

Will the Fed's Desire for Neutral Spark Conflict?

by James St. Aubin, CIO of Ocean Park Asset Management

- The Federal Reserve is grappling with where the “neutral rate” stands and that has the potential to reduce the number of rate cuts over the next year versus market expectations.
- As the Fed tackles the right level of the neutral rate, the market may be unwisely underestimating the potential impact.

There may be a confrontation brewing between the Federal Reserve and the market and ironically, it's over something neutral. I'm talking about the neutral rate, of course.

For those who don't know, the neutral rate references the level at which the central bank's fed funds rate neither limits nor stimulates economic growth, while inflation and employment remain relatively stable.

The neutral rate is a highly theoretical concept. Yet, it could result in a very real tension between the market and the Fed and that's never pretty. So, how'd we get here?

Transparency has its price.

It started at the Fed chairman's press conference after the central bank's late October meeting where it made a widely expected 25 basis-point rate cut. What mattered was what chairman Jerome Powell said about what lies ahead.

Even before Powell commented on the neutral rate, he had already poked the market at the press conference by casting doubt on the prospects of a December cut.

Responding to a question about whether he was uncomfortable about market expectations for a cut, Powell emphatically stated, “a further reduction in the policy rate at the December meeting is not a foregone conclusion.” Powell's response reflected the absence of relevant data due to the government's recent shutdown and a wide dispersion of views among the Fed's voting members.

Never mind the journey. It's about the destination.

This cautious stance reflects deeper uncertainty about the Fed's destination, not just its next move. And when I say “destination,” I mean the neutral rate.

The fed funds targeted range is now 3.75%-4.00% and the Federal Open Market Committee's (FOMC) Summary of Economic Projections (SEP) is estimating 3% as the long-term neutral rate. The question becomes: how much confidence does the FOMC (comprised of the Fed's voting members) hold in the SEP view?

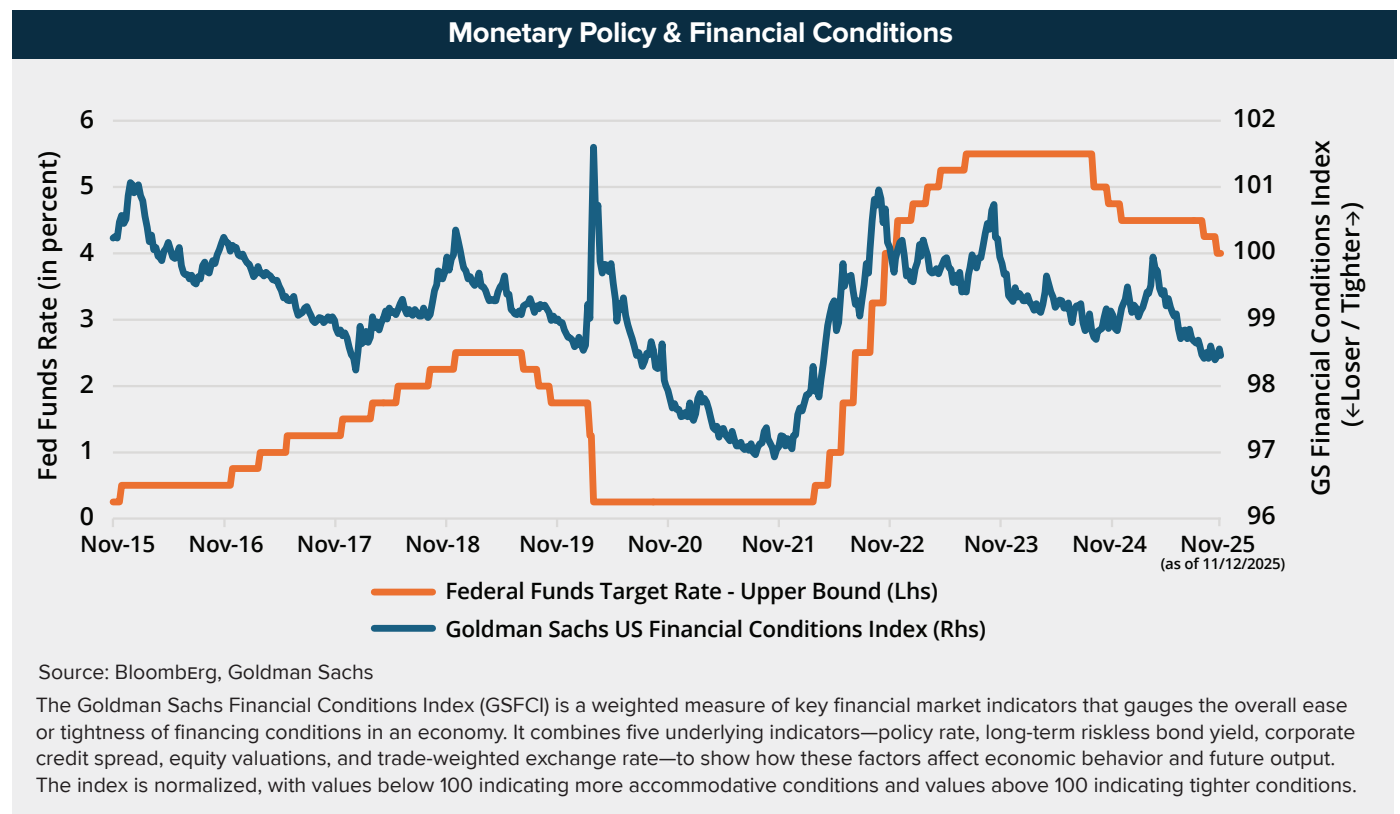
Powell went out of his way to note in the press conference that there is a range of expectations for the neutral rate, declaring:

"...many estimates of the neutral rate live in the 3% to 4% area, you're there now, you're above the median number for the Committee, but I think there are people on the Committee who have higher estimates of the neutral rate."

To reiterate, the neutral rate, also known as “r-star,” is an unobservable theoretical concept, and it’s the assumed fed funds rate that neither stimulates nor restricts economic activity. Academic economic models will attempt to estimate the equilibrium rate of interest with questionable precision. In practice, empirical judgment is the ultimate guide. And since monetary policy operates through financial conditions, the prevailing view of where the neutral rate lies should be tested against what financial conditions are telling us.

The stage is set.

Consider the backdrop. Even though inflation remains stubbornly above the Fed’s 2% target, financial conditions, as measured by various indices which track indicators like stock market, credit spreads and exchange rates, indicate an accommodative stance. Yet, the Fed still characterizes current monetary policy as restrictive. The apparent contradiction between perceived restrictive policy while financial conditions signal the opposite is precisely the puzzle Powell is addressing.



The fed funds futures market is pricing in three to four more rate cuts through early 2027, which roughly aligns with the last SEP and appears to be comforting to investors. However, if the FOMC ultimately determines the neutral rate is higher than the current 3% estimate, that's when a clash between the central bank and the financial markets will emerge.

There could be a repeat of the 2018 Fed vs. market standoff. That's when Powell's "autopilot" comment about future rate hikes rattled investor confidence and sent the S&P 500 Index to the brink of bear market territory. The Fed ultimately backed down.

Is the market in denial?

So far, the market has taken Powell's questioning of the neutral rate in stride, perhaps interpreting it as mere cautious hedging. But could that be wishful thinking?

Will the market's expectations for further meaningful easing end up being misplaced?

For investors, the takeaway is straightforward: focus less on individual rate decisions and more on the Fed's framework for the neutral rate of interest. If Powell continues to reinforce the idea that the economy can withstand higher rates, his caution will likely prompt more defensive positioning and those with strong risk management will be thankful.



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