

Dutta's Monetary Thoughts

Don't expect a strong signal from Powell

Neil Dutta

Tayloring Policy

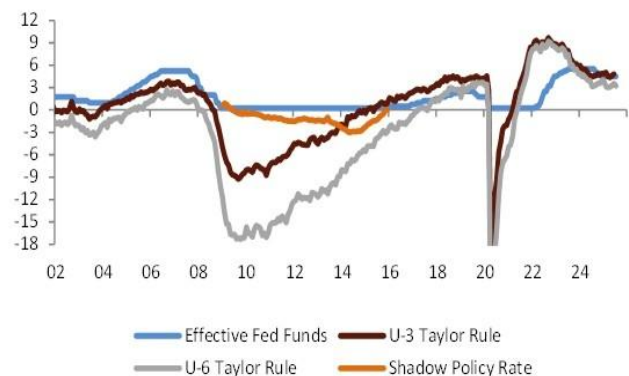
Leaning on the U3 unemployment rate and thus, characterizing the labor market as “solid” is doing a lot of work for the monetary policy hawks. I estimate a simple Taylor Rule where:

Fed target rate = $1.0 + (1.3 \times \text{core PCE inflation}) - (2.0 \times \text{Unemployment Gap})$

Here, the unemployment gap is defined as difference between the U6 unemployment rate (underemployment rate) and the average U6 rate in 2019, the year before COVID. The rule from this equation implies lowering the funds rate by 1.3ppts if inflation falls by 1ppt and by almost 2ppts if the underemployment rate rises by 1ppt.

Using this framework, monetary policy is too restrictive. Specifically, this equation implies that the federal funds rate “should be” 125bps lower. Now, there are caveats worth pointing out. For example, I might be too pessimistic on neutral rates; perhaps it's closer to 1.5 percent, in which case the federal funds rate would be only 75bps lower.

Taylor rule using U6 rate implies more aggressive Fed rate cuts



Source: Haver Analytics, Renaissance Macro Research

At any rate, the broader point is that the Fed is going to be in a predicament if they continue to ignore broader measures of labor market underutilization. Discouraged worker counts are up, black unemployment is up, college educated unemployment is up (I am not sure how any of this has to do with immigration) and have all gone a bit beyond what one would expect with a U3 rate of 4.2 percent.

No one on the FOMC is going to support the White House on an aggressive easing cycle but like with everything the President says if you think long enough, you can't help but conclude, "well, maybe he has a point." Getting the first two cuts out of the way is not an especially heavy lift, in my view. Taking out some insurance against further deterioration in the labor market makes sense.

Parsing Powell

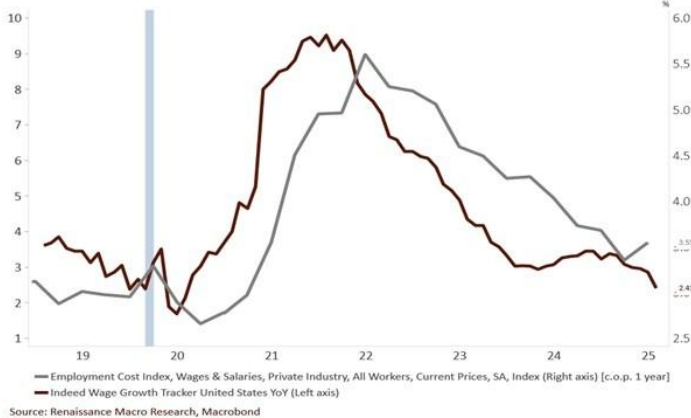
Powell's speech at Jackson Hole is likely to focus on the economic outlook and about how the Fed intends to balance the risks between both sides of its dual mandate for the foreseeable future, especially during supply shocks.

Recall that in the previous framework the Fed adopted a Flexible Average Inflation Targeting approach (FAIT) that was designed to pursue a make-up strategy when inflation ran below two percent. When COVID hit, the Fed pursued a policy of ensuring labor market health was fully restored before beginning to normalize rates. Fighting the last war so to speak.

