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Fed's Dual Mandate (Inflation & Growth): Which Part Matters the Most?

a.k.a. More Cuts Need to be Priced into the Curve

Summary Extract:

- The Fed is stuck between a 'rock and a hard place', as it worries about higher inflation and potentially weaker growth.
- The growth outlook for the US economy, though, is already deteriorating Real income growth is slowing; job creation is weaker than the recent NFP data suggests; while wage growth is slowing (and set to continue to slow).
- Inflation pressures have also now largely dissipated. Traditional inflation drivers (labour, oil, etc) as well as most measures of inflation, point to low/limited price pressures. The tariffs tax, meanwhile, is not the same inflationary impulse as the one in 2020/21 (driven by aggressive money creation).
- As such, the Fed doesn't need to be cautious (and slow to react to weak growth) and should accelerate its rate cutting plans.

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Fed's Dual Mandate (Inflation & Growth): Which Part Matters the Most?

a.k.a. More Cuts Need to be Priced into the Curve

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Introduction: Stuck 'Between a Rock & a Hard Place'

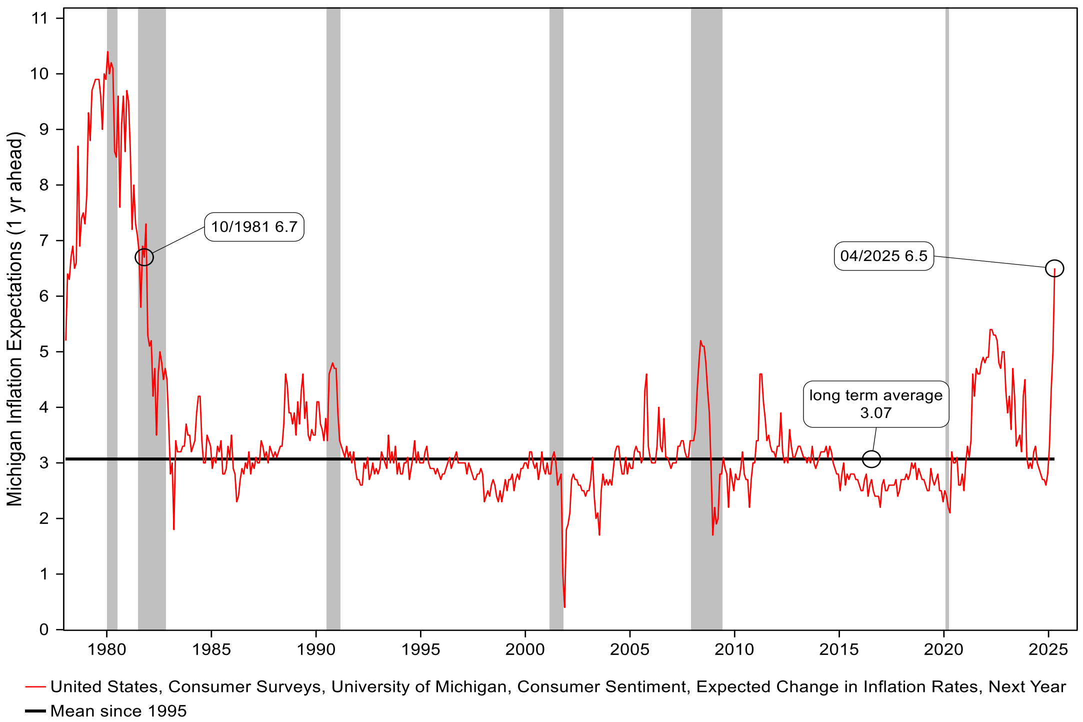
"Don't think we need to be in a hurry to adjust rates"; "can't say which way this will shake out"; "Fed may find its dual mandate goals in tension"; "risk of higher unemployment and higher inflation have risen"

Source: Fed's last press conference, 7th May 2025, Chair Powell quotes

The Fed, in its own mind, is 'stuck between a rock and a hard place'. On the one hand, policy remains (modestly) restrictive, although the "economy is (purportedly) still in a solid position". On the other hand, they're concerned about the impact of tariffs on inflation (especially given the sharp upward spike in 'inflation expectations').

Indeed, as the Michigan survey demonstrated, 1 year inflation expectations have spiked sharply, i.e. to 6.5% in the past 3 months, their highest since early 80s (fig 1); while the 5 year expectations are at their highest since the early '90s.

Fig 1: Michigan 1 year inflation expectations shown with US recessions



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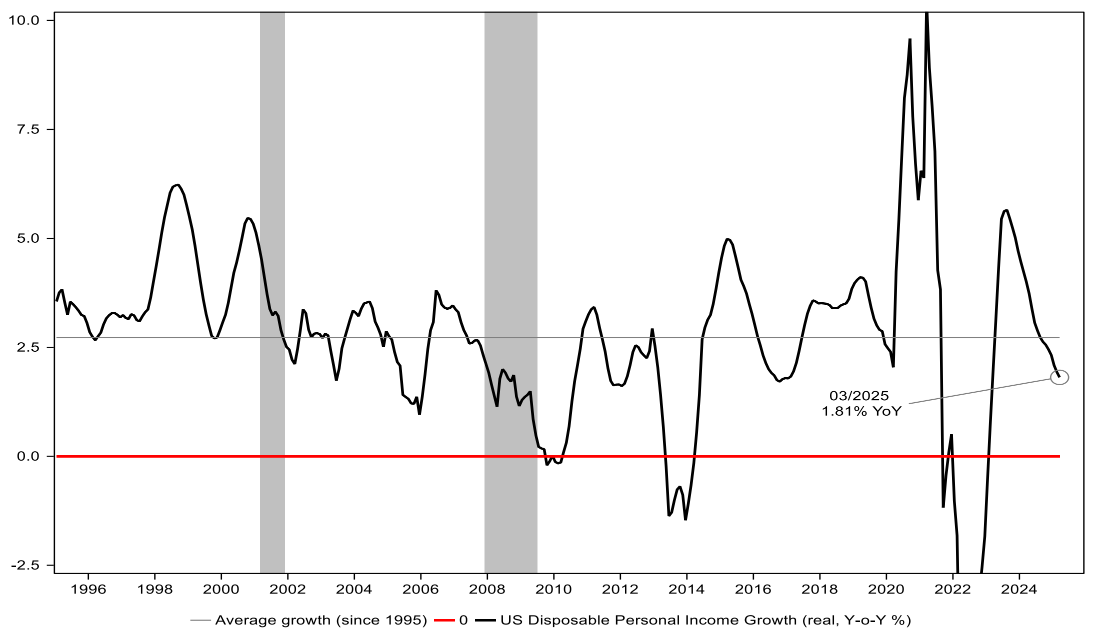
Because current central bank economic forecasting models include a component for 'inflation expectations', the Fed, in its own eyes, remains stuck. That is, if it cuts rates too soon, it risks stoking those expectations and losing 'inflation fighting credibility' as a result. If it's too late, though, growth and employment will suffer.

For 6 key reasons, we think the Fed is looking at the wrong metrics. The evidence is growing that the US economy is slowing; while inflation is already beaten & mostly, therefore, in the rearview mirror. Added to that, tariff hikes are equivalent to a VAT tax hike, like we've seen previously in Japan or the UK, and, as such, their main effect is akin to a fiscal tightening (i.e. into an already slowing economy).

As we have laid out in prior research, the US has a **soft underbelly of growth**. That is, significant parts of the US economy are already feeling the effects of tight money (e.g. as illustrated by weak housing activity). As DOGE continues its work, fiscal policy looseness is dissipating and, as a result, exposing that soft underbelly.

Fig 2: Real disposable income growth (YoY %)



Source: Longview Economics, Macrobond

All of this **implies that the Fed needs to cut rates** and market expectations need to change (i.e. price more cuts into the front end of the curve). As the Fed starts to accelerate/realise that need (i.e. that the growth part of the mandate is the issue), then the curve should steepen further and do so via a 'bull steepening', i.e. with lower 10 year yields (as opposed to the recent phase of a bear steepening, albeit the progress of the tax cutting package in Congress needs to be watched closely in that respect – see 'key risks' section at end). Our 6 reasons for this expectation are laid out below (section 2).

