KPMG Economics

Powell sets sights on salvaging soft landing Mapping the descent in rates

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"The time has come for policy to adjust."

- Chairman Jay Powell, August 22, 2024

Federal Reserve Chairman Jay Powell brought the certainty that financial markets pined for in his annual address at the Jackson Hole Symposium: The Fed is ready to cut, starting in September.

The speech was his most consequential since the short, but solemn speech he delivered on the same stage two years ago. Back then, he pledged to do whatever it took to derail a blistering bout of inflation, even if that meant a recession.

He evoked the spirit of former Fed Chairman Paul Volcker, who broke the back of inflation with two brutal recessions in the early 1980s. He feared that he may need to do the same to derail a bout of post-pandemic inflation.

Two years later, he has set his sights on nailing a soft landing. He signaled that the risks to the outlook were now to the downside and more aggressive rate cuts may be needed. He is trying to avoid a recession.

"The upside risks to inflation have diminished. And the downside risks to employment have increased…We will do everything we can to support a strong labor market as we make further progress toward price stability," he said.

He is not alone in his concerns. Several participants at the July meeting discussed a rate cut and were no doubt emboldened by the sharp slowdown in employment in July.

A key ally for Powell, Governor Chris Waller, agreed regarding the shift in risks. "I believe that the balance of risks is now weighted more toward downside risks to the FOMC's maximum-employment mandate," he argued.

A weaker second half

Real GDP is expected to rise at a 2.1% annualized pace in the third quarter, after rising an upwardly revised 3% in the second quarter. Consumer spending picked up at the start of the quarter, but the housing market slumped. Business investment slowed. Inventories were modestly drained. Government spending held strong, with the end of the fiscal year looming. The trade deficit continued to widen, as retailers and producers scrambled to stockpile imports ahead of potential port strikes on the East Coast on October 1.

Real GDP is forecast to slow to 1.4% in the fourth quarter, in response to earlier rate hikes and the uncertainty surrounding the election. Businesses are particularly hesitant to make large investments until the cloud lifts on the course of policy in 2025 after the election. This is at the same time that Congress has decided to once again punt on a budget. There is some headline risk of a government shutdown, given the fact that no budget has been decided for fiscal 2025, which starts October 1st but a continuing resolution is likely. Government shutdowns are highly unpopular and unlikely prior to the election.

Another showdown over the debt ceiling is possible in January. Congress needs to either lift it or suspend it for longer to prevent a default. The Treasury can buy time for negotiations but the clock is ticking.

The Fed starts cutting. The goal for the Federal Reserve will be to shore up the labor market and create a tailwind for growth with lower rates and inflation in 2025. The fed funds target range is expected to drop from 5.25%-5.5% to 4.25%-4.5%, which is still restrictive, by year-end.

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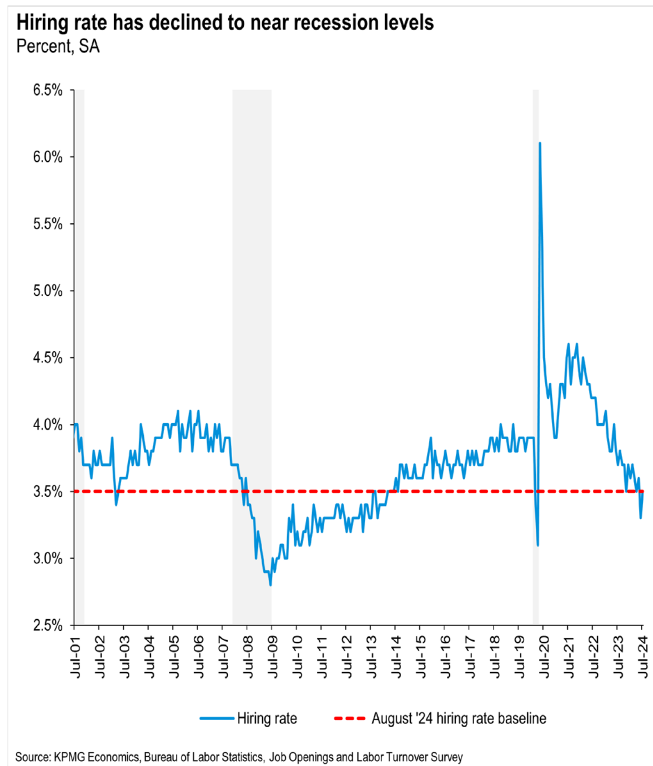
The challenge is that soft landings are rare and as much about luck as skill. We have never achieved one in the wake of an actual bout of inflation. That would be legendary and seal Powell's legacy.

