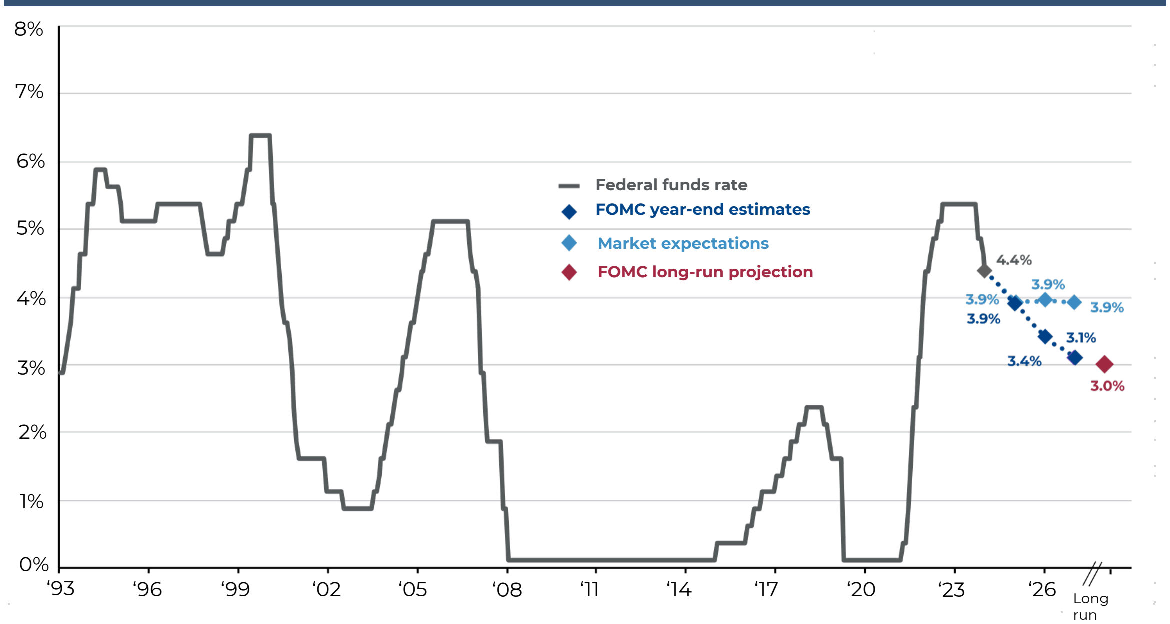
THE FED'S GHOST:
ITS HUNT FOR NEUTRAL

In the dimly lit corridors of monetary policy, the Federal Reserve is chasing a ghost - the elusive "neutral rate" of interest, or r*. The phantom benchmark, where policy neither stimulates nor restricts growth, remains an ever-fleeting mystery. Despite guiding the economy to a soft landing, the Fed's war is far from won. Even with rates at supposedly restrictive levels, clear evidence of their impact is puzzlingly absent, raising questions about future policy action. Is the Fed on the brink of mastering this elusive economic specter, or will the hunt leave it grappling with unintended consequences as inflationary pressures creep back into focus? The answers will define the year ahead.

Against the odds, the Federal Reserve engineered what most market forecasters believed improbable - a soft landing for the U.S. economy. It has steered the highest inflation seen in decades into a manageable range without tipping the economy into recession, following a rate-hiking cycle that raised the policy rate from 0.25% to 5.50%.

Stepping into 2025, both sides of the Fed's dual mandate, full employment and stable prices, are on relatively solid though not perfect footing. The Consumer Price Index (CPI), a key measure of price stability, has climbed to 2.9% in recent months. This level is a significant improvement from the highs of 2022, yet the data remains firmly above the Fed's 2% inflation target. Getting to that target is likely to be more challenging than anticipated as resilient economic growth and persistent shelter inflation continues to hinder further progress. The other side of the mandate remains robust with the labor market posting a healthy string of job gains and an unemployment rate sitting at 4.1%. The Fed's 1.00% of rate cuts since September reflected an impulse to support employment in the event of a slowdown after progress on inflation provided leeway to do so. The focus now turns to what lies ahead for this year.

Federal Funds Rate Expectations



Source: Bloomberg, FactSet, Federal Reserve, J.P. