Economics

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December Flashlight for the FOMC Blackout Period

Slower Pace of Easing on the Horizon

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Summary

- We expect the FOMC will reduce the federal funds rate by 25 bps at the conclusion of its upcoming meeting on December 18 while simultaneously emphasizing that future rate cuts will be slower-going and dependent on incoming data.
- Data over the inter-meeting period suggest ongoing resilience within the U.S. economy. The labor market cooling remains contained while the last few inflation readings show a stubborn pace of price growth that remains about a percentage point above the central bank's 2% target.
- Fed policymakers have hinted that their base case remains a 25 bps cut for December. But, officials have also suggested that current policy is now at a place where further reductions could occur more slowly. Thus, we expect that after lowering the target range by 25 bps to 4.50%-4.75% in December, additional easing is likely to occur at an every-other-meeting pace.
- The quarterly update to the Summary of Economic Projections is likely to underscore the extent to which the U.S. economy has been stronger than expected in recent months. That said, projections for 2025 may be more dispersed than usual given that individual participants might assume different economic policy outcomes, such as higher tariffs, lower taxes or slower growth in the foreign-born labor force.
- We look for the median participant estimate of the fed funds rate at the end of 2025 to rise by 25 bps to 3.625%. However, we would not be shocked to see it increase 50 bps given the recent run of firm data and the possibility of some participants re-centering the risks to their forecasts in light of potential policy changes.
- FOMC participants' estimates of the long-run federal funds rate has been creeping higher over the past year, and we anticipate it will continue to do so with the median long-run dot rising to 3.0%.
- There is a chance that the FOMC will adopt a technical adjustment to the interest rate it pays on overnight repurchase agreements (ON RRPs). If so, then overnight interest rates may fall by a few more bps than the 25 bps decline that typically follows a reduction in the target range by a similar amount. More broadly, a tweak to the ON RRP rate would be yet another sign that quantitative tightening is nearing its conclusion.

FOMC Dot Plot Expectations

	Previous Median (September SEP)	Wells Fargo Economics Forecast	
		Projected Median (December SEP)	WF Fed Funds Rate Forecast
2024	4.375	4.375	4.375
2025	3.375	3.625	3.625
2026	2.875	3.125	3.625
2027	2.875	3.000	—
Longer run	2.875	3.000	3.375

End of year value; Forecast as of December 11, 2024

Source: Federal Reserve Board and Wells Fargo Economics

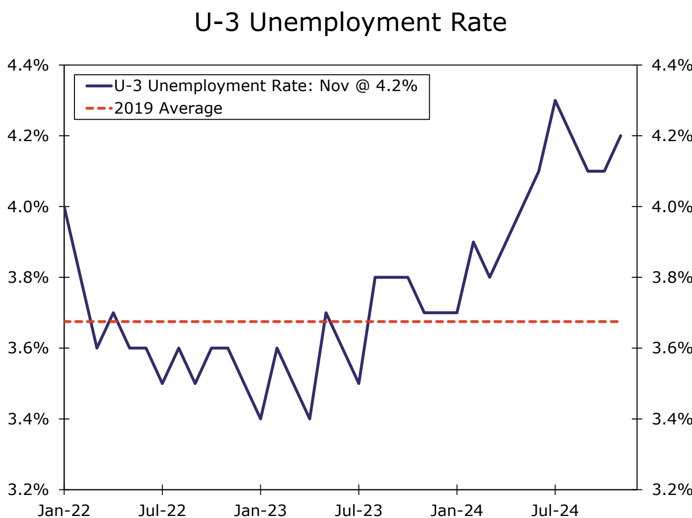
FOMC Outlook: 25 bps on December 18 Before Pace of Easing Slows

Economic data generally have come in hotter than expected recently.

We expect the FOMC will reduce the federal funds rate by 25 bps at its upcoming meeting on December 17–18 while simultaneously emphasizing that future rate cuts will be slower-going and data dependent. Economic data generally have come in hotter than expected since the FOMC started cutting rates at its September meeting. Nonfarm payroll growth rebounded in November to 227K, bouncing back from the weak 36K reading in October (revised up from 12K initially) and pushing the three-month moving average for job growth up to a respectable 173K per month. The unemployment rate ticked up to 4.2%, but it remains slightly below its recent peak of 4.3% in July (Figure 1). Real GDP grew at a sturdy 2.8% pace in Q3, and recent monthly data lead us to project that output will grow at a solid, albeit slower, pace of 2.1% in the current quarter.