Powell's tenure as Chairman ends in May 2026, when he intends to retire. If he cuts rates and averts a recession, while taming inflation, he will leave the Fed a hero. The wild card is the outcome of the election and its impact on broader economic policies. Those shifts could dramatically alter the trajectory on rate cuts.

This edition of *Economic Compass* examines the recent weakness in the labor market, why concerns about a recession have reemerged and how the Powell Fed is likely to navigate those shifts. Powell is clearly open to a one-half percentage point cut in September. He has allies, but the majority within the Fed is still leaning toward a quarter point.

We expect the Fed to cut short-term rates by a full percentage point by year-end, the same as last month. A half percent cut is a heavy lift for September but possible later this year. The employment data are expected to play a greater role in the Fed's decisions from here on out. The unemployment rate is expected to hit 4.3% by year end.

Chart 1



"Where does that leave us? In a bit of a no man's land, where the Fed waits for the last two pieces of data on inflation and retail sales to see where the consensus falls."

Skating on thin ice

Fragilities in the labor market

The three-month moving average for payroll gains dipped to 116,000 in August from 146,000 in July. That is within the margin of error for the survey and not significantly different than zero.

The unemployment rate ticked down to 4.2% in August from 4.3% in July. Temporary layoffs abated as workers returned to work following Hurricane Beryl. A record-breaking 461,000 workers were unable to work due to bad weather in July. More than a million households in Texas had to deal with floods and power outages during the week of the July employment survey.

The Bureau of Labor Statistics noted that the hurricane was not the sole reason for the weakness in July. We would not have even noticed the disruption if the underlying demand for workers had been more robust.

The "Sahm Rule," an early recession indicator, was breached again in August. That raised another red flag for the Fed that it could risk waiting too long to cut and inadvertently trigger a full-blown recession. Unemployment tends to rise slowly, then rapidly, before it morphs into a vicious cycle of job and spending losses. That would be a larger problem for the Fed.

That is a point that San Francisco Fed President Mary Daly and Chicago Fed President Austan Goolsbee have stressed in recent weeks. "I'm going to try to put a really fine point on it," Daly said prior to the release of the August employment report.

"I am watching it extremely carefully because any added slowing would be unwelcome. And we do not want to wait until we see it because then it's too late," she warned.

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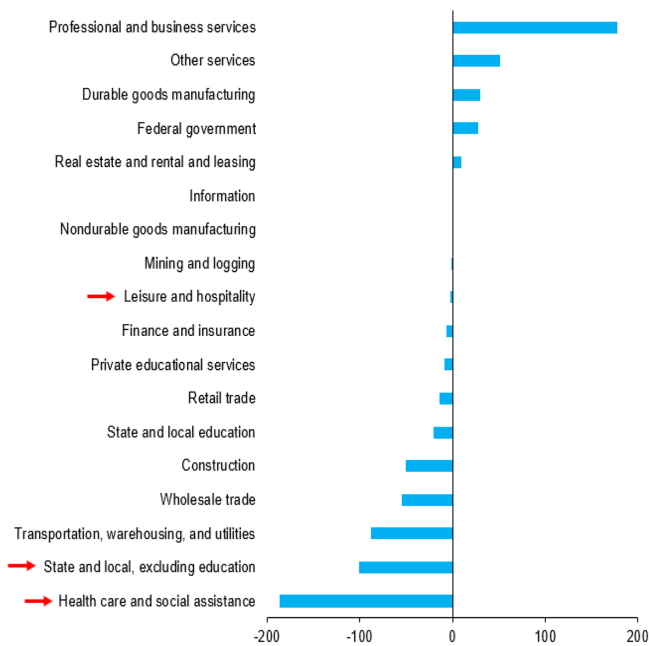
Chart 2



Goolsbee carried the argument further after the report's release. "…[T]here are definite warning signs of things over-cooling," he said.

He argued that the Fed would need a string of rate cuts to avoid a recession. However, he fell short of promising an outsized cut in September due to concerns of pushback against larger cuts by his colleagues.

Chart 1 lays out the pace of hiring in late July. It dipped to the lowest level since the onset of the pandemic. It is rapidly approaching levels more consistent with a recession than an expansion.

