June 24, 2025

Dutta’s Monetary Thoughts

Don’t Let “wait to learn” turn into “sit back and relax”

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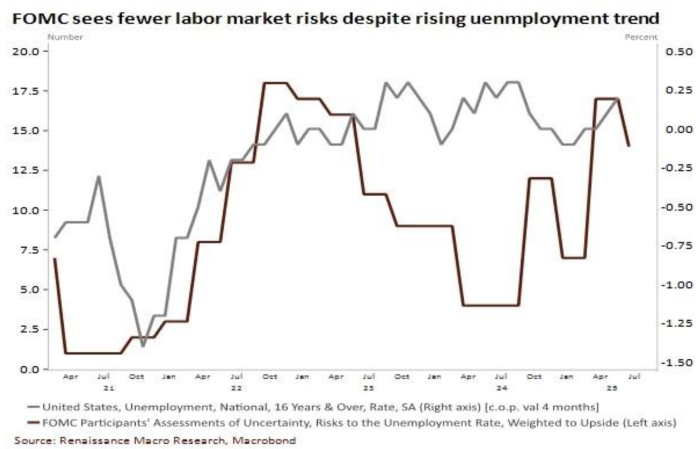
Forecasts are conditional

The most important thing to know about the FOMC interest rate projections is that they are conditional. Assumptions drive conclusions. If the assumptions turn out to be wrong, then the FOMC will come to a different conclusion.

As an example, in June 2024, the FOMC saw the appropriate Federal Funds rate at 5.125 percent, or just one quarter-point cut by the end of that year. By the end of last year, the FOMC ended up lowering the policy rate by a full percentage point to a midpoint of 4.375.

Conditions changed and the Fed responded accordingly. Right now, the FOMC does not appear to be especially concerned about the labor market but quite concerned about the outlook for consumer prices. I take the opposite view with heightened concern about the labor market

At the margin, FOMC participants feel somewhat better about the labor market: the number of participants seeing risks as weighted to the upside declined. This comes even as actual unemployment has been rising for the last four months. That suggests some willful ignorance about the state of the economy.



Indeed, the unrounded U3 unemployment rate has advanced an average of 0.06ppt per month for the last four months. If you assume this continues between now and year-end, the unemployment rate hits 4.65 percent in December. At this pace, the unemployment rate hits the Fed's year-end projection by the end of Q3. This is an optimistic assumption; the latest data on continuing claims implies the pace of increase has stepped up in recent weeks. At any rate, absent a policy response, it is difficult to see why labor markets stabilize on their own.

Outlook for employment deteriorating

Moreover, the outlook for the jobs market is deteriorating as the Fed takes a "wait to learn" approach. This is a passive tightening of policy, reinforcing the downside already in train.

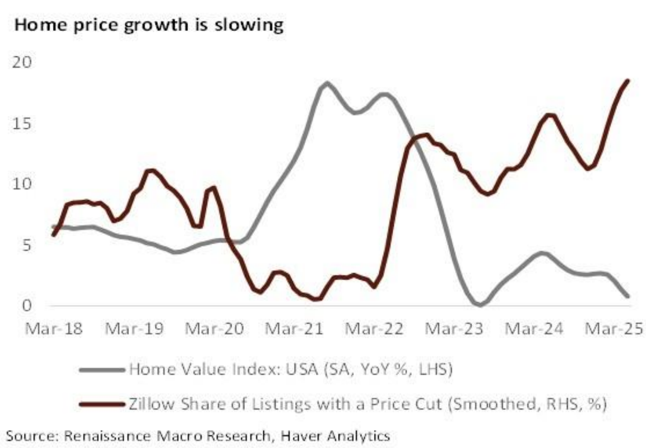
Here is what we already know.

Housing construction to drop

Housing conditions are cooling off. The main difference between the present and the last time residential investment contracted back in 2022 is that housing starts are running well below completions now. This means that housing units under construction will continue sliding. This is important since construction constitutes half of residential investment.

Home prices are on track to drop this year. With inventories rising, more listings are seeing prices cut. Over the last three months ending in May, Zillow's Home Value Index has declined 1.63 SAAR. The drop in home prices is notable because it comes at a time when most consumers expect home prices to rise. Sellers might be inclined to remove their listings altogether while everyone else feels less of a wealth effect. The drop in net worth to income likely pushes up personal saving rates.