These days, Powell has repeatedly been saying two things: (1) "our obligation is to prevent a one-time increase in the price level from becoming an ongoing inflation problem" and (2) "labor market conditions have remained solid." The language here ought to evolve.

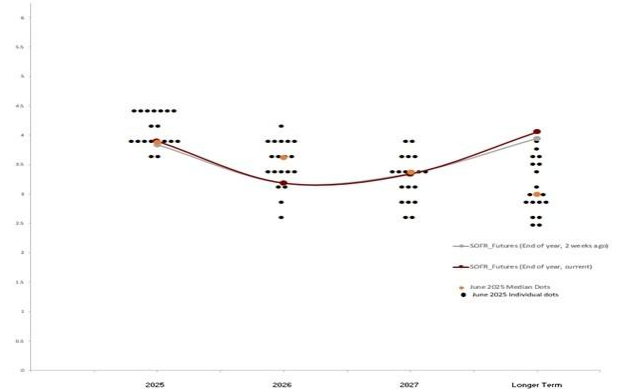
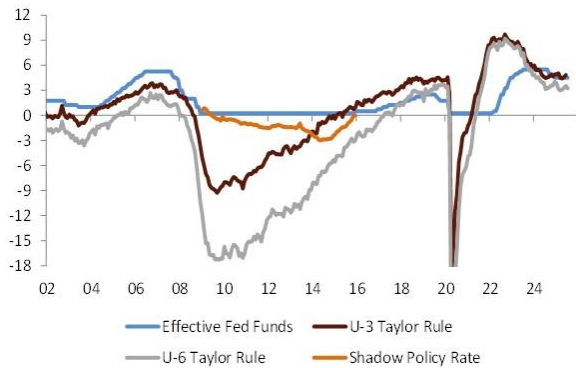
These two things are related. Lately, labor market conditions don't feel too solid. So, while tariffs might raise prices, it's hard to see why this can be anything more than a one-off because the labor market is already cooling off. Note that this requires an admission that economic conditions are not robust.

Wage growth in job postings cooling off

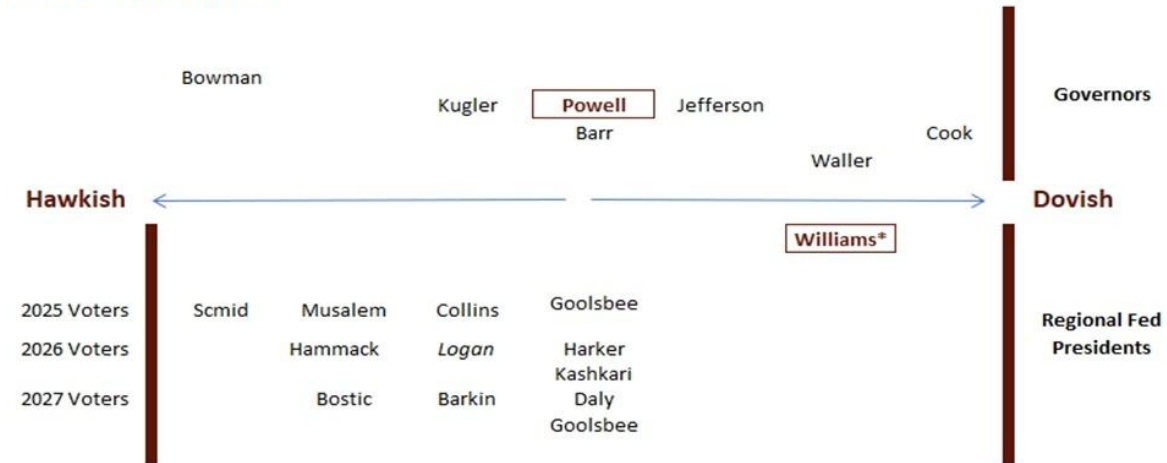


For Powell, the emphasis might be on moving slowly. From the Fed's perspective. There's quite a bit of uncertainty in the labor market. For example, is the slowing more demand or supply related? The U3 unemployment rate remains low despite weaker jobs growth as an example. For equity investors, it might be wise to take some chips off the table heading into Jackson Hole.