Three sectors – state and local governments, healthcare and social assistance, and leisure and hospitality – have accounted for more than 70% of the rise in employment since mid-2023. Those sectors suffered some of the largest declines in job openings in late July. That leaves us with less of a tailwind for employment gains going forward. (See Chart 2.)

The COVID-era stimulus and windfall revenue gains that enabled state and local governments to catch up on hiring post-pandemic have since dried up. Tight margins and financial stress in the healthcare sector are limiting hiring and leaving doctors' offices short-staffed. The ranks of those out on vacation in August dropped to the lowest level for the month since August 2020. That will take the wind from the sails of hiring in leisure and hospitality.

The relay race, which passed the baton from the most to the least interest-rate sensitive sectors, is losing steam. That begs the question of which sector will drive employment gains and whether underlying demand will be enough to continue to absorb those entering the labor market.

More worrisome, the ratio of job openings to job seekers, which is a measure of worker leverage, dropped below the threshold hit prior to the pandemic in late July. That will intensify the downward pressure on wages. (See Chart 3.) Advertised wage gains have fallen back to pre-pandemic levels, while reports of cuts to entry-level wages are on the rise.

Alternative measures of unemployment, which include discouraged workers and those who could only find part-time instead of full-time jobs, have risen. The U6, as it is known, jumped from a low of 6.5% in December 2022 to 7.9% in August 2024. That is one-half percent more than the increase in overall unemployment. The ranks of those forced to accept part-time instead of full-time work due to economic reasons are at the highest level since May 2021.

Those who are categorized as "voluntary" part-time workers have also soared. However, voluntary part-timers include those who cannot work full-time due to childcare problems. That is not exactly voluntary and reveals the Catch-22 that many families face; they are forced to choose between caring and providing for their children.

The ranks who could not work due to childcare problems in August tied the highest level for the month on record. The other instance was August 2020, when many schools were still online.

Some deeper digging into the data reveals that about 90% of those most affected by the childcare crisis are women. Women of color are hit particularly hard, as they dominate the ranks of part-time workers.

This is at the same time that it is taking longer for those who lose jobs to find new jobs. The ranks of those who are unemployed for 15 weeks or longer have risen significantly over the last year.

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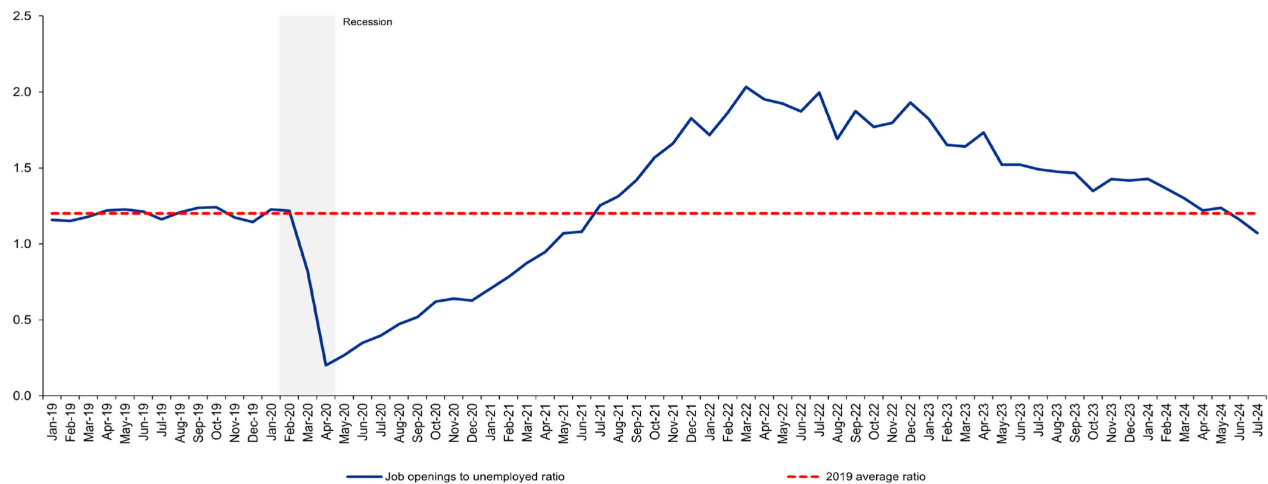
Chart 3



Mapping the descent in rates

The Fed could use the September meeting to catch up and move a half percent on cuts. That would appeal to those who argued for a cut in July.

Some outside of the Fed have argued that a half percent cut may look like the Fed is panicking and upset financial markets. Those fears could be allayed with dissenting votes. There could be more than one dissent if Powell pushes hard for a half percent cut.

The key is to avoid a dissent from those closest to Powell, among the Board of Governors. Former Fed Chairman Paul Volcker resigned after he lost the battle with the Board of Governors to stop the deregulation of the banking industry in May 1987.

Powell would not risk that on his watch. That is why the pivot by Waller was so important prior to the meeting. Dissents by Governors are so rare that the last dissent we saw in response to a rate decision was in 2005.

Waller opened the door to an outsized cut, but not necessarily in September. “I was a big advocate of front-loading rate hikes when inflation accelerated in 2022, and I will be an advocate of front-loading rate cuts if that is appropriate. Those decisions will be determined by new data and how it adds to the totality of the data and shapes my understanding of economic conditions,” he cautioned.

Where does that leave us? In a bit of a no man’s land, where the Fed waits for the last two pieces of data on inflation and retail sales to see where the consensus falls. Both are scheduled to be released prior to the September meeting.

The consumer price index (CPI) hit its lowest annual pace since February 2021 in August. In a recent drop in prices at the gas pump suggests more good news for September.

The core measure of the CPI, which strips out the food and energy components of the index, was stickier. Some of that is due to a sharp improvement in inflation last year. That is largely due to a sharp improvement in inflation last year.

Those “base effects,” as they are known, drop out of the data in January. The math on year-over-year measures gets much better. Core inflation is poised to move much closer to the Fed’s 2% target in early 2025.

Consumer spending picked up in July. A rebound in vehicle sales following a massive cyber attack on dealers in late June. Increased discounting helped spur those gains. Vehicle sales cratered again in August, despite a sweetening of incentives. New vehicles have become a luxury purchase, reserved for households in the top two quintiles of income.

Another red flag is the saving rate, which dipped to 2.9% in July. That was its second lowest level since 2008, the height of the subprime crisis.

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Consumers leveraged their credit cards to keep spending afloat in July. Any additonal weakness in employment would curb those spending gains in the forth quarter.

On net, a half percent cut in rates is possible and probable before year-end. That holds the forecast for rate cuts of one percent by year-end.

What about the election? The Fed does not have a horse in that race. The lags in monetary policy suggest that anything the Fed does now will create a tailwind for 2025.

When pushed on whether the Fed weighed potential policy shifts due to the election, Powell was emphatic. “We absolutely do not do that,” he said. That said, policy shifts post-election could dramatically alter the course of rate cuts.

A surge in tariffs, curbs to immigration and deportations would limit growth and stoke inflation. Those policies in the extreme result in stagflation. That would force the Fed to reverse course, hike rates and trigger a recession.

Threats of price caps are also worrisome, although less concrete. They fuel shortages and unleash unwanted inflation once they are lifted. However, it is unclear how caps would be implemented. “Price gouging” is a vague term and tough to prove, given the spectrum of factors affecting prices up and down supply chains.

Bottom Line

The Fed is ready to cut and will continue to cut through year-end. The only debate will be the size of cuts. Financial markets have already front-run the Fed and priced in at least one percentage point of cuts this year. That seems reasonable, given recent weakness in the labor market and Powell’s desire to achieve a soft landing.

Powell was late to raise rates, for which he has humbly accepted responsibility. He does not want to repeat that mistake by waiting too long to cut. This is personal as well as professional. He does not want workers to endure any more pain than necessary to tame inflation. His legacy depends upon it. That is a powerful motivator.

