Special Commentary — August 4, 2024

Updating Our Fed Funds Forecast
When the Facts Change, We Change Our Minds

Economist(s)

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Summary

- The FOMC has largely succeeded in its mission to return inflation to its target of 2%. However, recent data suggest the risks to the "full employment" part of the Fed's dual mandate are rising. Payroll growth has slowed and unemployment is rising.
- As measured by the real fed funds rate, the stance of monetary policy is quite restrictive at present. In our view, the FOMC needs to get back to a "neutral" stance of policy quickly or else it risks a vicious circle of labor market weakness leading to sluggish spending, leading to further labor market weakness, etc.
- We now look for the FOMC to cut rates by 50 bps at its meeting on September 18 with another 50 bps rate cut on November 7. We forecast the Committee will reduce its target range for the federal funds rate to 3.25–3.50% by the middle of next year, which is in the vicinity of what many observers, including us and numerous members of the FOMC, consider to be neutral.
- We continue to forecast that the economic expansion, which has been in place since mid-2020, will remain intact due, at least in part, to aggressive Fed easing. We will be releasing a full forecast update later this week in our August U.S. Monthly Outlook.

All estimates/forecasts are as of 8/4/2024 unless otherwise stated. 8/4/2024 20:00:17 EDT. **This report is available on Bloomberg WFRE**

Recent Signs of Labor Market Weakness Prompt Changes to Our Fed Funds Forecast

Recent economic data, especially those related to the labor market, have convinced us that Federal Reserve policymakers will soon be changing policy in a meaningful way. The Federal Open Market Committee (FOMC) had been focused almost entirely on bringing inflation back to its 2% target, an endeavor that has largely been successful. The core rate of PCE inflation, which Fed officials believe is the best measure of the underlying rate of consumer price inflation, has retreated from 5.5% (year-over-year) in September 2022 to 2.6% in June (Figure 1). Moreover, the core PCE price index rose at an annualized rate of only 2.3% between March and June. As we wrote in a report describing the July 31 FOMC meeting, the Committee is now "attentive to risks to both sides of its duel mandate" (i.e., “price stability” and “full employment”) rather than only emphasizing the “price stability” part of its mandate.

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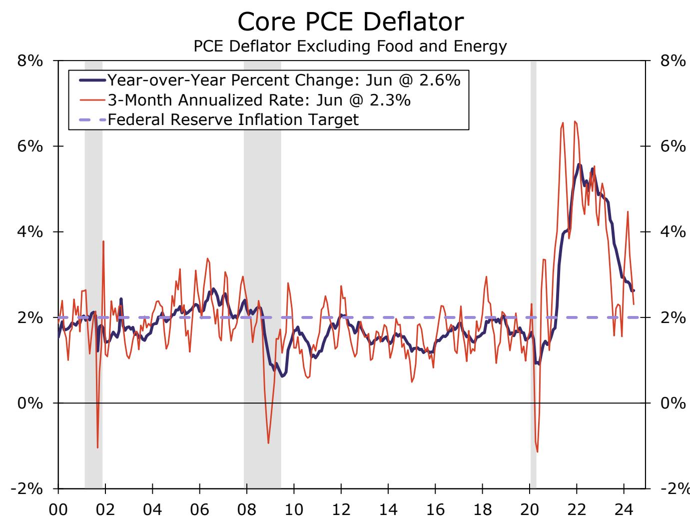
The risks to the labor market have become even more apparent in recent days. For starters, the number of initial jobless claims (i.e., the number of individuals filing for unemployment insurance for the first time) rose during the week ending on July 26 to its highest level in nearly a year. The number of individuals who remain jobless and therefore continue to file for unemployment compensation, which has been trending higher since late May, has risen to its highest level since November 2021 when the jobs market was still recovering from its pandemic-induced swoon. The number of respondents describing jobs as "hard to get" in the most recent Conference Board survey of Consumer Confidence edged up to its highest level since early 2021.

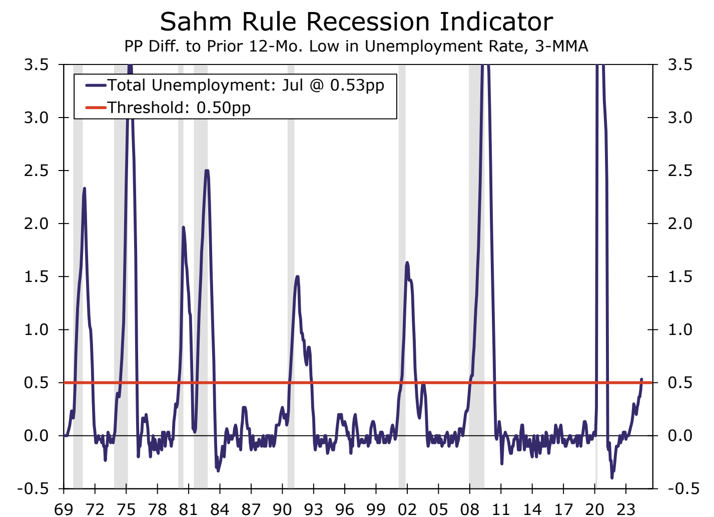
Data released on Friday showed that nonfarm payrolls rose by only 114K in July, well below the average monthly increase of 168K in the second quarter. Moreover, that gain was narrowly based with healthcare, government and leisure & hospitality accounting for most of the rise in payrolls last month. The unemployment rate jumped up from 4.1% in June to 4.3% in July, thereby surpassing the so-called “Sahm Rule” threshold, which has been a perfect indicator of recession over the past 60 years (Figure 2). (See our July 25 report for further reading on the “Sahm rule.”)