Monetary metrics



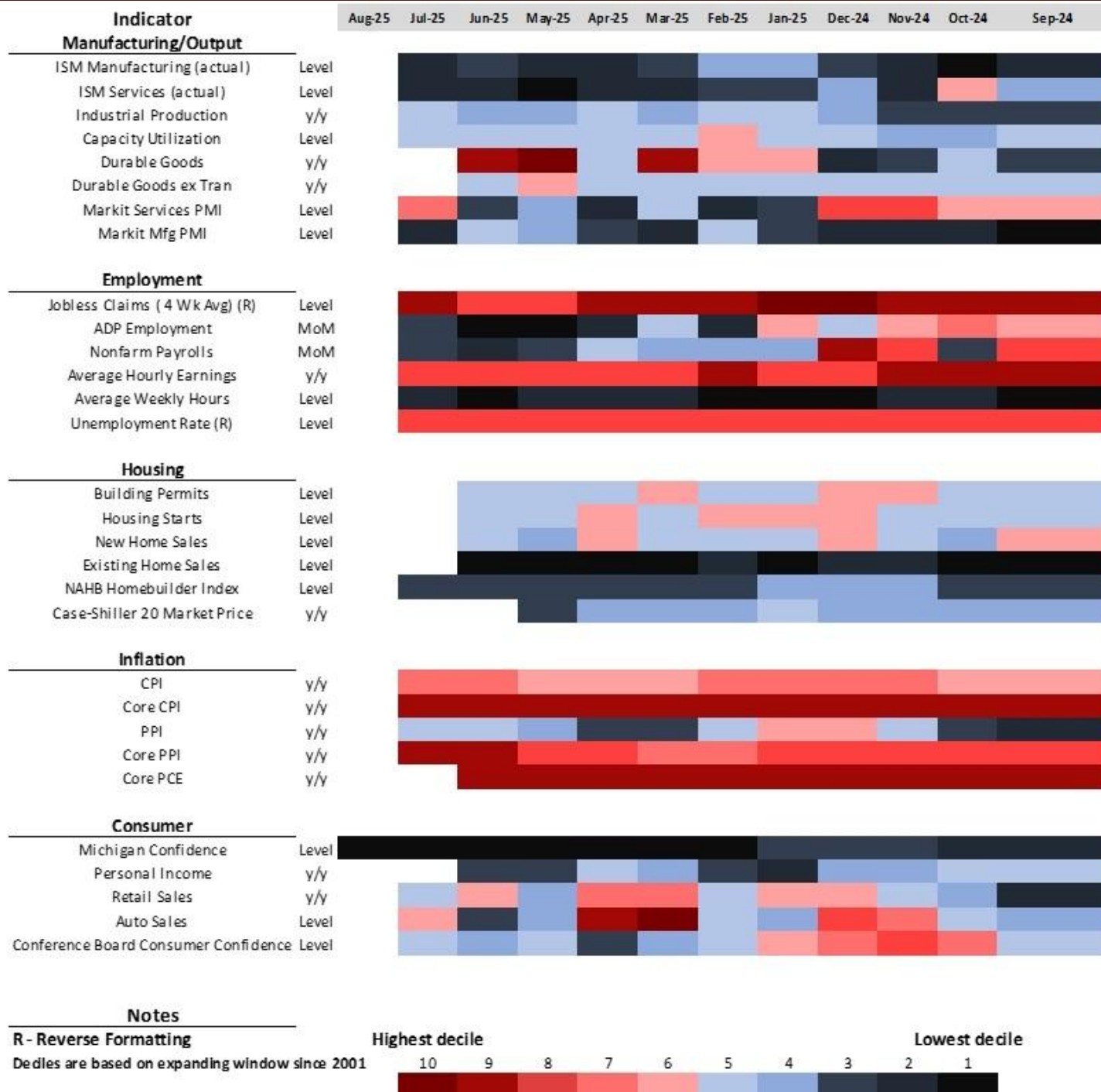
Hawks and Doves



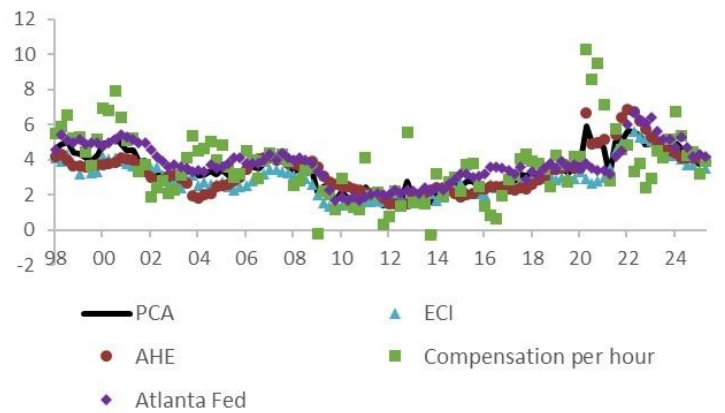
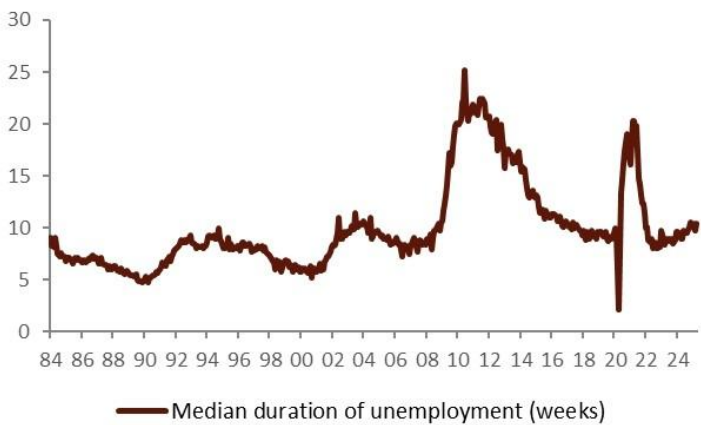
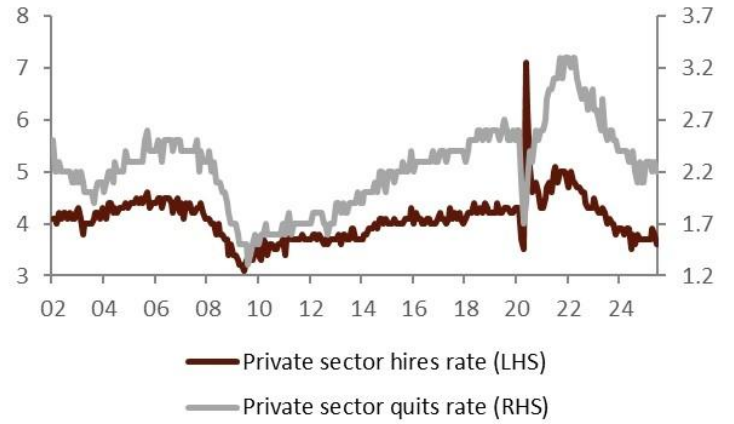
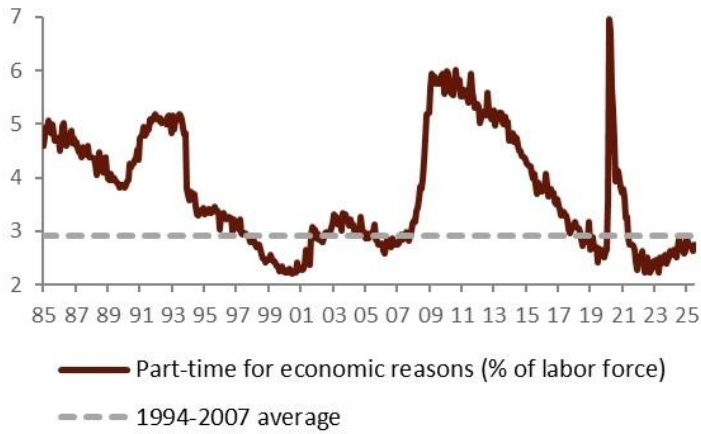
*Federal Reserve Bank of NY President always votes
Boxed individuals represent FOMC core

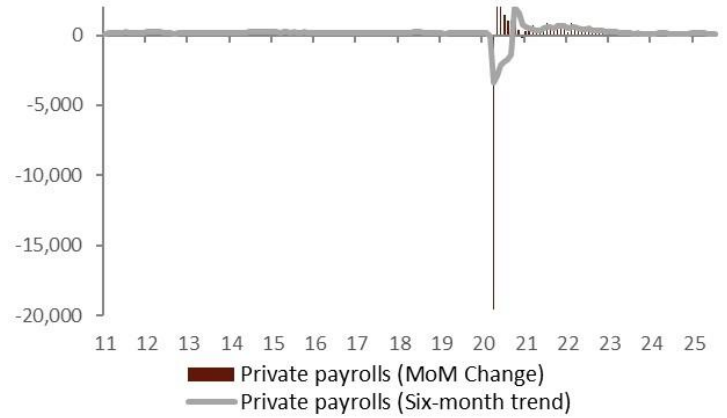
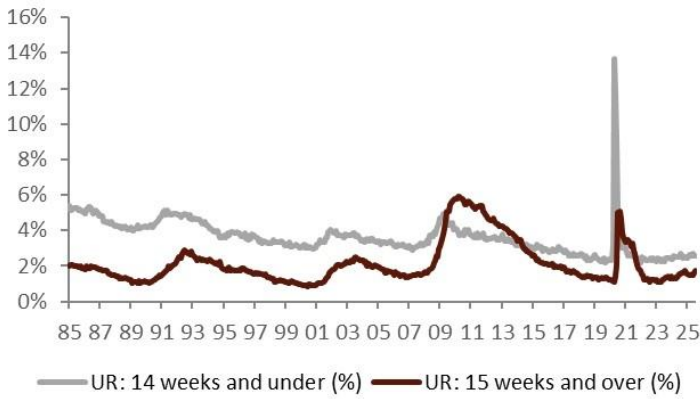
FOMC Forecasts	Median				Central Tendency			
	2025	2026	2027	Longer run	2025	2026	2027	Longer run
Change in real GDP	1.4	1.6	1.8	1.8	1.2–1.5	1.5–1.8	1.7–2.0	1.7–2.0
March projection	1.7	1.8	1.8	1.8	1.5–1.9	1.6–1.9	1.6–2.0	1.7–2.0
Unemployment rate	4.5	4.5	4.4	4.2	4.4–4.5	4.3–4.6	4.2–4.6	4.0–4.3
March projection	4.4	4.3	4.3	4.2	4.3–4.4	4.2–4.5	4.1–4.4	3.9–4.3
PCE inflation	3.0	2.4	2.1	2.0	2.8–3.2	2.3–2.6	2.0–2.2	2.0
March projection	2.7	2.2	2.0	2.0	2.6–2.9	2.1–2.3	2.0–2.1	2.0
Core PCE inflation	3.1	2.4	2.1		2.9–3.4	2.3–2.7	2.0–2.2	
March projection	2.8	2.2	2.0		2.7–3.0	2.1–2.4	2.0–2.1	
Projected policy path								
Fed funds rate	3.9	3.6	3.4	3.0	3.9–4.4	3.1–3.9	2.9–3.6	2.6–3.6
March projection	3.9	3.4	3.1	3.0	3.9–4.4	3.1–3.9	2.9–3.6	2.6–3.6