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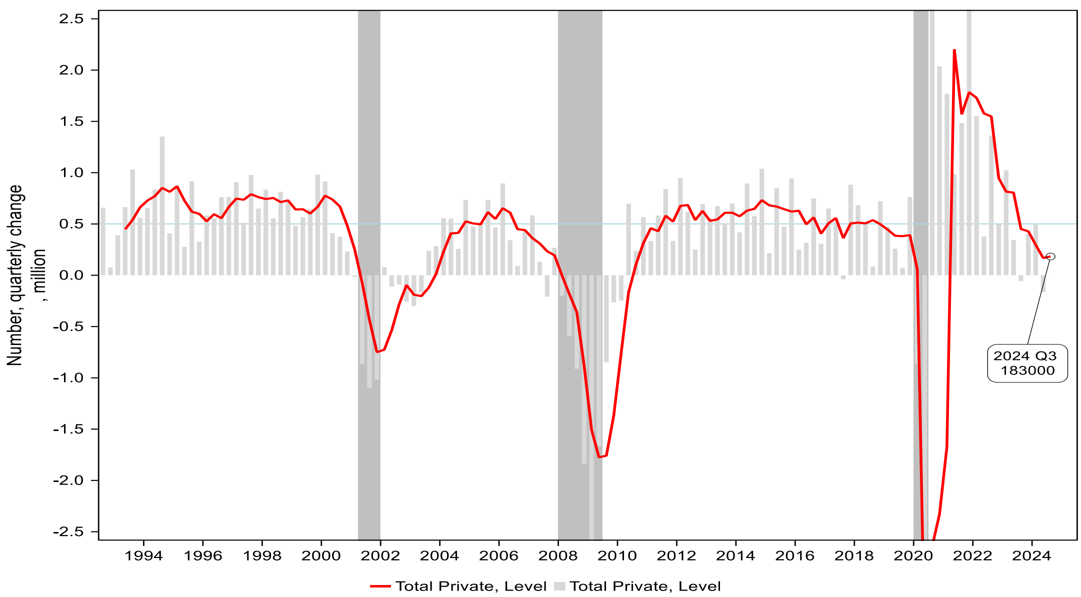
Section 2: Six Key Reasons the US Economy is Soft

1. Real disposable household income is growing at below average rates. As per official (BEA) PCE personal income and spending data, last month real disposable income growth slowed to 1.81%, its lowest rate (other than the pandemic) in over a decade. As fig 2 shows, slowdowns below average levels (i.e. below 2.7% annual growth) usually occur during mid-cycle slowdowns (or recessions). Those phases of economic weakness typically push the Fed to change its monetary policy stance (and ease policy).

We also produce an adjusted real income growth measure for the US economy (adjusting for non-cash items included in the PCE data, and adjusting for actual mortgage payments rather than imputed rental values). On this measure, growth is also below average (at 2.5% latest data point versus the long term average of 2.8%). A weak labour market (see below) and slowing wage inflation (see below) are likely to drive further weakness in real income growth (at least in the near term).

2. The **labour market is slowing** – and job creation is probably weaker than the official nonfarm payroll data suggests. The quarterly census of employment and wages data (for Q3, i.e. QCEW*), for example, was published earlier this month (7th May). It comes out with a 7 month lag relative to the monthly nonfarm payrolls data but has a much higher accuracy (it's also one of the key inputs for the annual benchmark payroll revisions of the NFP data).

Fig 3: Quarterly job gains/losses (QCEW data, quarterly RoC, number)



Source: Longview Economics, Macrobond

*NB this survey covers more than 95% of US jobs and is one of the key inputs into the annual benchmark revisions. The data includes government employees as well as private sector workers.

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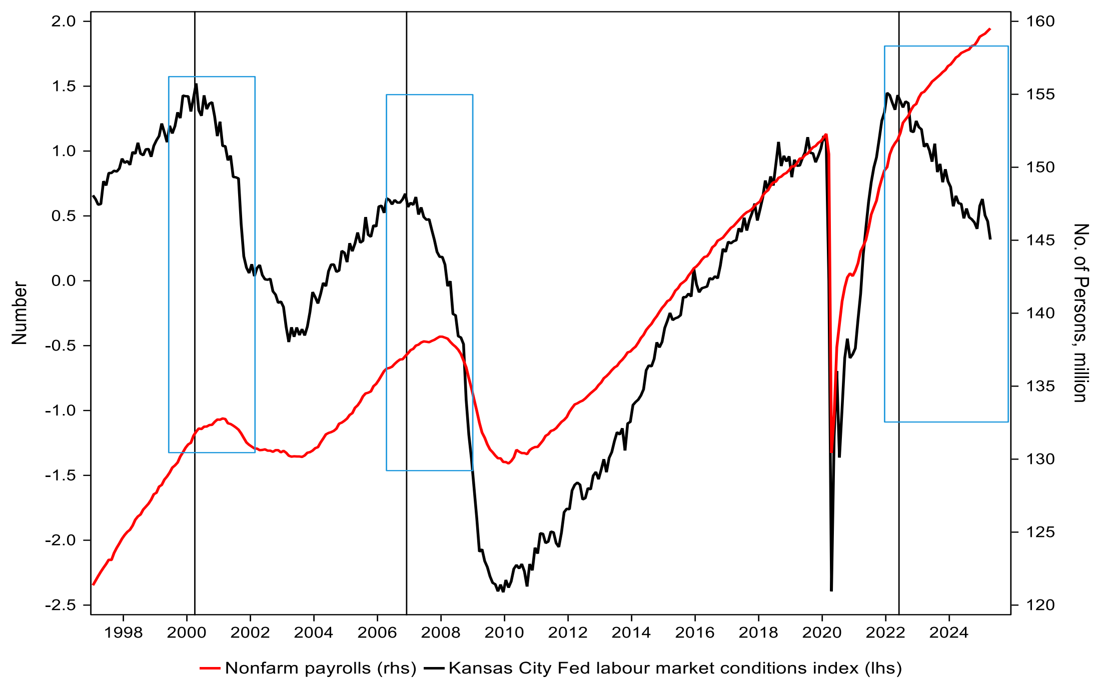
According to the latest data, job creation in Q3 2024 was negative by 1k relative to Q2 2024 (after -163k in Q2/Q1). The four quarter smoothed average is slowing and running at +183,000, its weakest since 2010 (fig 3).

Added to that, most labour market indicators (i.e. which look at the strength of the jobs market) point to further weakness ahead (figs 9 – 13). The Kansas City LMCI (Labour market conditions index** - fig 4), for example, has been trending down for the past 2 years, although non-farm payroll data hasn't, as yet, rolled over; overtime hours worked are at low levels (averaging 3.6 hours – one of their lowest levels in 25 years outside recessions); the average work week is on 34.3 hours (close to non-recessionary lows of the past 20 years); blended ISM employment indices are on 50 (on a 6 month smoothed basis); the number of people unemployed for 27 weeks or more has been ticking higher for the past two years; whilst permanent job losers have also been ticking up. In other words, whilst employment isn't collapsing (as it would in a recession), it remains weak (around the edges) – and probably weaker than the NFP data suggests.

It's also worth noting that the unemployment rate, while low at 4.2%, is above its recent lows of 3.4% (in April 2023), while the labour force participation rate at 62.6% is close to 1pp below its pre Covid (most recent) high at 63.3%. Both factors, therefore, point to some (modest) level of slack in the labour market.

Fig 4: Kansas City Fed LMCI** vs. US non farm payrolls (total employed)



Source: Longview Economics, Macrobond

**NB The Kansas City Fed Labor Market Conditions Indicators (LMCI) are two monthly measures of labour market conditions based on 24 labour market variables. One indicator measures the level of activity in labour markets and the other indicator measures momentum in labour markets.

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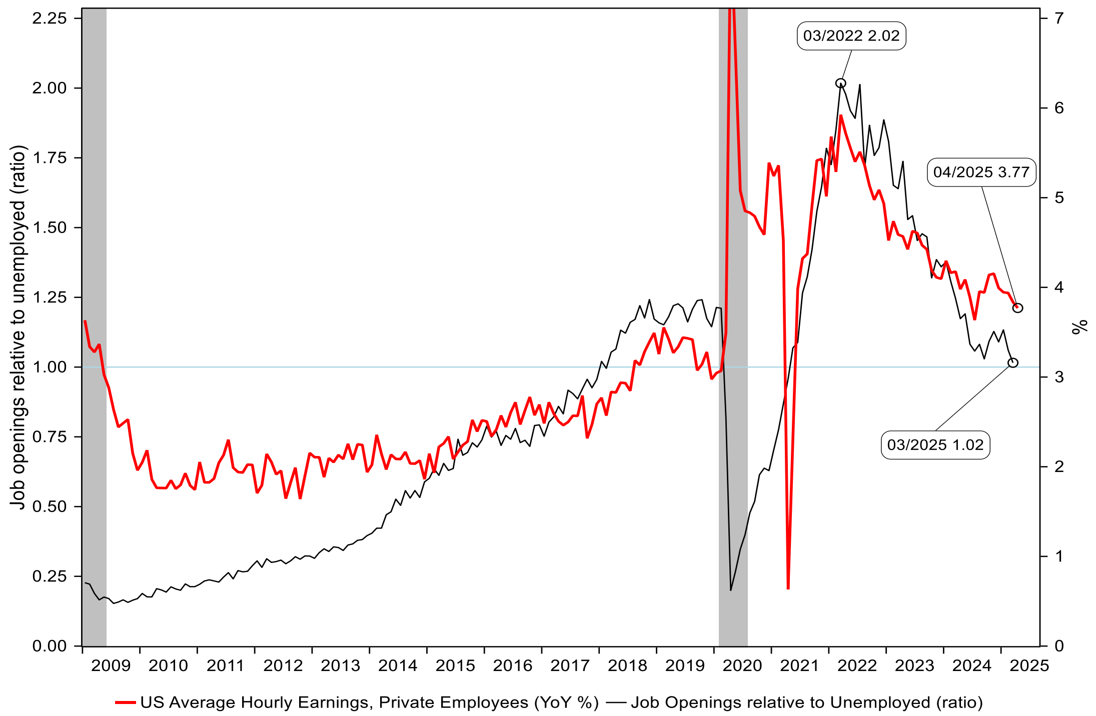
3. Wage Inflation is Slowing: Weak payroll growth, coupled with modest levels of slack in the labour market, are driving that **slowing wage inflation trend**. Wage inflation peaked mid-2022, and has steadily slowed since then (as per ECI data, fig 14). Softness in the economy and slack in the labour market suggest that that slowing trend should continue. Average earnings (wage inflation) data is exhibiting the same underlying trend. As fig 5 shows, there's a strong correlation between various key labour market indicators (like the LMCI & 'jobs plentiful less jobs hard to get') and wage inflation. Hence continued labour market softness should translate into lower wage inflation.

Fig 5: Job openings rel. to unemployed vs. average hourly earnings (YoY %)



Source: Longview Economics, Macrobond

4. Actual inflation is already (anyhow) low: Whilst headline inflation came in at 2.3% Y-o-Y yesterday, with core inflation of 2.8% (Y-o-Y), underlying measures of inflation are more benign. Core inflation, excluding shelter, was 1.8% YoY in April (fig 6); median annual inflation was 1.6% Y-o-Y (fig 15); while monthly median inflation was 0.02% (close to zero, fig 16); and producer price inflation (final demand/next update tomorrow) was below 1% (fig 17). Apart from US shelter inflation, therefore, (most of which is an artificial, imputed price), US inflation is essentially back within its target range.

Furthermore, **key inflation drivers (and inputs) are also already at low levels and/or trending lower.** The oil price, for example, is down 12% YTD (& 22% Y-o-Y, fig 19). Baltic freight rates (global shipping transportation rates) are at low levels (fig 18), wage inflation (as highlighted above) is falling and below its key 4% – 4.5% level (which is consistent with 2% inflation, assuming 2 – 2.5% productivity growth); while house prices are running at around 5% Y-

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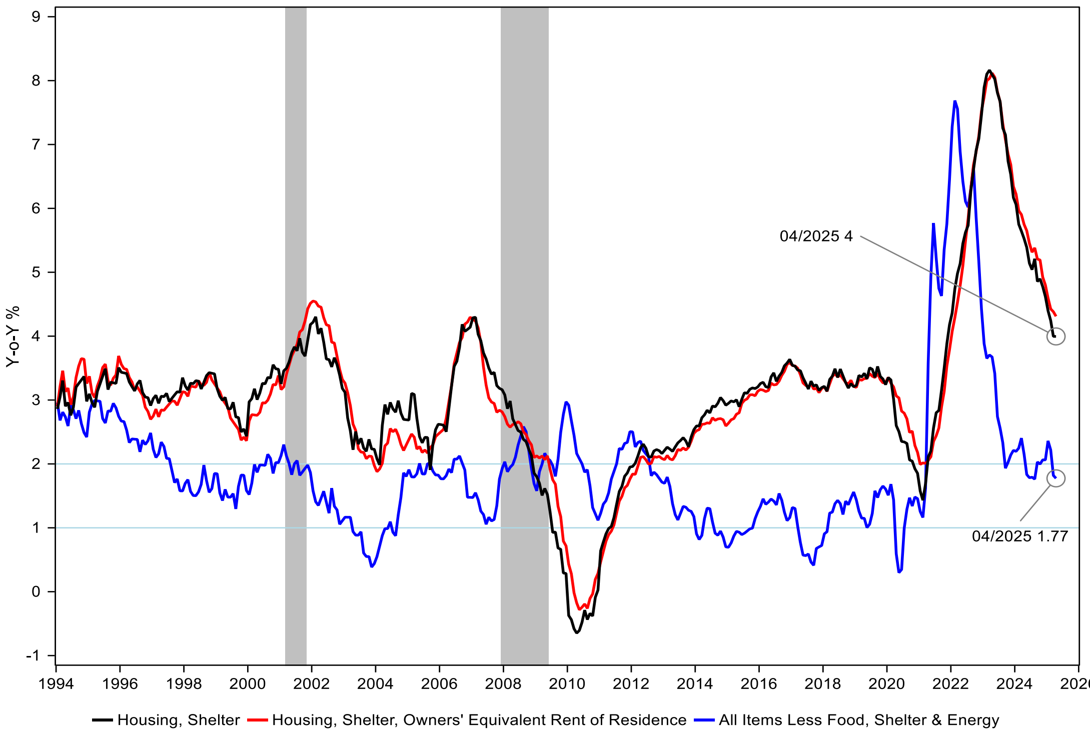
o-Y and food prices (i.e. the S&P GSCI agricultural and livestock index) are up only 1.3% Y-o-Y (i.e. effectively zero).

Fig 6: US core inflation (ex. shelter) vs. shelter inflation (both Y-o-Y %)



Source: Longview Economics, Macrobond

5. **Housing**, meanwhile, is also under pressure held back by high bond yields and mortgage rates. Reflecting that, while mortgage applications (for purchase only) are up on an annual basis, they are barely above 40 year lows (fig 23). The Michigan house buying conditions index is also close to record multi decade lows (fig 24), while activity levels are weak (existing home sales, for example, are close to their 2007 - 09 lows***).

6. Finally, **'Tariffs' are a tax on the consumer**, although not all of the tariff will fall on the consumer. Our estimates (see 2nd May 'Longview on Friday' for detail) are that around $151 billion will fall on the consumer (with domestic and foreign businesses, and substitution effects, picking up/affraying the rest). That, however, is still around 0.6% of income. Given real income growth is already weak, this added 'tax' will further undermine consumption trends.

Conclusion: The Fed is biding its time. The growth outlook for the US economy, though, is deteriorating whilst inflation pressures have now largely dissipated. Traditional inflation drivers (labour, oil, etc) as well as most measures of inflation, point to low/limited price pressures. Traditional growth drivers, meanwhile, are showing signs of weakness, which is set to worsen as the 'tariffs tax' hits consumers. The likelihood of a mid-cycle slowdown is growing (the recession risk is present but not our central case) and the Fed is

