is likely to underperform payrolls assuming some payback following November's 750,000 jump. That may help put the unemployment rate back on an upward trend, rising to 3.8% in December, and probably further next year. (See Chart 3.)

We also expect renewed softening in wage growth, where we think there is there is scope for a smaller 0.2% m/m increase in average hourly earnings, pushing the annual rate down to 3.8%, its lowest since May 2021.

Chart 3: Unemployment Rate (%)



Source: Refinitiv, Capital Economics

Fri. 5th January - ISM Services Index (Dec.)

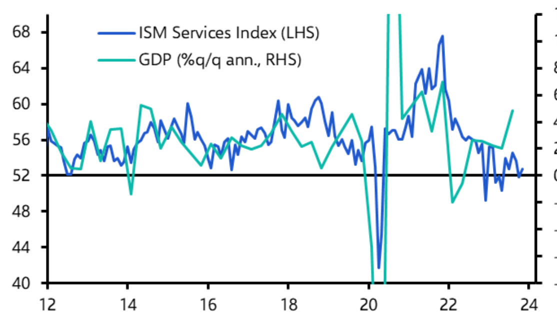
Forecasts	Time (EST)	Previous	Median	Capital Economics
Headline Index	10.00	52.7	52.0	53.0

Fourth-quarter slowdown in services-sector activity growth

We expect the ISM services index to have been broadly unchanged at 53.0 in December. That would be consistent with a near-stagnation in GDP.

The rise in the ISM services index in November, to 52.7, was driven by a stronger rise in new orders which suggests there could be scope for a continued rebound in December. That said, early service sector survey evidence has been mixed, with the S&P Global services PMI edging up this month, but the New York Fed's Business Leaders survey slipping quite sharply. On balance, we suspect the ISM services index was little changed. The big picture is that the index has taken a leg down from the third quarter and, although the relationship has been far from perfect recently, it is consistent with a sharp slowdown in GDP growth in the fourth quarter. (See Chart 4.)

Chart 4: ISM Services Index & GDP Growth



Source: Refinitiv

Economic Diary & Forecasts

Upcoming Events and Data Releases

	Release/Indicator/Event	Time EST (GMT-5)	Previous*	Median*	CE Forecasts*
Mon 25th	Christmas Day Holiday – Markets Closed	-	-	-	-
Tue 26th	Case-Shiller House Prices (Oct)	09.00	+0.7%(+3.9%)	-	-
Wed 27th	No Significant Data Released	-	-	-	-
Thu 28th	Advance Goods Trade Balance (Nov)	08.30	-$89.6bn	-$89.5bn	-
	Initial Jobless Claims (w/e 23rd Dec)	08.30	205,000	-	-
	Pending Home Sales (Nov)	10.00	-1.5%(-6.6%)	+0.5%	-
Fri 29th	Chicago PMI (Dec)	09.45	55.8	51.0	-
Mon 1st	New Year's Day Holiday – Markets Closed	-	-	-	-
Tue 2nd	Construction Spending (Nov)	10.00	+0.6%	+0.5%	
Wed 3rd	ISM Manufacturing Index (Dec)	10.00	46.7	47.1	46.0
	JOLTS Job Openings Rate (Nov)	10.00	5.3%	-	-
	Fed FOMC Minutes (13th Dec Meeting)	14.00	-	-	-
Thu 4th	Change in ADP Employment (Dec)	08.15	+103,000	+100,000	-
	Initial Jobless Claims (w/e 30th Dec)	08.30	-	-	-
Fri 5th	Change in Non-Farm Payrolls (Dec)	08.30	+199,000	+150,000	+150,000
	Unemployment Rate (Dec)	08.30	3.7%	3.8%	3.8%
	Average Hourly Earnings (Dec)	08.30	+0.4%(+4.0%)	+0.3%(+3.9%)	+0.2%(+3.8%)
	Average Weekly Hours Worked (Dec)	08.30	34.4	-	34.4
	ISM Services Index (Dec)	10.00	52.7	52.0	53.0
	Factory Orders (Nov)	10.00	-3.6%	-	-
Selected future data releases and events					
9th Jan	International Trade (Nov)	08.30			
11th Jan	Consumer Prices (Dec)	08.30			
12th Jan	Producer Prices (Dec)	08.30			
31st Jan	Fed Policy Announcement	14.00			

*m/m(y/y) unless otherwise stated
Sources: Bloomberg, Capital Economics

Main Economic & Market Forecasts

%q/q ann. (%y/y) unless stated	Q3 2023	Q4 2023	Q1 2024	Q2 2024	Q3 2024	Q4 2024	2023	2024	2025
GDP	+4.9	+1.4	+0.6	+0.7	+1.7	+1.9	(+2.4)	(+1.6)	(+2.1)
CPI Inflation[1]	(+3.6)	(+3.1)	(+2.7)	(+2.4)	(+2.2)	(+2.2)	(+4.1)	(+2.4)	(+2.4)
Core CPI Inflation[1]	(+4.4)	(+3.9)	(+3.4)	(+2.6)	(+2.6)	(+2.5)	(+4.8)	(+2.8)	(+2.4)
Unemployment Rate,%[1]	3.7	3.9	4.1	4.3	4.5	4.6	3.7	4.4	4.7
Fed Funds Rate,%[2]	5.25-5.50	5.25-5.50	5.00-5.25	4.50-4.75	4.00-4.25	3.50-3.75	5.25-5.50	3.50-3.75	3.00-3.25
10y Treasury Yield,%[2]	4.73	3.85	3.75	3.75	3.75	3.75	4.50	3.75	3.75
S&P 500[2]	4150	4750	4875	5000	5250	5500	4700	5500	6500
$/€[2]	1.06	1.10	1.10	1.10	1.10	1.10	1.10	1.10	1.15
¥/$[2]	149	142	141	138	134	130	145	130	125

Sources: Refinitiv, Capital Economics. [1]Period Average [2]End Period