High frequency data heat-map

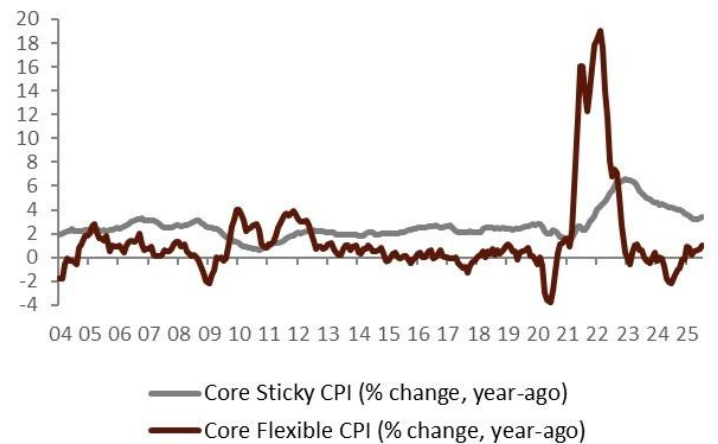
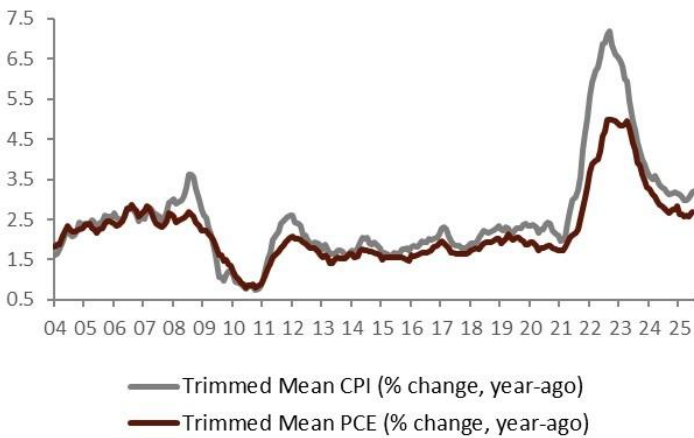
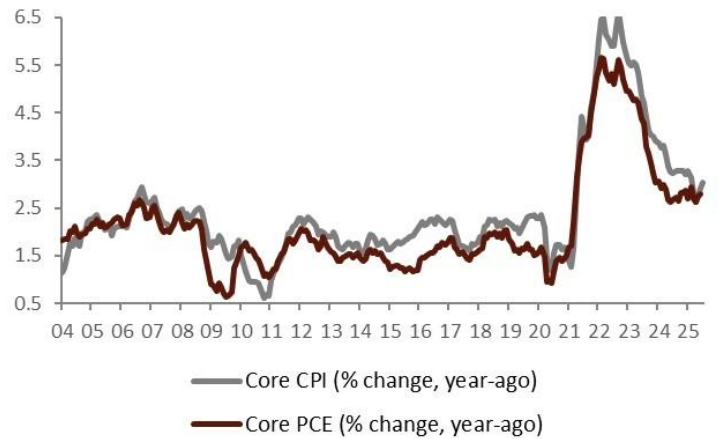
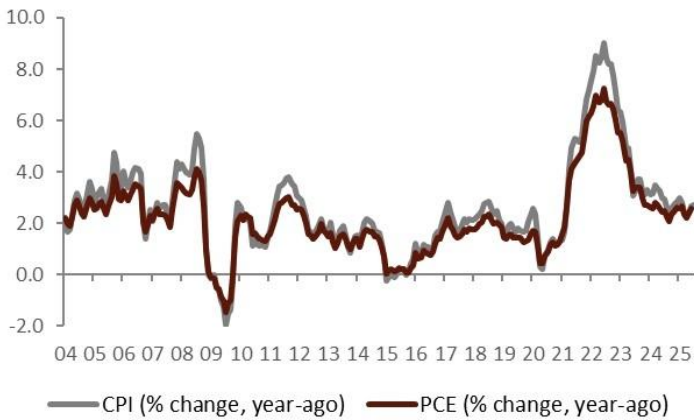


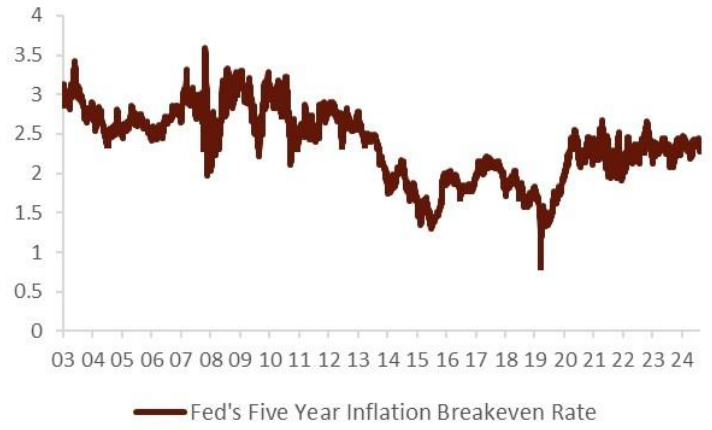
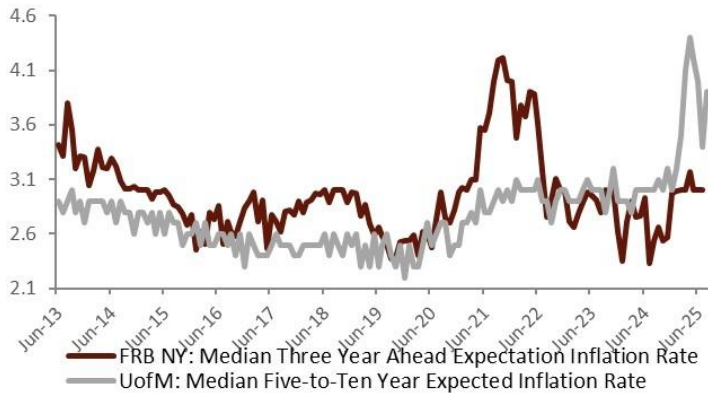
Labor market indicators