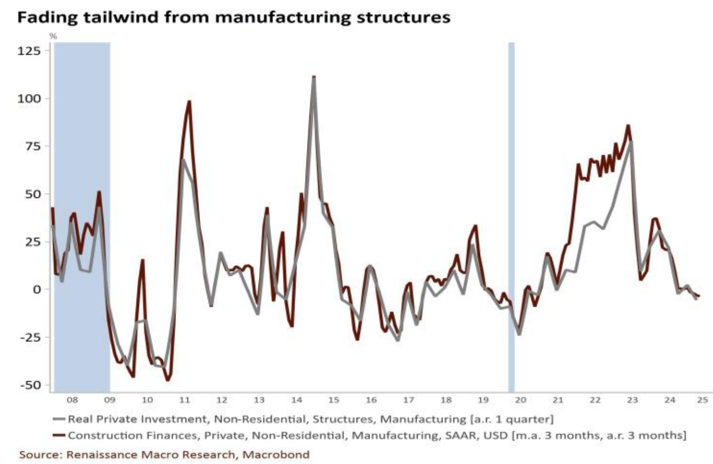
There is no reason to think housing conditions will change until the monetary policy outlook does.



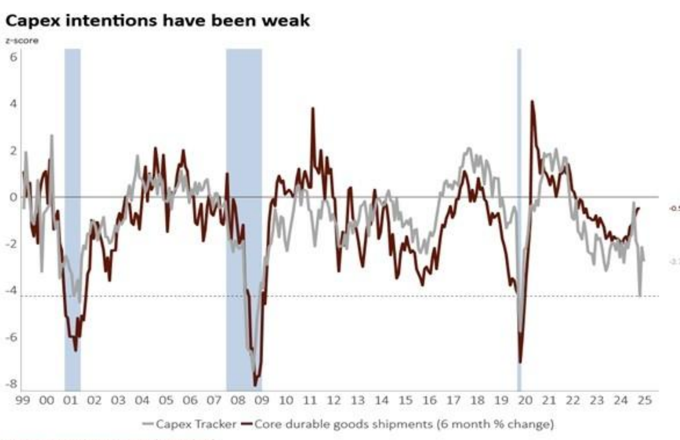
Investment spending is weak

Nonresidential business fixed investment is being held up by one thing: AI tech capex. Everything else is flat to down. That's not a good place to be.

I continue to see the outlook for business investment as sluggish.



First, non-residential structures investment has slowed as the tailwinds from fiscal policies wane. Data center and manufacturing construction have eased. Mining structures investment has seen another leg down. Architectural billings are contracting implying limited growth in the pipeline for much else.



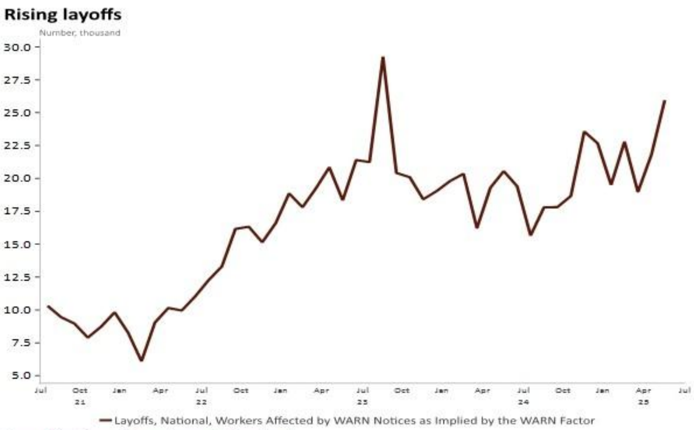
Second, even as trade tensions appear to have eased, capital spending intentions have not really perked up. So, even though uncertainty has declined somewhat, it has not been sufficient to push business investment expectations meaningfully higher. Data from the latest regional manufacturing PMIs points to weakness ahead in core durables.

Ultimately, investment will follow an accelerator effect. Growth expectations have been coming down. Thus, it stands to reason that investment will too.

