GENERALI ASSET MANAGEMENT

MARKET COMMENTARY

Inflation worries tilt the Fed towards slower accommodation

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- **After today's cut, the Fed now expect to reduce the policy rate by just 50bps in 2025, delaying to the following years any further accommodation. The FOMC raised again, to 3%, the median estimate of the neutral rate.**
- **The inflation forecast for next year was revised sharply up and its path has become more uncertain. Therefore, and as the policy rate is approaching the neutral level, the Fed has entered a new phase in its path of accommodation, characterised by more caution.**
- **Only some FOMC members have stared factoring in tariffs in their forecasts. The Fed will react to policy only when and to the extent which they will interfere with the achievement of the inflation and employment mandates.**
- **The clearly hawkish policy tilt hit the S&P, raised yields, and lifted the dollar to its highest value in two years.**

The Fed is entering a new phase in of policy accommodation, as uncertainty on inflation and the impact of rates on the economy increases. Chair Powell compared it to "driving in a foggy night" which requires slowing down. As a consequence, the median number of rate cuts appropriate for 2025 was reduced from four in September to just two.

The assessment of the economy remains positive, with domestic demand continuing to grow at around 3% annualised. The labour market is in a good shape but cooling, as showed by weak hiring and the downtrend in job creation and is now cooler than it was back in 2019, when inflation was substantially lower than 2%. The will to keep as it is now and the conviction that no more softening is needed to get to 2% inflation motivated the decision to cut at today's meeting. Powell reckoned that it was a close call, given the last strong inflation and activity prints. But in the end only one board member voted not to cut.

The FOMC remains confident that inflation remains on a downward path, but the pace is a bit disappointing. Powell pointed to the large role played by inputted prices like those for financial services, linked to the evolution of financial markets rather than to domestic demand, and pointed to the moderation in rents. Still both core and headline inflation projections were revised sizeably up (see table at the bottom). Powell did not provide many explanations for than but said that a few FOMC members have included their own assumption on tariffs, which could in part explain the higher inflation forecast, which does not see core inflation back to target before 2026.

After 100 bps of rate cuts, monetary policy is now much less restrictive, and the policy rate is closer to neutral. This requires caution on the "extent" of rate cuts (how much to ease further) and the "timing", i.e. when to slow down easing. On top of that, the resilience of the economy, testified by the sharp reduction in inflation with constantly low unemployment, shows that there is not need to rush to cut.

Powell avoided any direct comment on the new administration, reiterating that the Fed will react to policies only when there is enough clarity in their implementation and their effects on prices and inflation. He noted that the analysis carried out in 2018,

which stated that in many cases the Fed should look though the impact of tariffs on the price level, remains valid. Geopolitics deserves attention but he observed that it has not meaningfully affected the US economy so far.

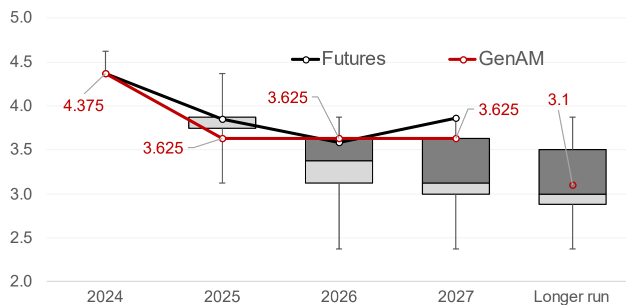
The median estimate of the longer term or neutral policy rate was raised again to 3%. Powel was careful in stating that it does not have a direct bearing with the current policy stance as it is driven by the structural features of the economy. However, since the estimates of long-term growth, unemployment and inflation were unchanged one could wonder whether the R-star estimate keeps creeping up because of expected wider fiscal imbalances.

We will revise our Fed funds rate forecast, which still sees a more frontloaded easing but a higher teminal rate

The unmistakeably hawkish tone of the forecast revision and the rate path hurt stocks, with the S&P down 2.5% on the announcement, driven down by tech. The two-year yield gained 11 pbs to 4.35 and the trade weight dollar rose to its highest level since November 2022.

FOMC "dots" and Fed fund rates forecasts

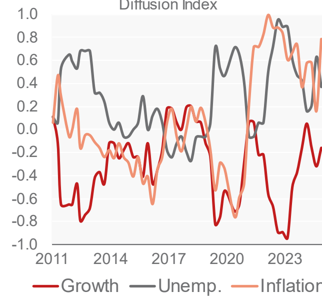
Middle of the range.
Year-end, median, quartiles and extremes of the distribution



Source:Federal Reserve Board, Datastream,GenAM estimates

FOMC projections: Balance of risks

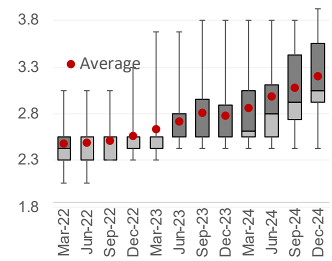
Diffusion Index



Source:Federal Reserve Board, GenAM

Distribution of the neutral rate estimates

Average, Median, quartiles and extremes of the distribution



Source:Federal Reserve Board, GenAM

	2024	2025	2026	2027	Longer run
GDP growth (Q4/Q4 ann.)	2.5	2.1	2.0	1.9	1.8
Sep. projections	*2.0*	*2.0*	*2.0*	*2.0*	*1.8*
Unemployment rate	4.2	4.3	4.3	4.2	4.2
Sep. projections	*4.4*	*4.4*	*4.3*	*4.2*	*4.2*
PCE infl. (Q4/Q4 ann.)	2.4	2.5	2.1	2.0	2.0
Sep. projections	*2.3*	*2.1*	*2.0*	*2.0*	*2.0*
Core PCE infl. (Q4/Q4 ann.)	*2.8*	*2.5*	*2.2*	*2.0*	-
Sep. projections	*2.6*	*2.2*	*2.0*	*2.0*	-
Federal funds rate	*4.4*	*3.9*	*3.4*	*3.1*	*3.0*
Sep. projections	*4.4*	*3.4*	*2.9*	*2.9*	*2.9*

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