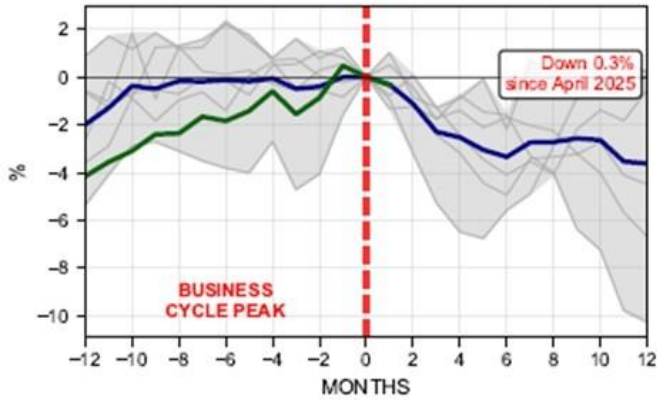
Inflation indicators



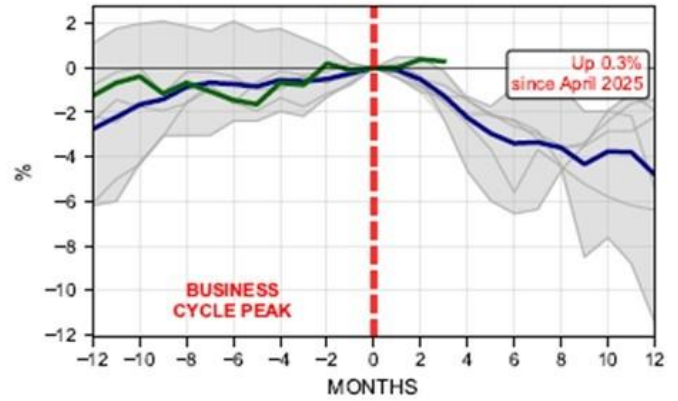


NBER RECESSION INDICATORS DASHBOARD

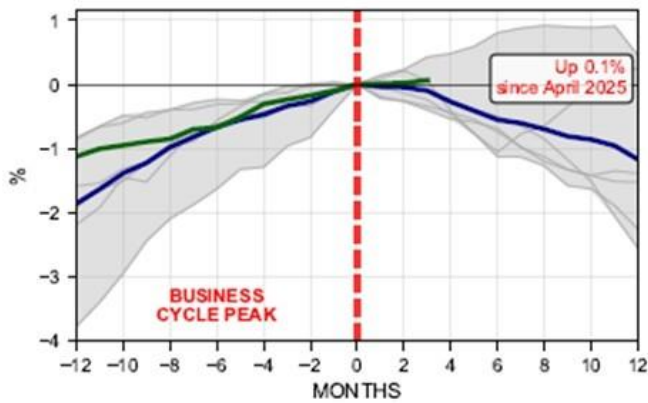
REAL SALES: MANUFACTURING AND TRADE INDUSTRIES



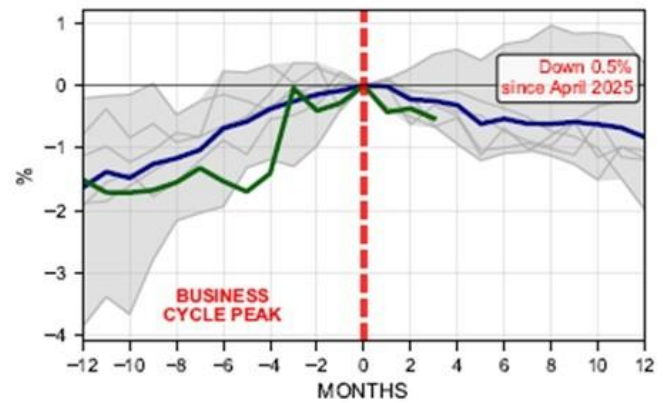
INDUSTRIAL PRODUCTION



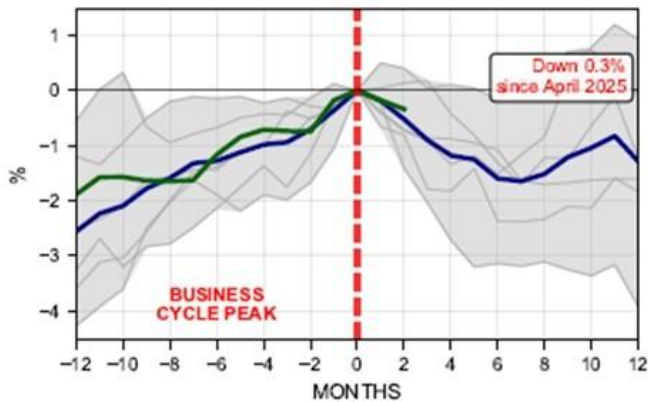
US NONFARM PAYROLLS



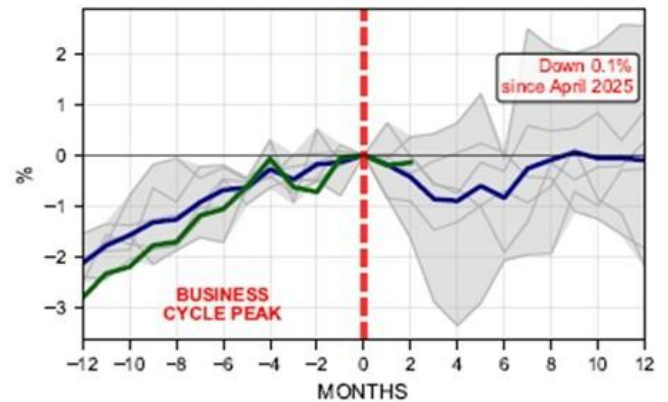
CIVILIAN EMPLOYMENT



REAL PERSONAL INCOME MINUS CURRENT TRANSFER RECEIPTS



REAL PCE



PAST CYCLES (RANGE)
 PAST CYCLES
 PAST CYCLES (MEAN)
 CURRENT CYCLE

Past 7 cycles excluding Covid-19 period

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