Not much cushion in labor

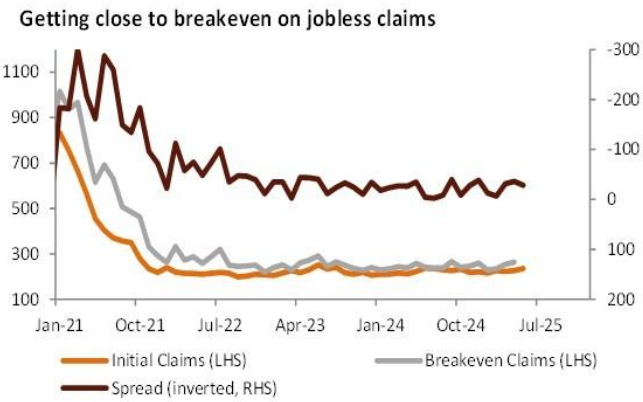
Labor markets have been defined by a low rate of hiring and low firing dynamic. Conditions are fine if you have a job, but not so good if you are looking. The risk in this situation is that with hiring rates low, it does not take much in the way of layoffs to lead to negative jobs growth. This is a fragile equilibrium.

It's clear that layoffs are perking up.



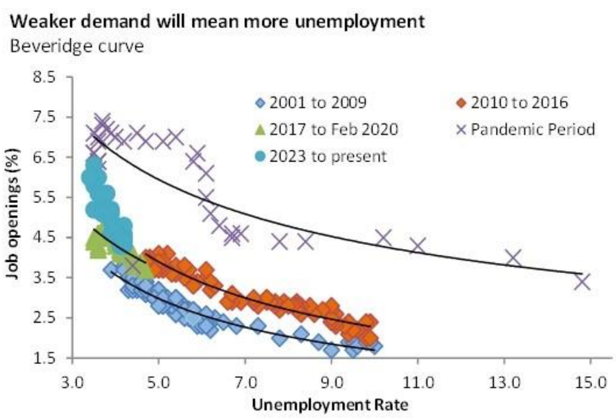
Source: Renaissance Macro Research, Macrobond

Data compiled by the Cleveland Fed shows that Worker Adjustment and Retraining Notifications (WARN) are rising. WARN notices are advance notifications that some employers must provide to their employees and local governments, typically filed 60 days before the expected layoff event. As a result, WARN notices can be thought of as a leading indicator of unemployment. The latest news is not especially encouraging. WARN notices jumped to 25,950 in May, the highest level since August 2023.



Source: Haver Analytics, Renaissance Macro Research

Initial claims have moved up somewhat in recent weeks and while the current level remains low, it is hard to see why initial claims don't move up a bit more in the weeks ahead. After all, layoff announcements have perked up. In this month alone we have seen major news from P&G, Microsoft and Intel. Finally, as we have shown using JOLTs data, initial claims are already running close to their breakeven level, which we estimate to be around 260,000. Any higher and we should anticipate negative employment growth outright.



Source: Haver Analytics, Renaissance Macro Research

Finally, labor demand continues to slowdown; this can turn out to be a serious problem given where the labor market resides along the Beveridge Curve, the relationship between job openings and unemployment. Our nearby figure plots the latest data. Up until recently, the labor markets were operating at a point along the curve where declines in labor demand would mean very little for the unemployment rate. Now, however, if job openings keep falling, we are likely to see higher unemployment follow.

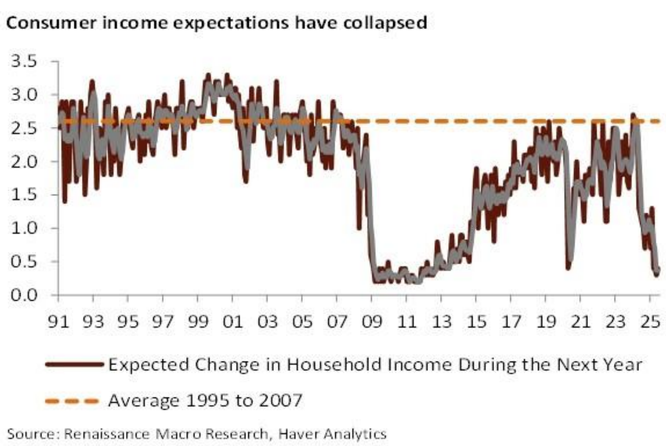
If the labor market is not a material source of inflation, the coming slowdown in labor markets may well imply that the labor markets soon become a source of disinflation.