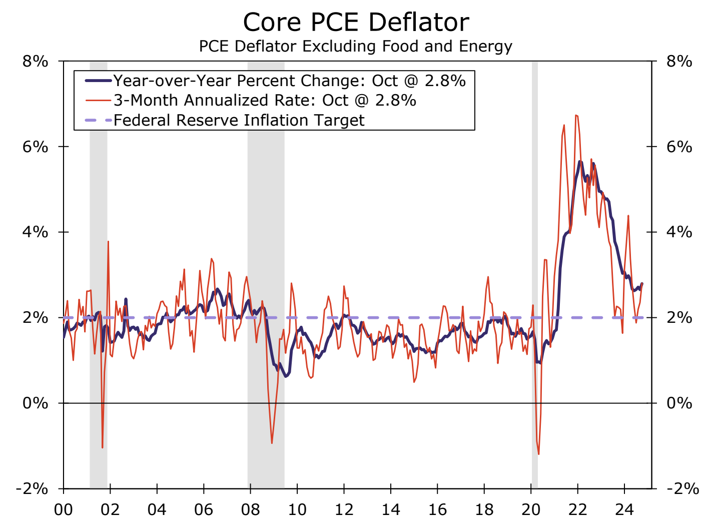
The inflation data also have been a bit firmer over the past couple months. The core PCE deflator increased at a 2.8% annualized rate in the three months ending in October, up from a 2.4% annualized rate when the FOMC last met in November and a 2.2% rate when the Committee gathered in September. On a year-over-year basis, core PCE inflation has been sticky around 2.7%-2.9% in recent months (Figure 2). Headline inflation has been tamer on the back of falling gasoline prices, but the overall PCE deflator is still up 2.3% year-over-year—about 30 bps above the FOMC's 2% inflation target. The recently released CPI data for November suggest that progress in reducing inflation once again stalled out last month. The stronger economic data have coincided with a further easing in financial conditions. Major U.S. equity indices have risen to all-time highs, while credit spreads have tightened further in recent months.

Figure 1



Source: U.S. Department of Labor and Wells Fargo Economics

Figure 2



Source: U.S. Department of Commerce and Wells Fargo Economics

Against this backdrop, the recent Republican sweep of Congress and the White House has led to significant uncertainty about the outlook for economic policy in 2025. A full review of the post-election policy outlook is beyond the purview of this report, and we would encourage our readers to check out our 2025 annual economic outlook report for further reading on this topic. That said, the FOMC likely will be weighing the prospects for fiscal policy expansion (e.g., tax cuts, more spending on border security and the military), fiscal policy contraction (spending cuts for nondefense areas) and significantly higher tariffs.

We believe the FOMC's thinking will still be guided by prospective policy changes next year.

Chair Powell is unlikely to comment much on the outlook for these policy changes while they remain speculative, but we suspect the FOMC will have a robust internal debate about the impact of these potential policies on the economy. At the December 2016 FOMC meeting, which followed in the wake of the last Republican election sweep, the research staff at the Board presented analysis on the economic impact of hypothetical tax cuts. The transcripts from that meeting reveal that roughly half of the Committee members incorporated an assumption of greater fiscal policy stimulus into their Summary of Economic Projection submissions. Thus, even if Chair Powell's press conference remarks

are noncommittal, we believe the FOMC's thinking will still be guided by prospective policy changes next year.[1,2]

Recent comments from Fed policymakers have hinted that their base case remains a 25 bps rate cut at the December meeting. Federal Reserve Governor Waller stated on December 2 that he "leans toward supporting a cut to the policy rate at our December meeting." John Williams, the president of the New York Fed, deferred on explicitly supporting a December rate cut but backed the notion that it will be appropriate to continue to reduce the federal funds rate over time. Federal Reserve Bank of San Francisco President Mary Daly, who will shift from a voter to a non-voter in 2025, also punted on an explicit commitment for the next FOMC meeting but reinforced the view that "we have to keep policy moving down to accommodate the economy." Beth Hammack, a voter as the president of the Federal Reserve Bank of Cleveland, remarked the Committee is likely "at or near" the point where a slower pace of reductions makes sense. Thus, even if policymakers opt to hold the federal funds rate steady on December 18, another reduction sometime in Q1 still strikes us as likely as the Committee transitions to an every-other-meeting pace of rate cuts.

While we expect an additional 25 bps point cut to the fed funds rate at the December meeting, the recent run of firmer data and the total amount of policy "recalibration" already undertaken point to further easing occurring at a more gradual pace in coming months. Few changes to the post-meeting statement's description of recent economic conditions seem necessary, and the characterization of the Committee's employment and inflation goals remaining "roughly in balance" is still reasonable, in our view. However, we anticipate that a rate cut on December 18 will be accompanied by an indication in the statement that there is a higher bar to subsequent policy easing and that future reductions in the target range for the federal funds rate will be undertaken more slowly. This policy guidance could be signaled, for example, by noting consideration for "any" or the "extent of" additional policy easing and/or emphasizing the cumulative amount of rate cuts since this summer.

Easing in coming months likely will occur at a more gradual pace.

Dots Headed Higher, but by How Much?