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Economic Forecast — September 2024												
	2023	2024	2025	2023:4(A)	2024:1(A)	2024:2(A)	2024:3	2024:4	2025:1	2025:2	2025:3	2025:4
National Outlook												
Chain Weight GDP[1]	2.5	2.6	1.8	3.4	1.4	3.0	2.1	1.4	1.7	1.9	1.8	1.9
Personal Consumption	2.2	2.5	2.0	3.3	1.5	2.9	3.2	1.9	1.7	1.7	1.6	1.9
Business Fixed Investment	4.5	3.9	2.8	3.7	4.4	4.6	4.0	2.2	2.6	2.7	2.2	2.0
Residential Investment	-10.6	3.1	-0.4	2.8	16.0	-2.0	-7.7	-6.5	0.0	4.8	6.0	6.6
Inventory Investment (bil $ '17)	44	55	72	55	28	69	66	57	57	69	80	82
Net Exports (bil $ '17)	-928	-1017	-1058	-919	-960	-1010	-1049	-1050	-1049	-1055	-1062	-1065
Exports	2.6	2.4	3.8	5.1	1.6	1.6	4.1	3.9	4.0	3.9	3.7	4.0
Imports	-1.7	4.4	3.8	2.2	6.1	7.0	7.5	2.8	2.7	3.5	3.5	3.2
Government Expenditures	4.1	3.0	0.9	4.6	1.8	2.7	1.9	1.0	0.6	0.5	0.5	0.4
Federal	4.2	2.2	1.1	2.4	-0.2	3.3	2.0	1.0	0.5	0.7	0.9	0.9
State and Local	4.0	3.5	0.8	6.0	3.0	2.3	1.8	1.0	0.6	0.4	0.2	0.2
Final Sales	2.9	2.5	1.7	3.9	1.8	2.2	2.1	1.6	1.7	1.7	1.6	1.9
Inflation												
GDP Deflator	3.6	2.4	2.3	1.6	3.1	2.5	2.0	2.1	2.2	2.4	2.6	2.6
CPI	4.1	2.9	2.1	2.7	3.8	2.8	1.2	2.3	1.8	2.2	2.5	2.9
Core CPI	4.8	3.3	2.4	3.4	4.2	3.2	1.9	2.4	2.6	2.4	2.5	2.4
Special Indicators												
Corporate Profits[2]	5.1	3.8	2.9	5.1	6.4	8.0	6.7	3.8	5.6	4.9	3.4	2.9
Disposable Personal Income	4.1	1.4	3.0	0.9	1.3	1.0	2.1	2.1	4.2	3.2	3.2	3.1
Housing Starts (mil)	1.42	1.34	1.37	1.48	1.41	1.34	1.31	1.31	1.34	1.37	1.38	1.41
Civilian Unemployment Rate	3.6	4.1	4.3	3.8	3.8	4.0	4.2	4.3	4.3	4.3	4.3	4.3
Total Nonfarm Payrolls (thous)[3]	2936	2120	962	617	771	597	381	371	235	308	225	194
Vehicle Sales												
Automobile Sales (mil)	3.1	2.9	2.9	3.1	2.9	2.9	2.9	2.9	2.9	2.9	2.9	2.9
Domestic	2.3	2.0	2.0	2.3	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Imports	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9
LtTrucks (mil)	12.4	12.6	12.8	12.6	12.4	12.7	12.6	12.8	12.8	12.8	12.8	12.8
Domestic	9.9	9.9	10.0	9.9	9.8	10.0	9.8	10.0	10.0	10.0	10.0	10.0
Imports	2.5	2.7	2.8	2.7	2.5	2.7	2.8	2.8	2.8	2.8	2.8	2.8
Combined Auto/Lt Truck	15.5	15.5	15.6	15.7	15.3	15.7	15.5	15.6	15.6	15.6	15.6	15.7
Heavy Truck Sales	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Total Vehicles (mil)	16.0	16.0	16.1	16.2	15.8	16.1	16.0	16.1	16.1	16.1	16.1	16.1
Interest Rate/Yields												
Federal Funds	5.0	5.2	3.9	5.3	5.3	5.3	5.3	4.7	4.2	3.7	3.2	2.9
10 Year Treasury Note	4.0	4.1	3.4	4.4	4.2	4.4	4.0	3.7	3.6	3.4	3.3	3.1
Corporate Bond BAA	5.9	5.8	5.5	6.2	5.8	6.0	5.9	5.7	5.6	5.6	5.5	5.4
Exchange Rates												
Dollar/Euro	1.08	1.09	1.10	1.08	1.09	1.08	1.09	1.09	1.10	1.10	1.10	1.10
Yen/Dollar	140.5	149.4	142.8	147.8	148.6	155.9	149.0	147.0	145.0	144.0	142.0	140.0

[1] in 2023, GDP was $22.4 trillion in chain-weighted 2017 dollars.

[2] Corporate profits before tax with inventory valuation and capital consumption adjustments, quarterly data represents four-quarter percent change.

[3] Total nonfarm payrolls, quarterly data represents the difference in the average from the previous period. Annual data represents 4Q to 4Q change.

Quarterly data are seasonally adjusted at an annual rate. Unless otherwise specified, $ figures reflect adjustment for inflation. Total may not add up due to rounding.

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