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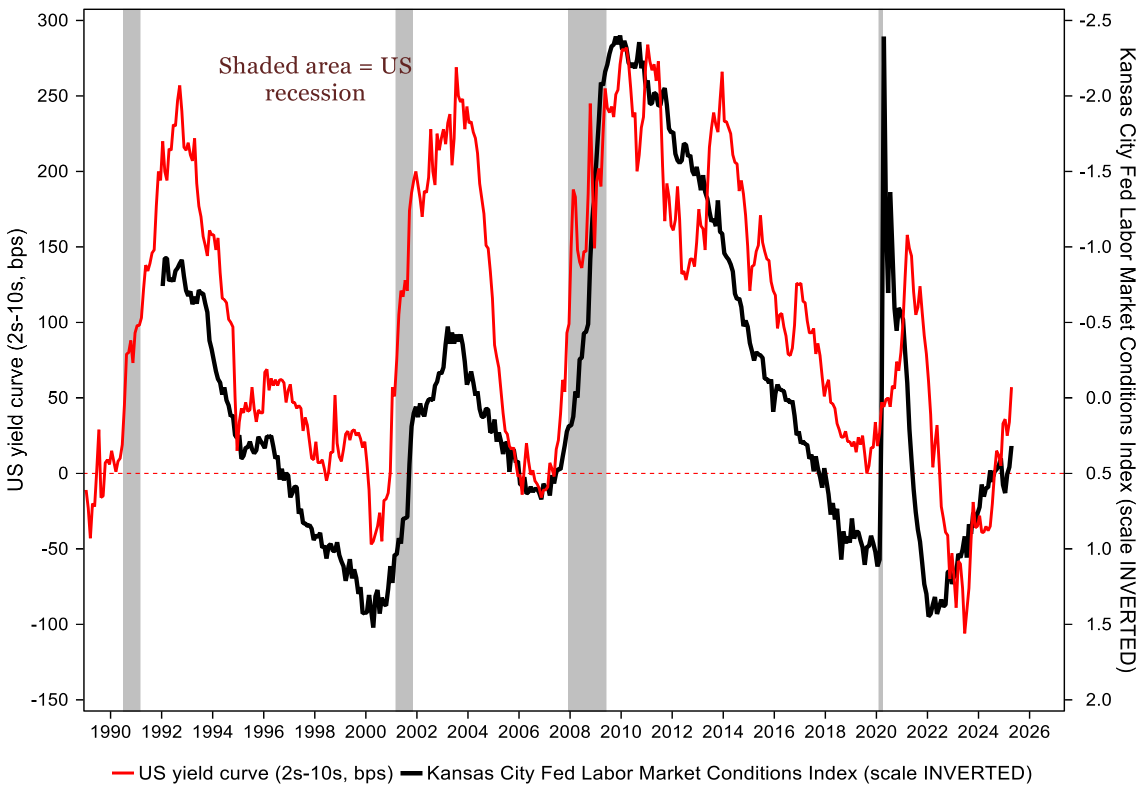
behind the curve. The tariffs tax is not the same inflationary impulse as the one in 2020/21 (driven by aggressive money creation). As such, the Fed doesn't need to be cautious (and slow to react to weak growth) and should accelerate its rate cutting plans.

The circle of the weak labour market, the need for more rate cuts and money supply growth, and an expected continued curve steepening is neatly squared with the two charts below (figs 7 & 8). We expect to publish a follow up trade recommendation over coming days (on either rates or the yield curve).

Fig 7: Kansas City Fed LMCI (inverted) vs. yield curve steepness



Source: Longview Economics, Macrobond

***NB new home sales transaction levels are better, at around mid-range levels (relative to history). In large part, that reflects the (mortgage) discounts being offered by builders. Overall, though, it's a much smaller market than the 'existing home sales market' (i.e. in terms of number of transactions per annum).

Key factors to watch and key risks to this trade include the progress in the fiscal tax cutting talks. The discussions in Congress continue to move forward. Bessent described them earlier this week as "(tax bill) moving better that I could have imagined". The key is how much is paid for with tariff revenue and spending cuts. A large fiscal loosening would undermine the expectation of a bull steepening (although wouldn't undermine the steepening idea, per se). The progress and emerging shape of this bill, therefore, needs to be monitored closely.

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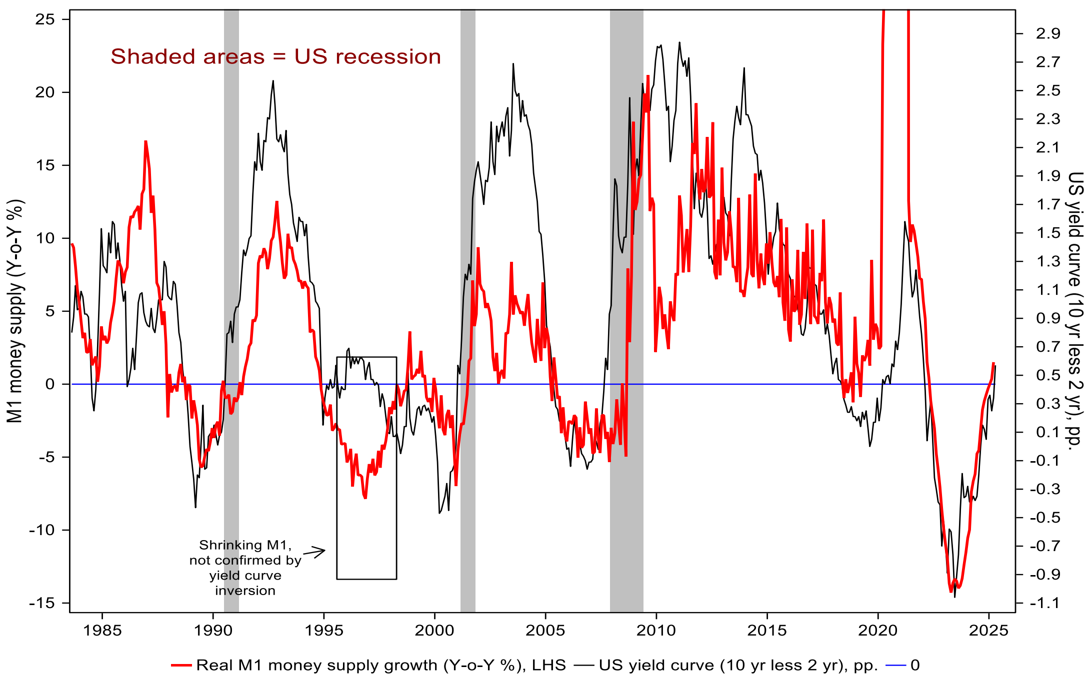
Fig 8: Real M1 money supply growth vs. yield curve steepness



Source: Longview Economics, Macrobond

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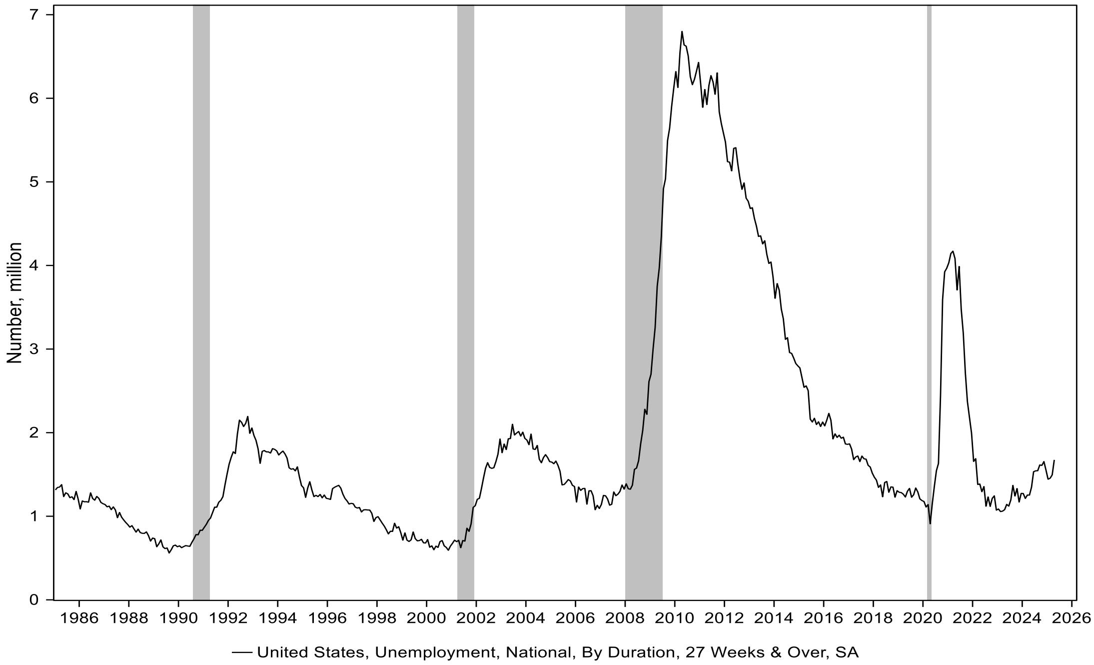
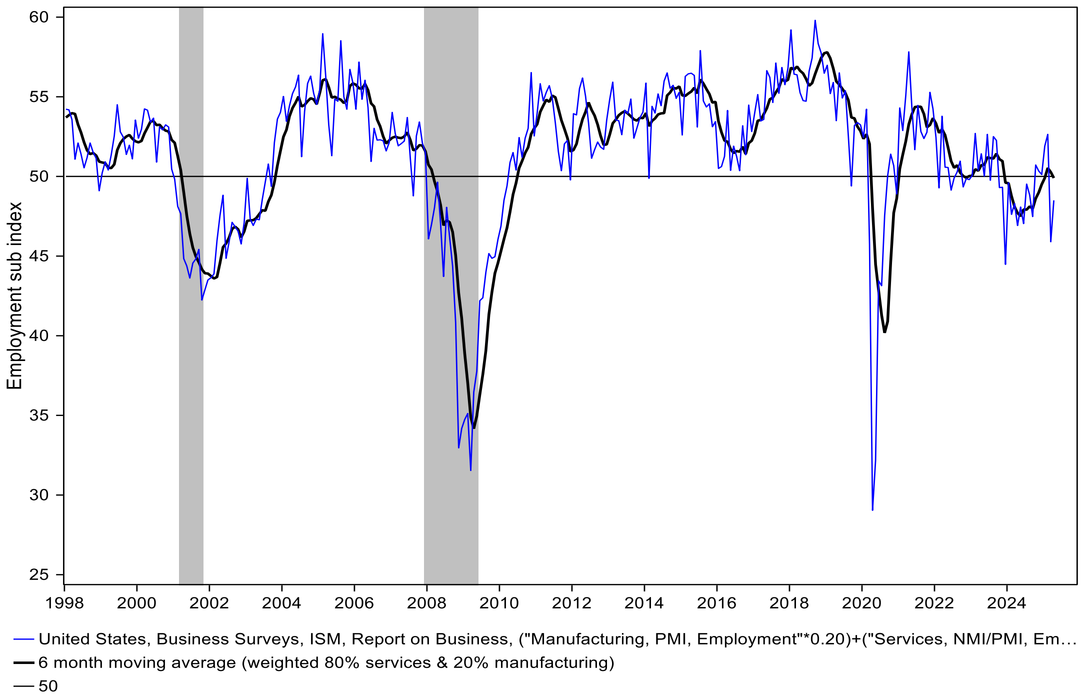
Appendix 1: Labour Market Charts

Fig 9: Unemployed for 27 weeks or more



Source: Longview Economics, Macrobond

Fig 10: Blended ISM employment indices (weighted 80%/20%)



Source: Longview Economics, Macrobond

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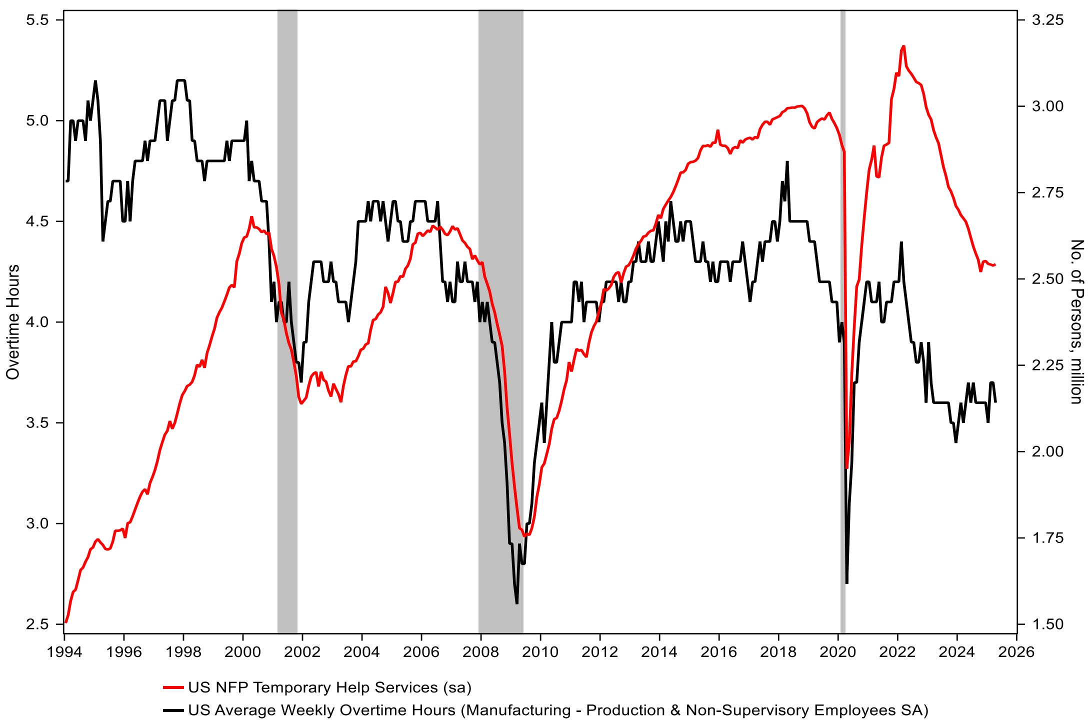
Fig 11: Manufacturing overtime hours worked & temporary help employees



Source: Longview Economics, Macrobond

Fig 12: Average weekly hours worked (per week, private employees)