Inflation expectations seem fine

Lastly, the Fed is holding off because of concerns about inflation; the risk is that higher prices from tariffs will push up inflation expectations. However, there is little evidence of this now. The Fed seems to be choosing one indicator and ignoring several others. Inflation expectations are (1) tame and (2) tough to justify given the dynamics in the jobs market.

First, analysts lamenting the rise in household inflation expectations are putting emphasis on one indicator while ignoring everything else.

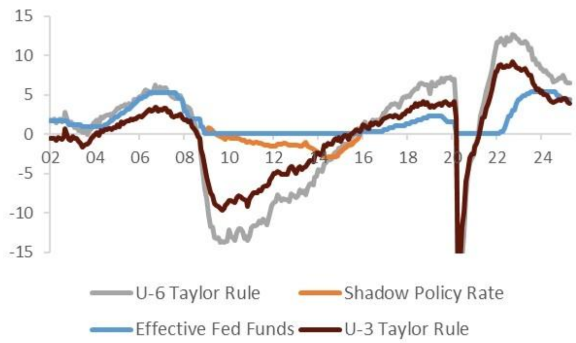
Our nearby figure plots one-year inflation expectations from the University of Michigan, New York Fed Survey of Consumer Expectations, and the Atlanta Fed Business Inflation Expectations. UMich is the notable outlier here. Looking through the details, there has been a sharp rise in the percent of respondents seeing prices going up by at least 10 percent. That's pretty tough to take seriously. Looking at longer run inflation expectations reveals a similar dynamic: UMich is the notable outlier.

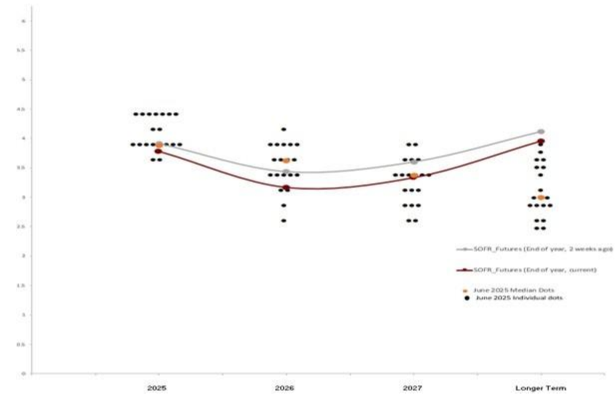


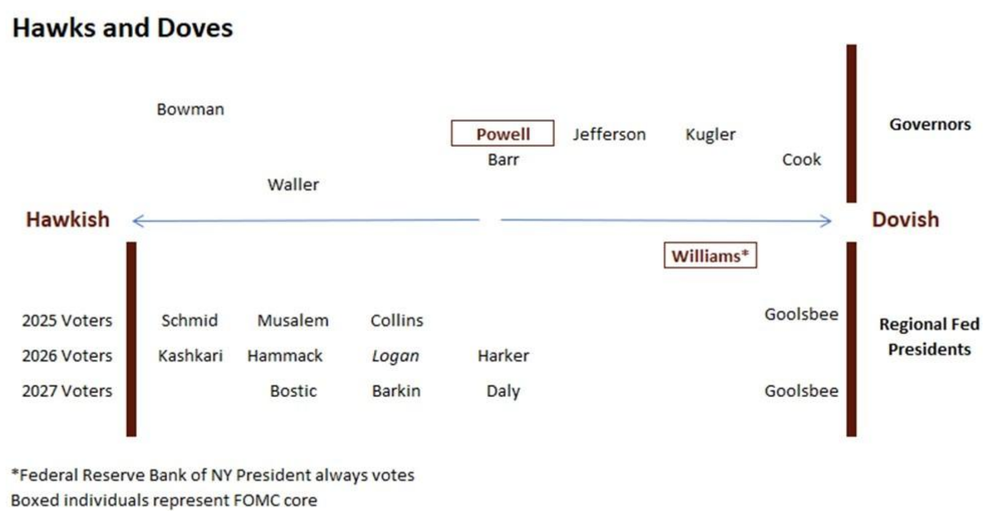
Second, there is little evidence that inflation expectations are translating into increased wage demands in the jobs market. As an example, posted wage growth according to data from Indeed, has cooled to 3.0 percent. This tends to lead actual wage growth. Moreover, consumer expectations about future income growth, according to data from the University of Michigan remains near record lows.

