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## US Macroeconomics

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# Lower Inflation = More Monetary Restriction

We do not believe the hurdle for rate cuts is that high. And if this is true, the Fed's central forecast of 75 basis points (bps) of cuts is insufficient.

Chair Powell told *60 Minutes* this week that the inflation data "doesn't need to be better than what we've seen, or even as good. It just needs to be good." That does not sound particularly hawkish. Rather it sounds like an excuse to lower rates. Of course, if growth suddenly falters and the unemployment rate unexpectedly rises, the Fed could become uber dovish and quickly so.

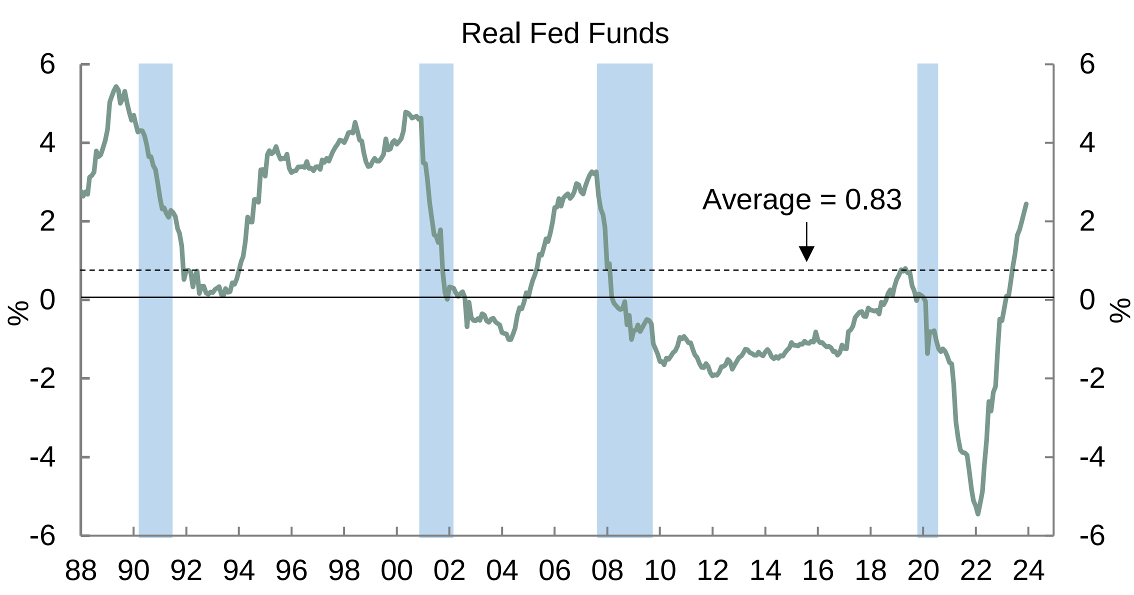
**At the moment, the three- and six-month rates of change on the core PCE deflator, the Fed's preferred inflation metric, are just 1.5% and 1.9% respectively**. Our best guess is core PCE inflation rose a modest 0.2% last month. We will know more after seeing the January CPI, which is released February 13.

If our January forecast is on the mark, the three- and six-month rates of change will remain low at 1.8% and 2.0%, respectively. This will not be enough to warrant a March cut because Powell dissuaded investors from such action following last month's FOMC meeting. And those comments came *before* the strong January employment report. Policymakers would need serious downward surprises for March easing to come back into play.

**The March inflation data will be available in April and to policymakers when they meet at their May 1 meeting. The figures could show year-over-year core PCE at just 2.2%**. If this happens, the 12-month rate of inflation will have fallen 70 bps in just three months, the amount the Fed expects to trim rates for the entire year.

As shown in the chart below, the real funds rate (nominal fed funds less the year-over-year core PCE) is already elevated at 2.4%, the highest reading since September 2007 (2.7%). **If our near-term inflation scenario comes to fruition, policymakers would have to cut rates 75 bps just to get the real fed funds rate back to where it is currently**. More cuts will be necessary.

The bond market has it broadly correct in pricing 125 bps in cuts this year and another 75 bps next year. This would bring the fed funds down to a range of 3.25% to 3.5%. Yet this could still be too high if inflation is hovering around 2% because real interest rates would still be at the upper band of what is considered neutral.




Source: Federal Reserve, BEA, Haver, SMBC Nikko

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