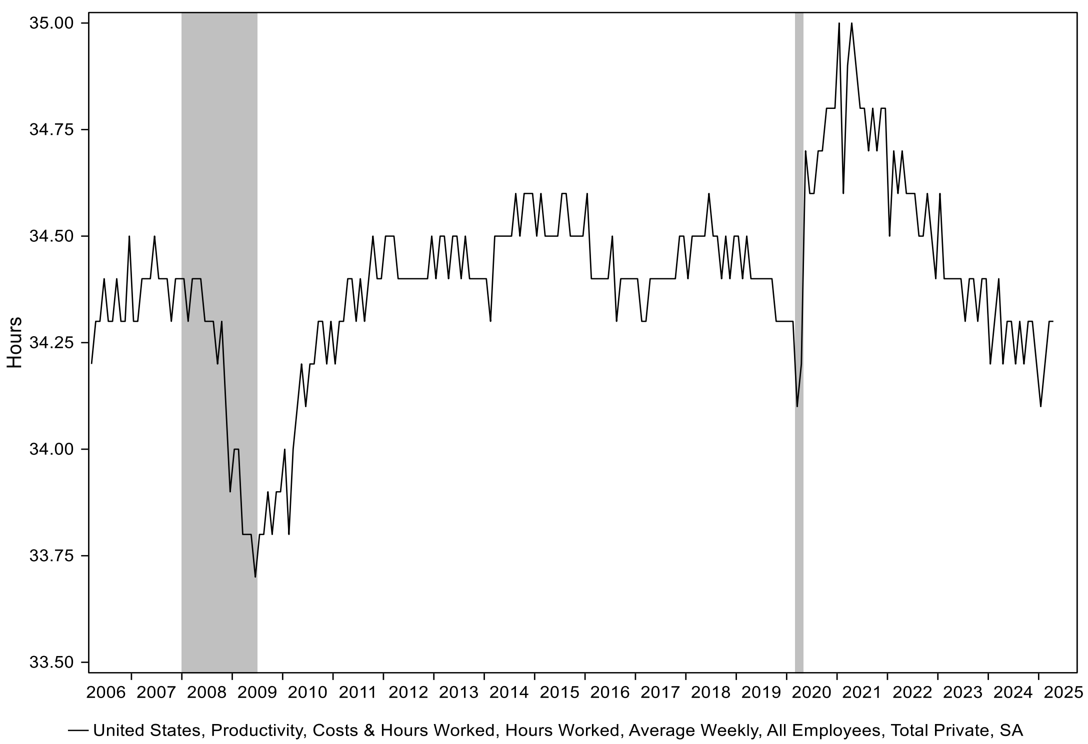


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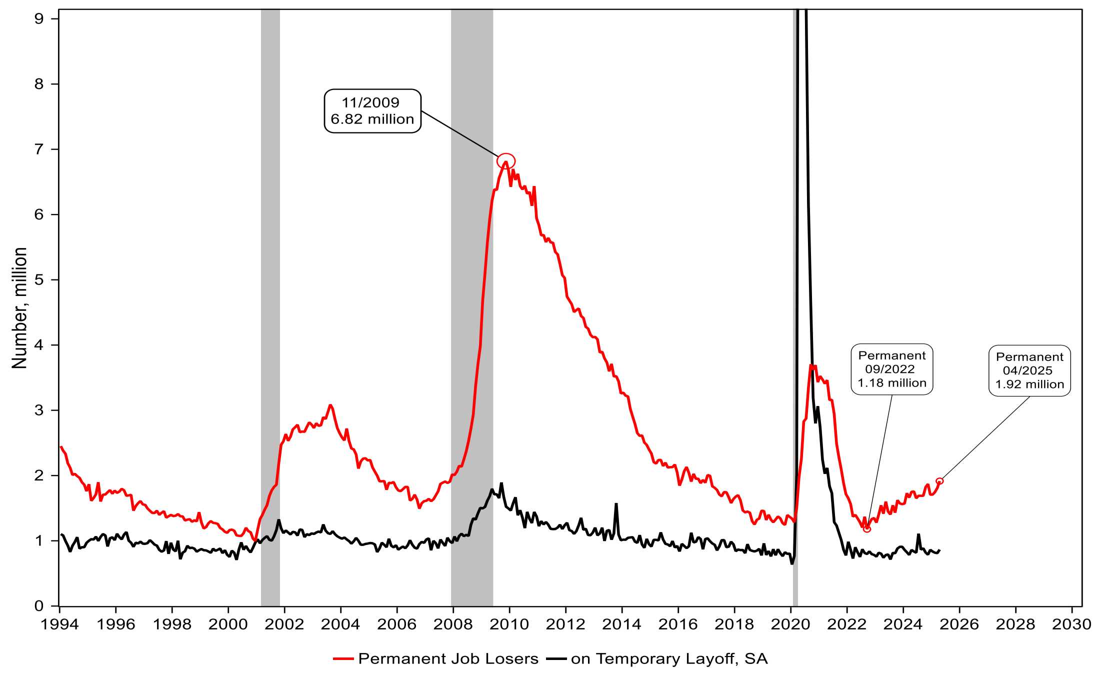
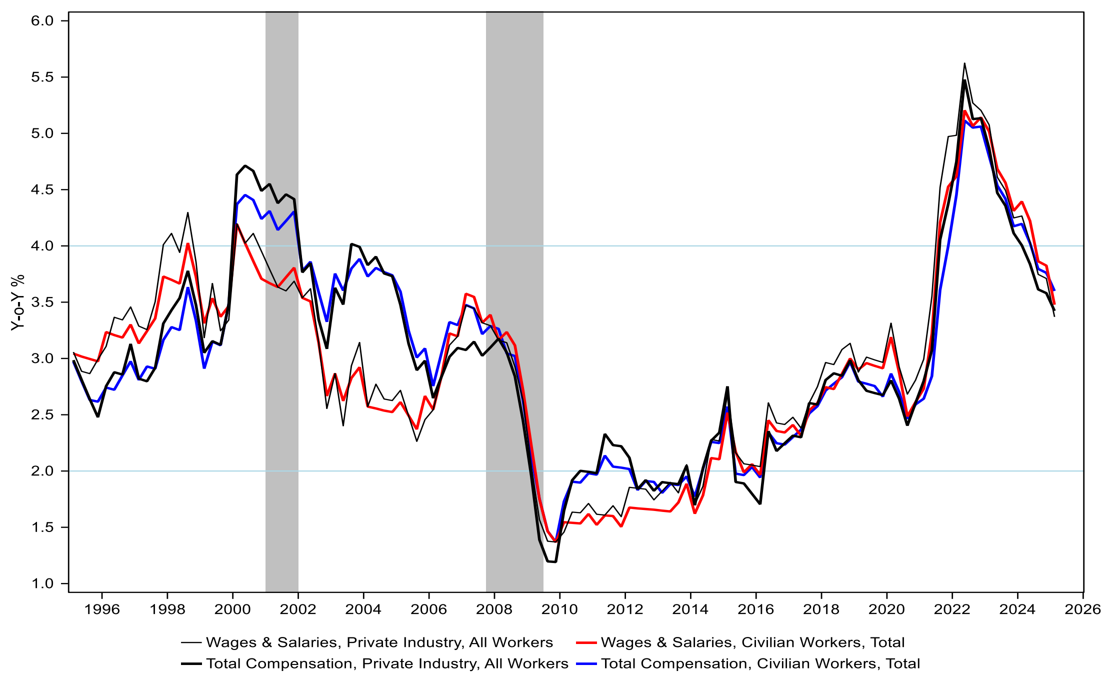
Fig 13: Permanent job losers & temporary lay-offs (million)



Source: Longview Economics, Macrobond

Fig 14: ECI – private and civilian workers (Y-o-Y %)



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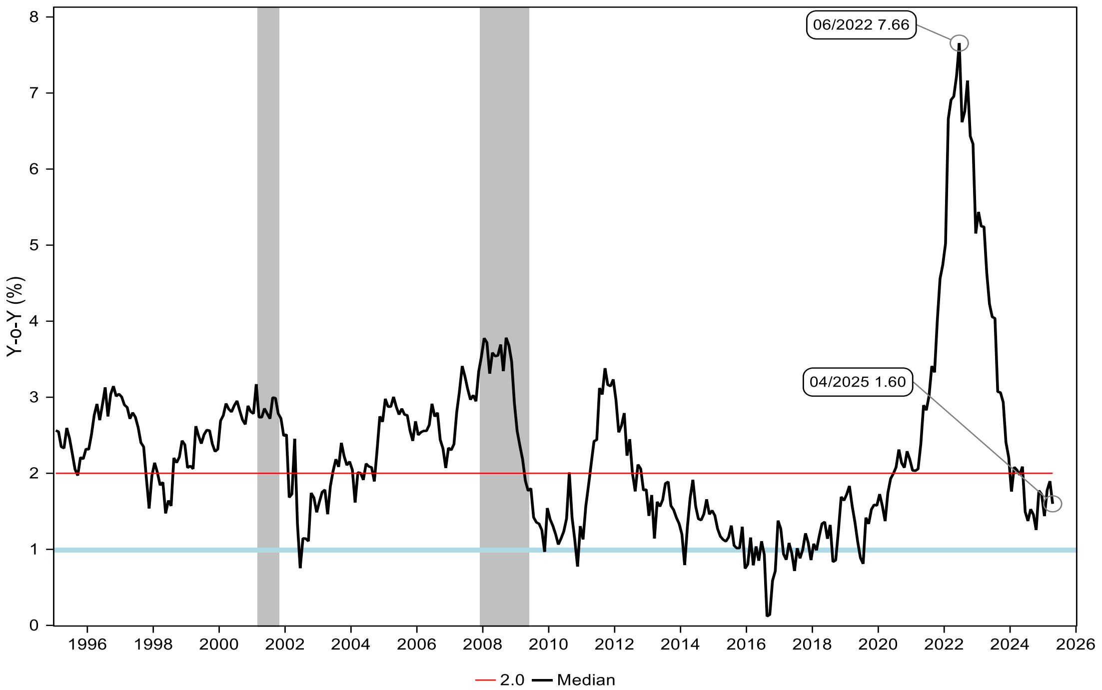
Appendix 2: US Inflation Measures

Fig 15: US median inflation (Y-o-Y %)



Source: Longview Economics, Macrobond

Fig 16: US monthly median inflation (M-o-M %, 1 & 6 month smoothed)

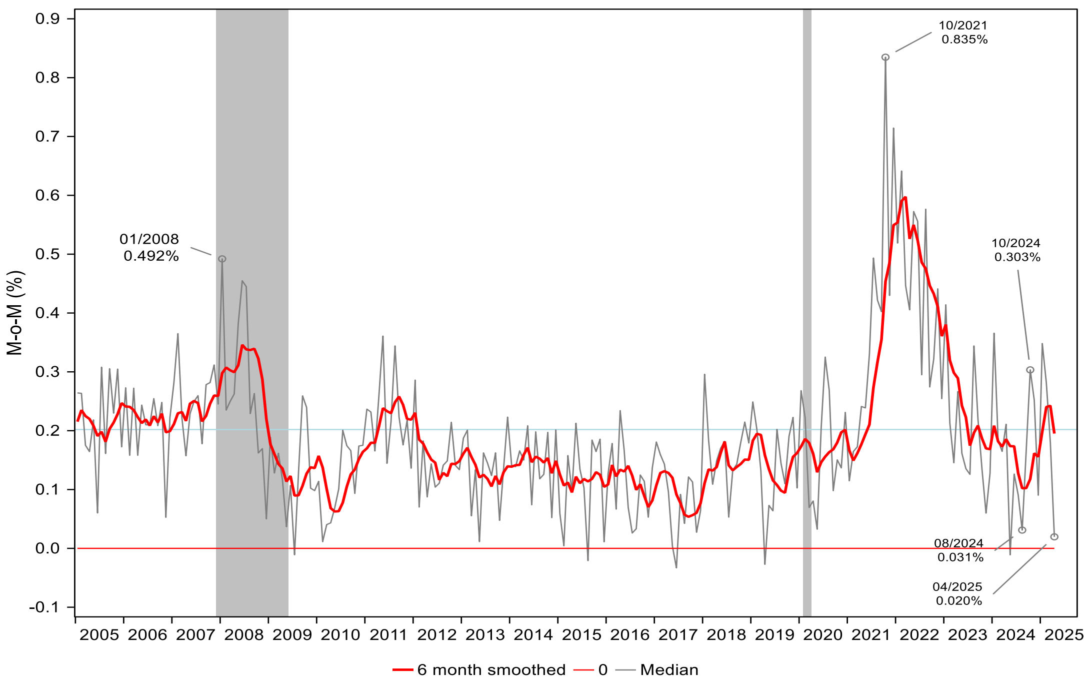


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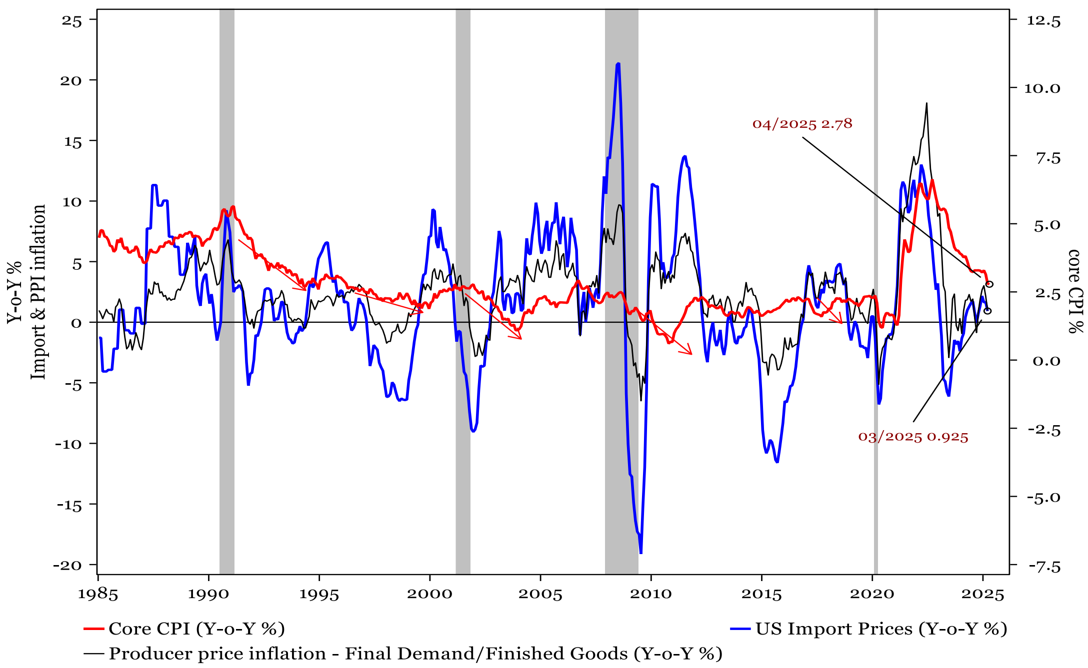
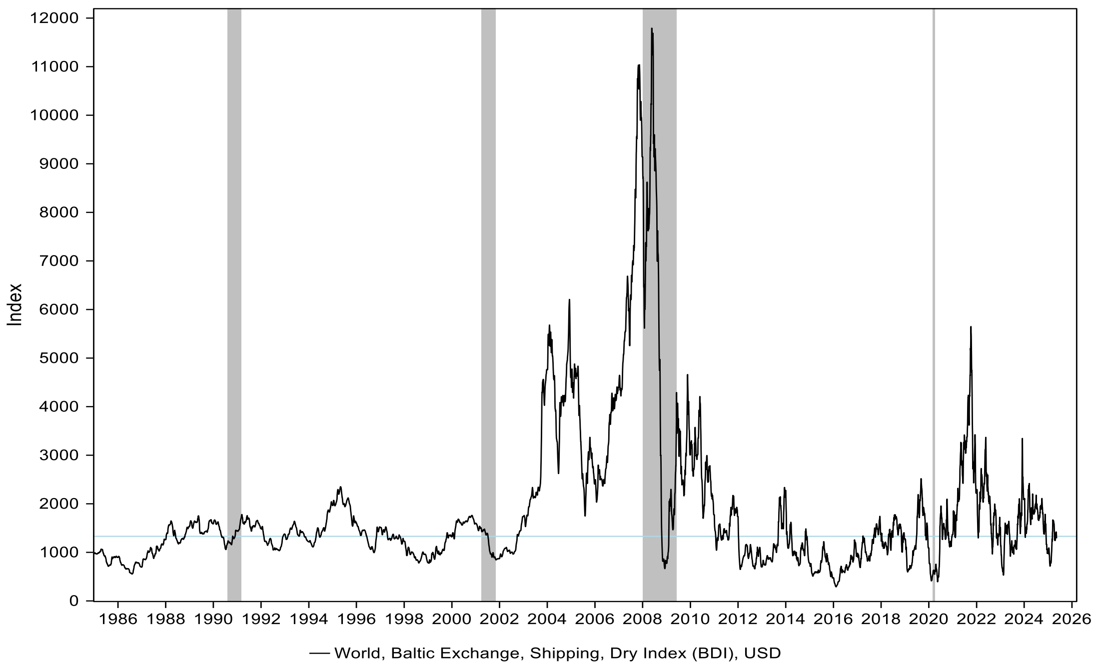
Fig 17: US Inflation – broken down into core CPI, import and producer prices



Source: Longview Economics, Macrobond

Appendix 3: Inflation data -> other

Fig 18: Baltic Freight Shipping Rates (Index level)



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Appendix 4: Inflation Inputs -> Oil & the cost of energy

Fig 19: WTI oil price – candlestick with key moving averages

Source: Longview Economics, Macrobond

Fig 20: Gasoline futures (USD/gallon)

Source: Longview Economics, Macrobond

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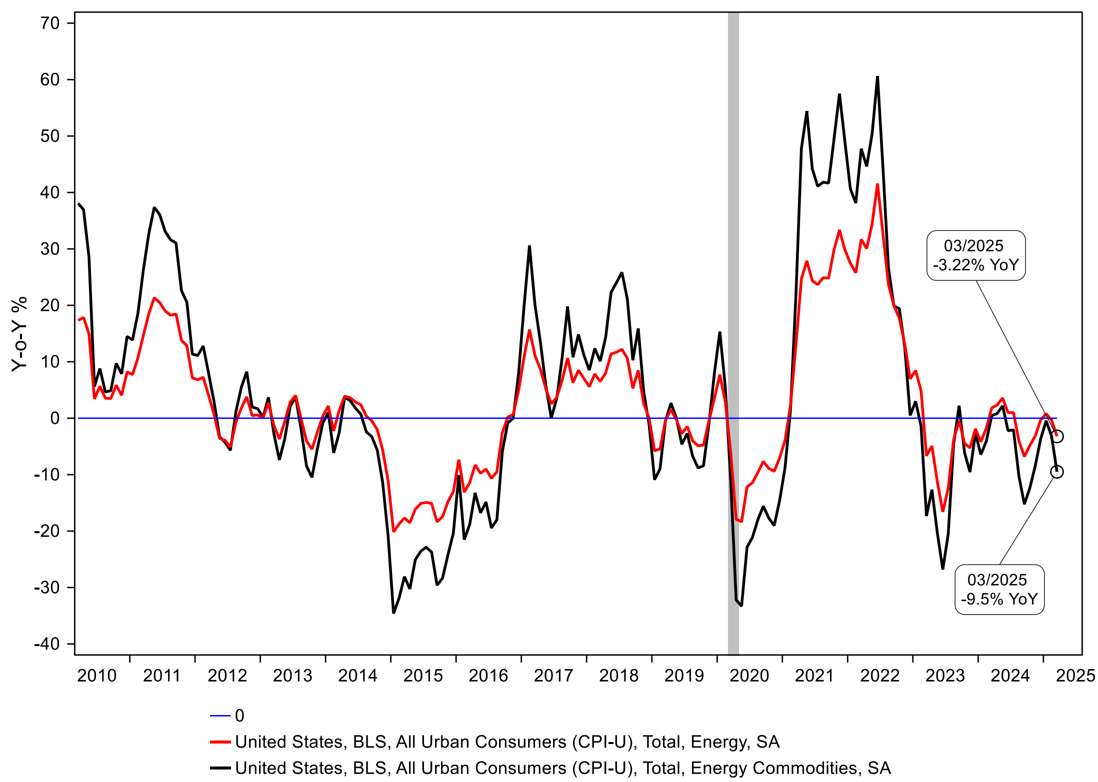
Fig 21: US (BLS inflation) energy & energy commodities (Y-o-Y %)