A source of disinflation from the jobs market Labor markets are transitioning from not being a source of inflationary pressures to being a source of disinflation. Labor market conditions have been slowing. The outlook implies ongoing weakness in the labor market remains in front of us. The rising slack in the jobs market will mitigate broad inflationary pressures – it's about the budget constraint!

Monetary metrics

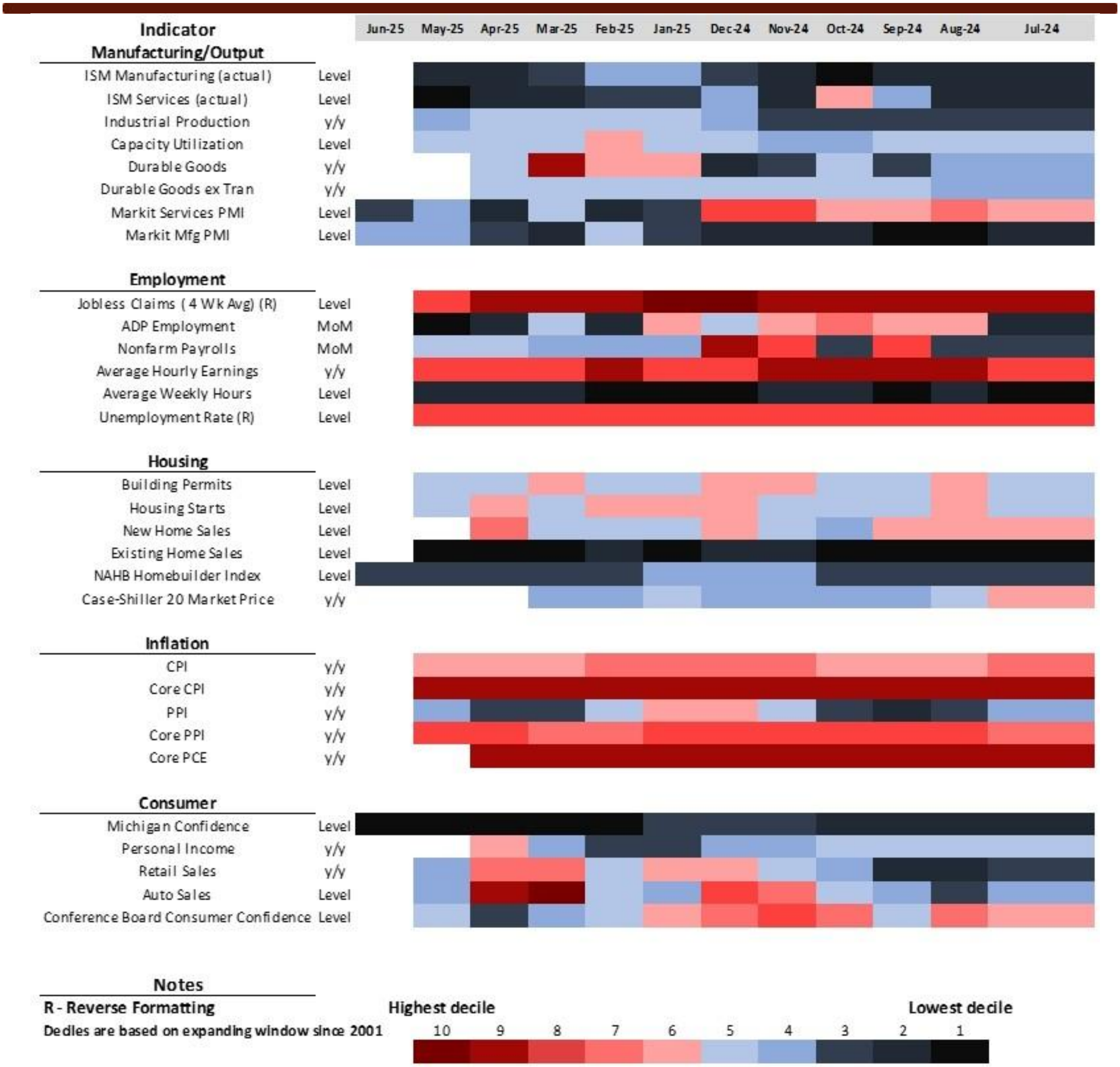