Figure 1



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

Figure 2



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

Getting Back to "Neutral" Will Require Aggressive Easing

With inflation on its way back to the FOMC's target of 2% and perceptible weakening in the labor market raising the risk of recession, we now look for the FOMC to cut its target range for the federal funds rate by 50 bps at the September 18 meeting (Figure 3). As we noted in our last U.S. Economic Outlook, we do not think the presidential election on November 5 will prevent the Committee from easing policy on September 18, especially if the labor market continues to show signs of weakness. Furthermore, we forecast another 50 bps rate cut on November 7 and a 25 bps reduction on December 18. The target range for the federal funds rate, which currently stands at 5.25%–5.50%, would be 4.00–4.25% at the end of the year under this forecast compared to our prior forecast of 4.75–5.00%. We also look for further easing next year. Specifically, we look for 25 bps rate cuts at each

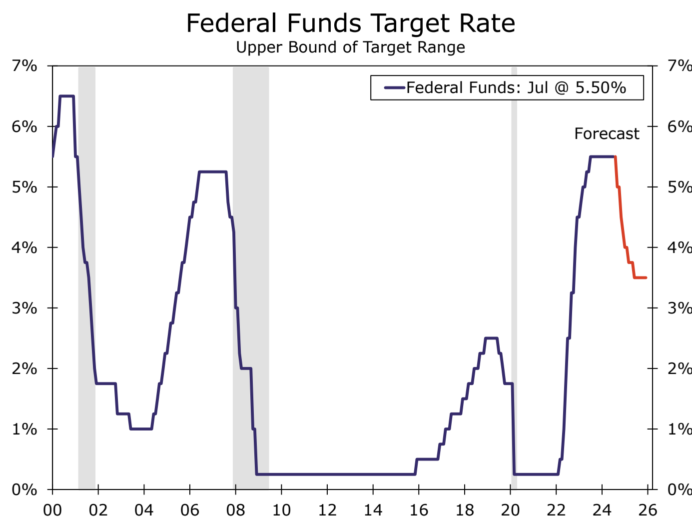
of the meetings in January, March and June. If realized, the target range for the federal funds rate would fall to 3.25%–3.50% in June 2025. Past June, we think the FOMC will stay on hold for a period of time as it assesses the impact from previous easing and "feels its way" to the "neutral" rate. Our previous forecast looked for 25 bps cuts at every other meeting in 2025, which would have taken the fed funds rate at 3.75–4.00% at the end of next year.

Why does the FOMC need to cut so aggressively? Fed policymakers have been successful in their efforts to rein in inflation due to the restrictive stance of monetary policy that has been in place for some time. Economists typically measure the stance of monetary policy via the real fed fund rate (i.e., the nominal interest rate minus the inflation rate). Using the year-over-year change in the core PCE price index as our measure of inflation, the real fed funds rate is closing in on 3%, a level that has not been visited since 2007 before the economy plunged into a deep recession (Figure 4). In other words, the stance of monetary policy is quite restrictive at present. In our view, the FOMC needs to get back to a "neutral" stance of policy quickly or else it risks a vicious circle of labor market weakness leading to sluggish spending, leading to further labor market weakness, etc.

The real fed funds rate is closing in on 3%.

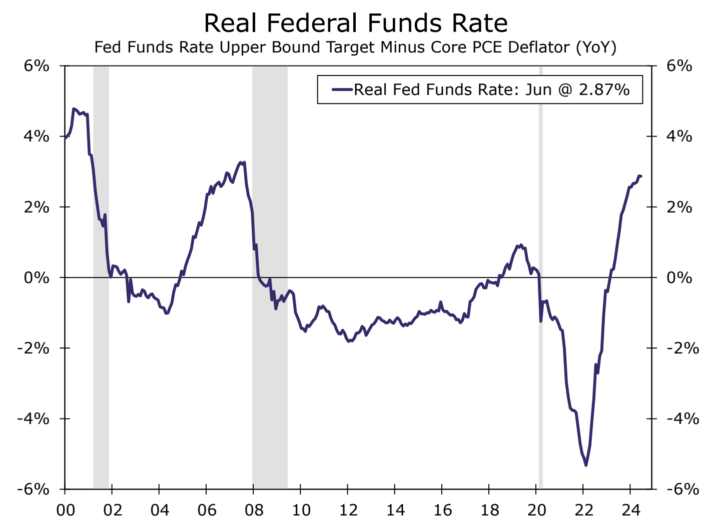
Where is neutral? As we discussed in our recent series on "r-star," the neutral or "equilibrium" interest rate is unobservable. However, many analysts, including us and numerous members of the FOMC, believe that the neutral real fed fuds rate may lie somewhere around 1%. Tacking on a 2% inflation rate implies that neutral in nominal terms may be somewhere around 3%. With the target range for the federal funds forecast currently standing at 5.25%–5.50%, the FOMC likely has 200 bps or so of easing that is needed to get back to the vicinity of neutral. With inflation on its way back to target and with signs of the labor market softening, we believe the FOMC will want to begin the process of returning to neutral as soon as possible.

Figure 3



Source: Federal Reserve Board and Wells Fargo Economics

Figure 4



Source: Federal Reserve Board, U.S. Department of Commerce and Wells Fargo Economics

We will be making some changes to our overall U.S. macro forecast over the next few days, and will be releasing the details later this week in our August U.S. Economic Outlook. We have been forecasting for most of the year that the economic expansion that has been in place since mid-2020 will continue, and that still is our view today. That said, the lackluster pace of hiring in July, combined with other labor market indicators continuing to weaken, implies that income growth and, hence, growth in consumer spending likely will be a bit weaker than we had anticipated a month ago. Although the risk of recession has risen, it still does not exceed 50%, in our view. Part of our relative optimism reflects that aggressive pace of Fed easing that we now envision, which should help to support interest rate-sensitive spending in coming quarters.

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