Monthly economic outlook for Private Equity

16 December 2024

A more cautious Federal Reserve Bank could restrain other central banks

The Federal Reserve Bank has embarked on its path of rate cuts, bringing the federal funds rate down 75 basis points from where it had been in August[i]. Additional rate cuts are still expected, but the pace of cutting is likely to be slower than previously anticipated. Expectations of a more hawkish Federal Reserve Bank are contributing to the strength of the US dollar and stymying other central banks' efforts to bring their own interest rates lower.

Inflation in the United States appears stuck above the Federal Reserve Bank's 2% target. The Federal Reserve Bank's preferred measure of inflation picked up in October, with headline inflation at 2.3% on a year-ago basis, up from 2.1% the previous month[ii]. Core inflation, which excludes food and energy, accelerated to 2.8%. Perhaps more worrying is that core prices grew by an annualized 3.3% from the previous month, the second consecutive month of growth above 3%[iii]. Part of the problem is that services inflation has accelerated to 3.9% on a year-ago basis in October[iv]. Services are typically more labor-intensive, which means that rising wage costs are more frequently passed onto consumers through higher prices. Wage growth in service-providing industries has accelerated from 3.4% on a year-ago basis in July to 4.0% in November.[v] Strong labor productivity growth can offset some of the inflationary pressure in the economy. Fortunately, labor productivity in the United States has been strong, growing more than 2% from a year earlier for five consecutive quarters[vi].

Changes to United States economic policy could also affect inflation and the path of interest rates. Policies such as tariffs, tax cuts, and immigration are expected to increase price pressures. Whereas deregulation would reduce business costs and ease price pressures[vii]. Bond markets appear to expect that the balance of economic policy will be modestly inflationary. The yield on the 10-year treasury bond increased 80 basis points between the middle of September and early November. However, the yield pared back 20 basis points of those gains since then[viii]. Similarly, the futures market's implied probability of four rate cuts next year has fallen.

Higher long-term rates in the United States have had implications in foreign exchange markets. The Japanese yen, the euro, the Mexican peso, and the South Korean won all depreciated more than 5% between the middle of September and the last week of November[ix]. Most major currencies depreciated at least slightly over this time period. A weaker currency raises the cost of imports, which can contribute to higher consumer prices, while increasing demand for exports, which puts pressure on capacity. Such events may prevent central bankers from cutting rates more quickly as they seek to support the value of their currency.

This dynamic is particularly important for European policymakers. Political turmoil in France and Germany has been linked to political disagreements over government budgets[x]. Lower interest rates in these countries could help alleviate some of the cost pressures that these governments are facing. This would likely allow for less painful budget tightening in the case of France, and less onerous fiscal expansion in the case of Germany.

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Endnotes

[i] Federal Reserve Board via Haver Analytics
[ii] US Bureau of Economic Analysis via Haver Analytics
[iii] Ibid
[iv] Ibid
[v] US Bureau of Labor Statistics via Haver Analytics
[vi] Ibid
[vii] https://www.piie.com/blogs/realtime-economics/2024/how-will-trumponomics-work-out
[viii] Federal Reserve Board via Haver Analytics
[ix] Ibid
[x] https://www.dw.com/en/germany-france-struggle-to-secure-budgets-risk-uncertainty/a-70781847