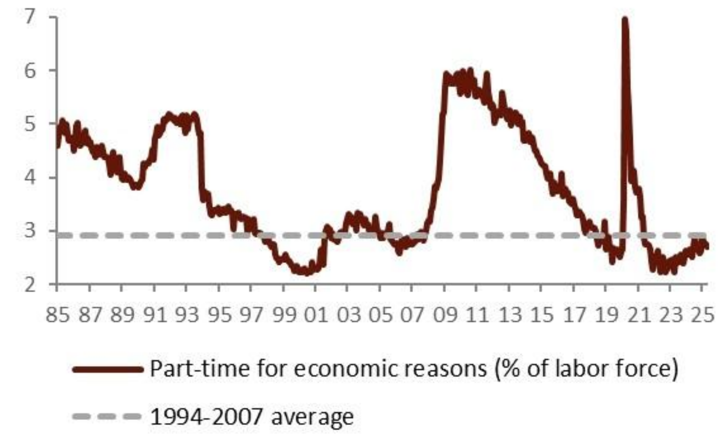


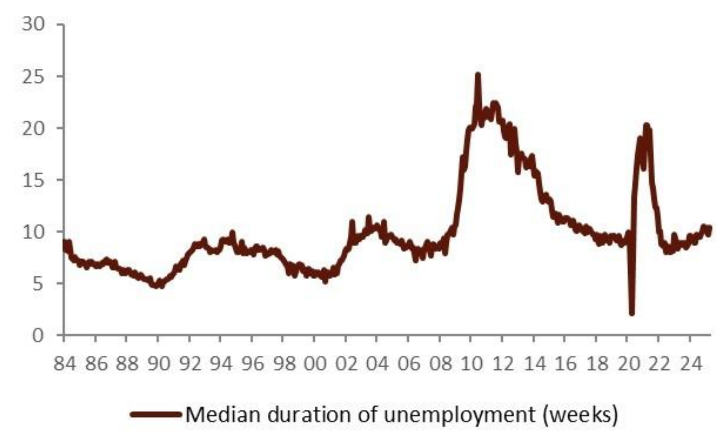
FOMC Forecasts	Median				Central Tendency			
	2025	2026	2027	Longer run	2025	2026	2027	Longer run
Change in real GDP	1.4	1.6	1.8	1.8	1.2–1.5	1.5–1.8	1.7–2.0	1.7–2.0
March projection	1.7	1.8	1.8	1.8	1.5–1.9	1.6–1.9	1.6–2.0	1.7–2.0
Unemployment rate	4.5	4.5	4.4	4.2	4.4–4.5	4.3–4.6	4.2–4.6	4.0–4.3
March 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