Source: Longview Economics, Macrobond

Appendix 5: Inflation -> Housing

Fig 22: House prices (FHFA) vs. CPI OER Housing component (both Y-o-Y %)

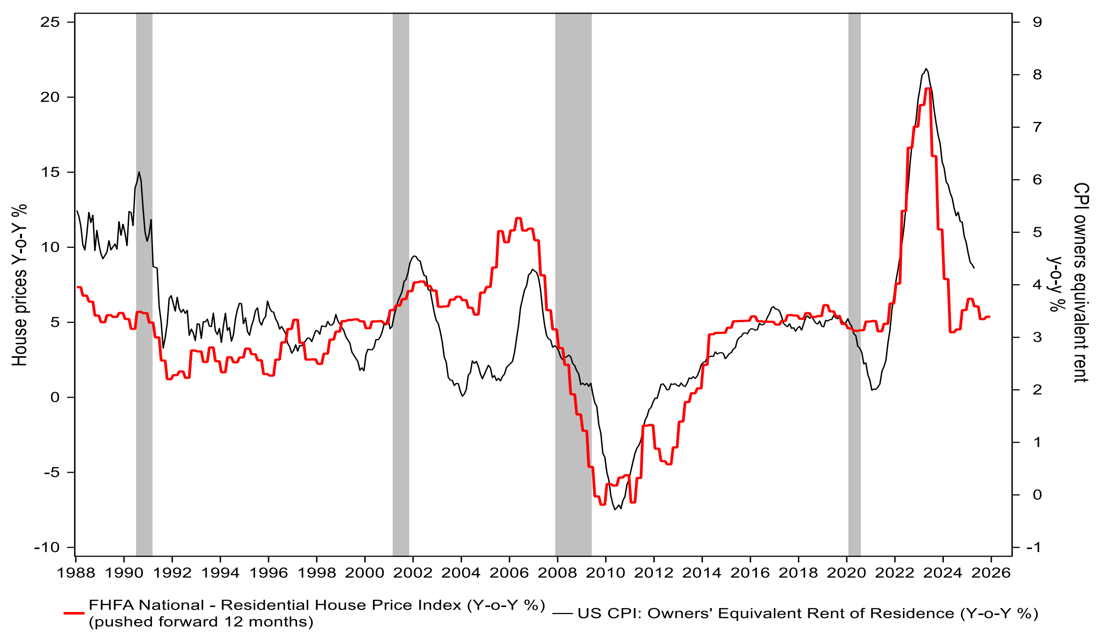


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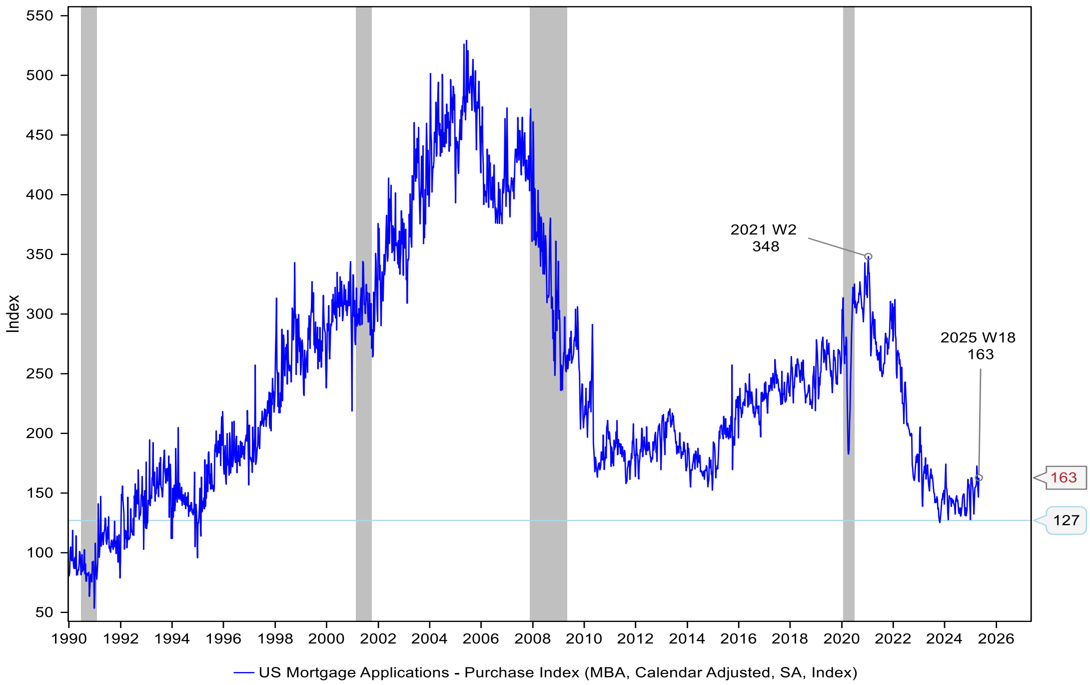
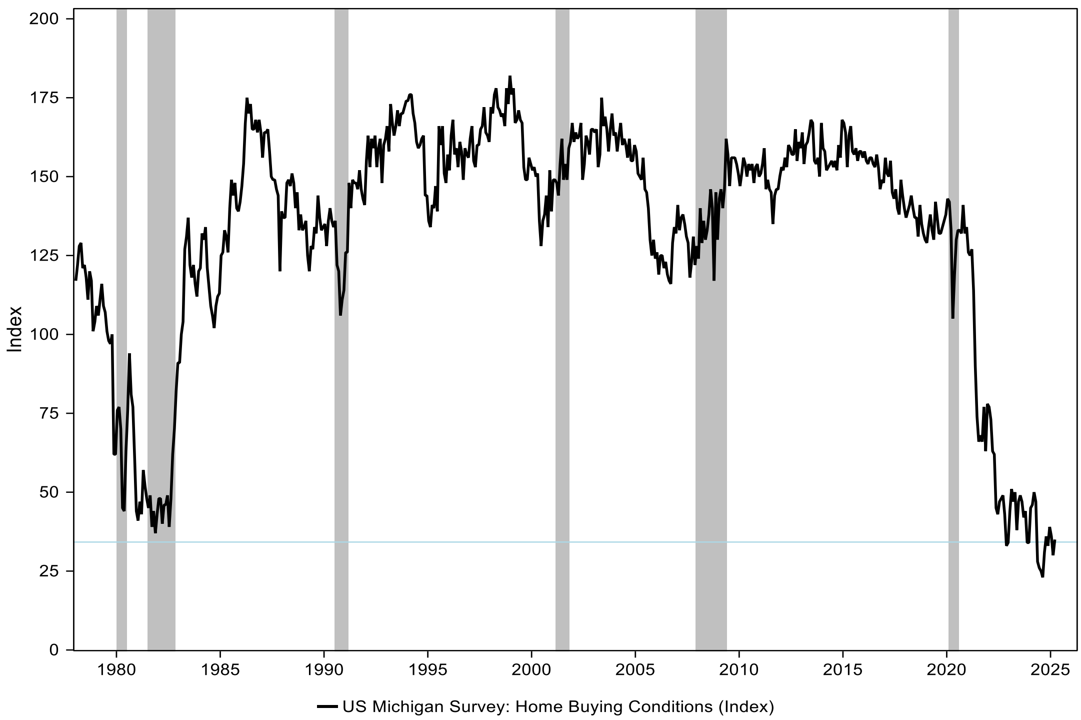
Fig 23: US mortgage applications index (purchase only, level)



Source: Longview Economics, Macrobond

Fig 24: Michigan home buying conditions index (with US recession bands)



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