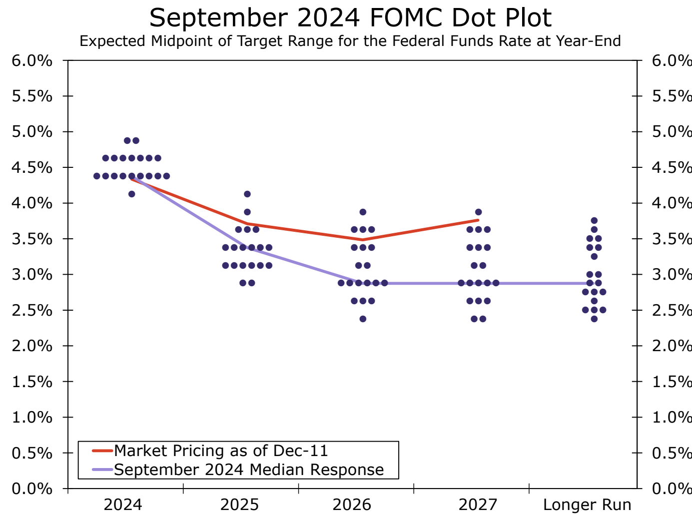
The December 17–18 FOMC meeting will include an update to the Committee's Summary of Economic Projections (SEP). The SEP was last updated at the September meeting, and those projections highlight the extent to which the U.S. economy has been stronger than expected over the past few months. The median participant in the September SEP expected the unemployment rate to average 4.4% in the current quarter. We expect this projection will drop to 4.2% based on the data we now have in hand. Similarly, the median participant expected real GDP growth of 2.0% this year, whereas we are currently tracking in the neighborhood of 2.4%. On the inflation front, the median participant projected 2.6% year-over-year growth in the core PCE deflator for 2024, while our current forecast is 2.9% with only a limited amount of price data left in the year.

Looking to next year and beyond, we expect the median projections for real GDP growth in 2025 and 2026 to move higher by a tenth or two to reflect this stronger momentum. We also believe the unemployment rate projections for the next few years likely will fall by a tenth or so. Similarly, we expect the inflation projections for 2025 and 2026 to rise by a tenth or two amid firmer price pressures of late. That said, there may be more dispersion in the economic projections than usual given that individual participants may assume different economic policy outcomes, such as higher tariffs, lower taxes or slower growth in the foreign-born labor force. The potential for significant non-monetary policy changes may also be evidenced by a shift in participants' assessments of uncertainty and risks around their economic projections.

In terms of the outlook for the federal funds rate, we think the median dot for 2025 will rise by 25 bps to 3.625%, although a 50 bps increase to 3.875% would not shock us. Our base case is that the median 2026 dot also will increase by 25 bps, bringing it to 3.125%. In the September dot plot, the 2027 median dot was in line with the "longer-run" dot, and we would expect that to still be the case in the upcoming projections. The "longer-run" median dot is currently 2.875%, and it has been creeping higher over the past year alongside estimates from private sector economists (Figure 3). We expect to see the longer-run dot rise to 3.0% in next week's update (Figure 4).

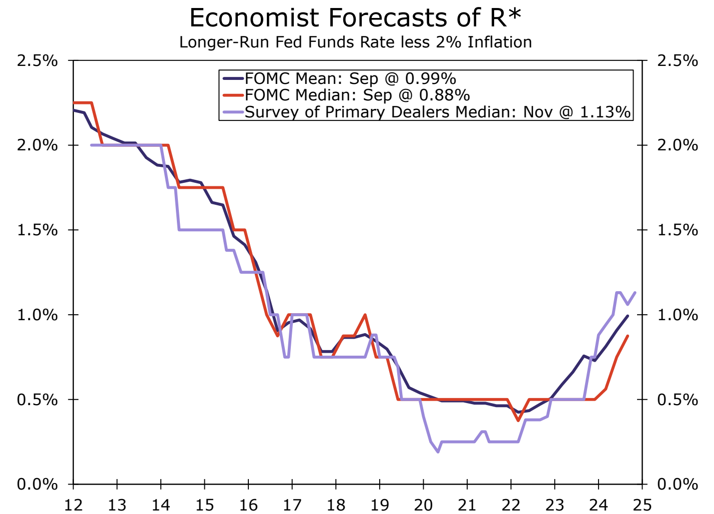
We think the median dot for 2025 will rise by 25 bps.

Figure 3



Source: Federal Reserve Board and Wells Fargo Economics

Figure 4



Source: Federal Reserve System and Wells Fargo Economics

QT Update and Possible Technical Adjustment?