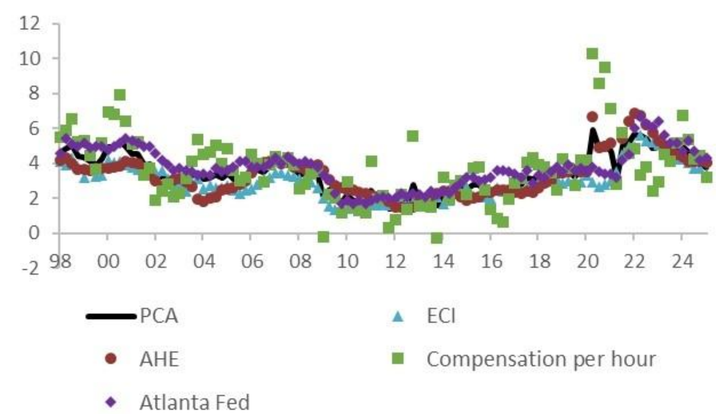
High frequency data heat-map

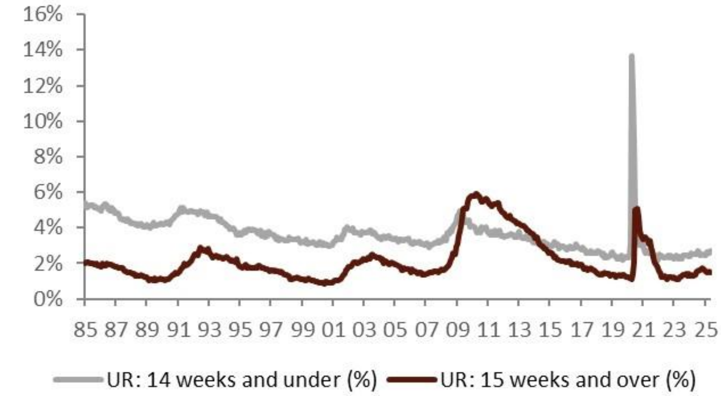


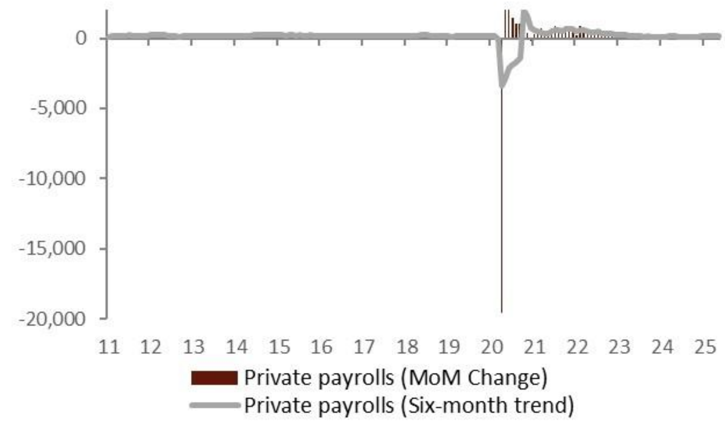
Labor market indicators



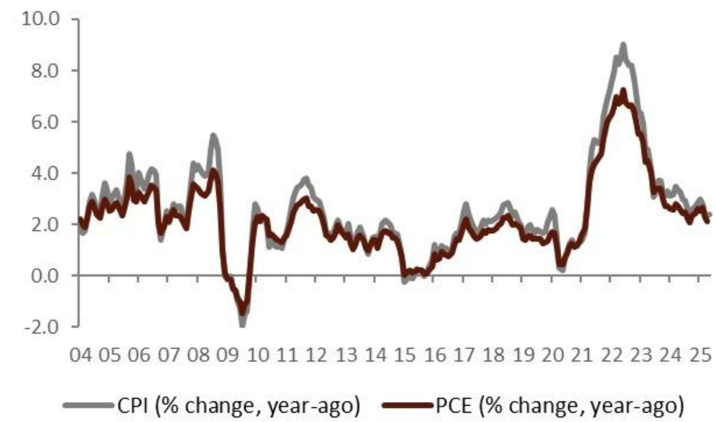


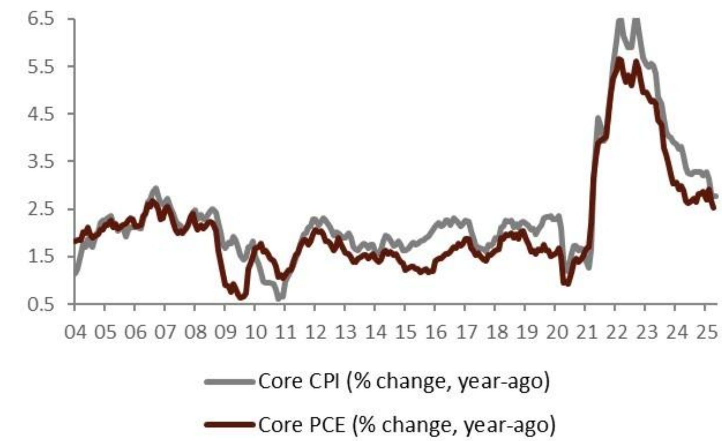


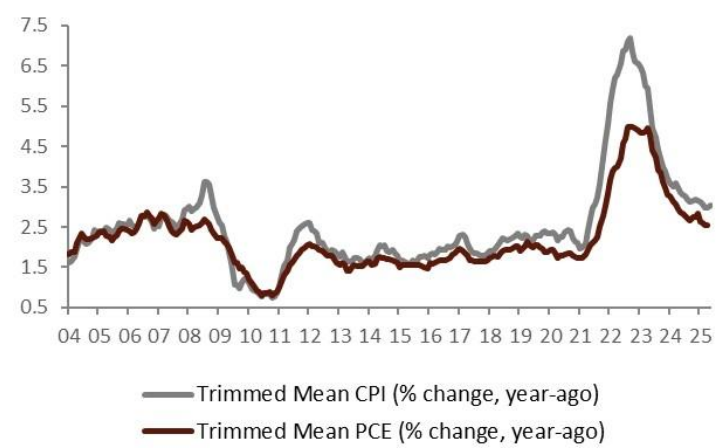


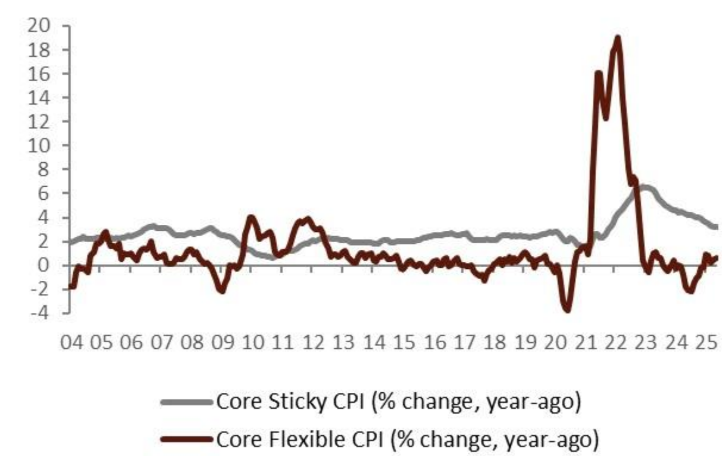