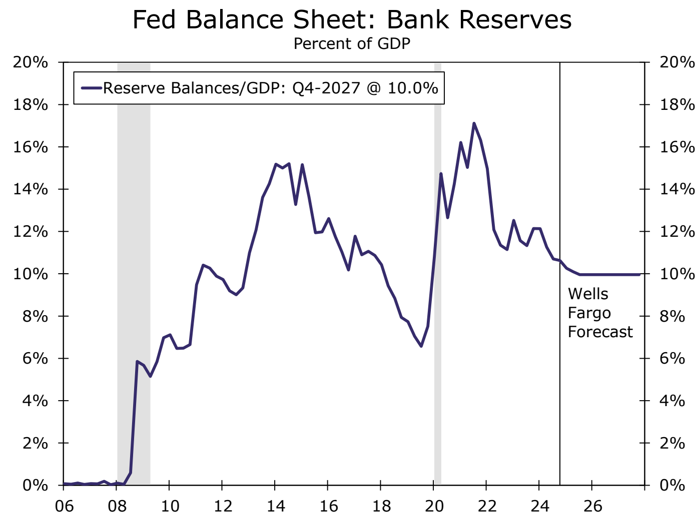
We expect the FOMC will once again reaffirm the ongoing pace of balance sheet runoff, more commonly known as quantitative tightening (QT). We believe the Committee will maintain the current monthly pace of balance sheet runoff, currently a maximum of $25 billion of Treasury securities and $35 billion of mortgage-backed securities (MBS), through the end of March. After that, we expect the central bank will maintain the size of its balance sheet for a couple of quarters such that it is flat in dollar terms but still declining as a share of GDP. We expect MBS runoff will continue and for pay-downs to be replaced one-for-one with Treasury securities as the Fed tries to further reduce the share of its security holdings that are mortgages. If our forecast is correct, then bank reserves will level off as a share of GDP around 10% (Figure 5).

The FOMC could tweak the interest rate it pays on overnight reverse repurchase agreements.

There is a chance the Committee will adopt a technical adjustment to the interest rate it pays on overnight reverse repurchase agreements (ON RRPs). The Federal Reserve uses the ON RRP rate and the interest rate on reserve balances (IORB) to help keep short-term interest rates, most notably the federal funds rate, within the target range for the fed funds rate. Money market rates such as the Secured Overnight Financing Rate (SOFR) have drifted higher amid ongoing balance sheet runoff (Figure 6). This development presents the FOMC an opportunity to tweak the ON RRP rate by 5 bps to bring it in line with the bottom end of the target range for the fed funds rate, rather than being 5 bps above it as is currently the case. The primary advantage of such a move would be to put some modest downward pressure on money market rates, helping to keep them from drifting undesirably higher as QT continues to remove excess liquidity from the financial system.

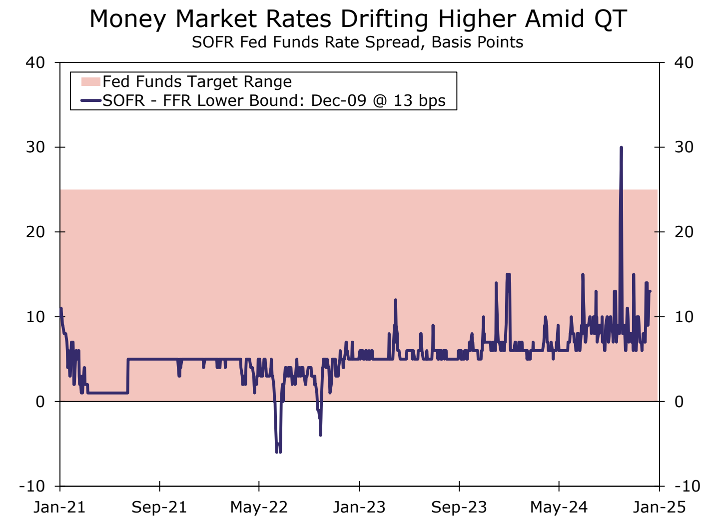
The minutes from the November FOMC meeting revealed that the Fed staff provided an informational briefing to the Committee on this idea. That briefing does not necessarily mean the FOMC will follow through with such a move, but it is clearly a possibility at one of the next few meetings, including the one next week. If the FOMC brings the ON RRP rate in line with the bottom end of the fed funds target range, then overnight interest rates such as SOFR and the federal funds rate may fall by a few more bps than the 25 bps decline that typically follows a reduction in the target range by that amount. More broadly, a tweak to the ON RRP rate would be yet another sign that QT is nearing its conclusion.

Figure 5



Source: Federal Reserve Board and Wells Fargo Economics

Figure 6



Source: Federal Reserve Bank of New York, Bloomberg Finance L.P., and Wells Fargo Economics

Endnotes

1 – "Report to the FOMC on Economic Conditions and Monetary Policy," Federal Reserve Board, December 7, 2016. (Return)

2 – "Meeting of the Federal Open Market Committee on December 13-14, 2016," Federal Reserve Board, December 14, 2016. (Return)

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