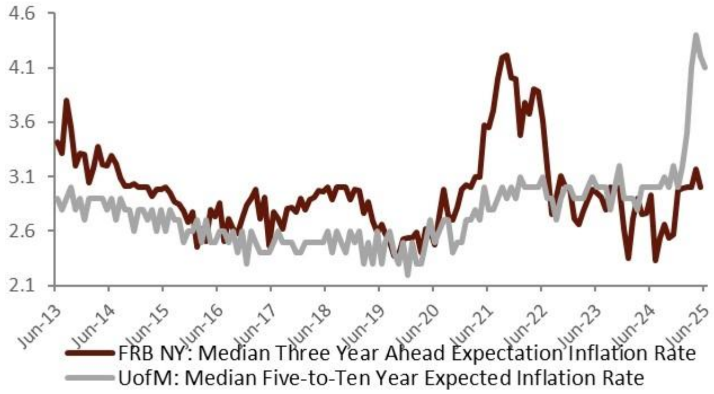
Inflation indicators







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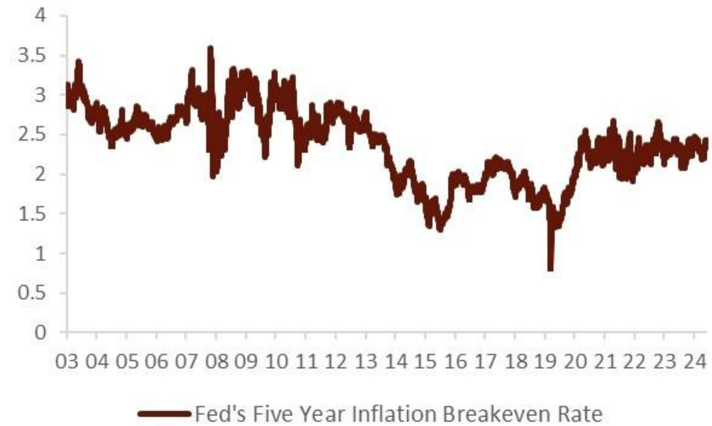
FRB NY: Median Three Year Ahead Expectation Inflation Rate
UofM: Median Five-to-Ten Year Expected Inflation Rate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Fed's Five Year Inflation Breakeven Rate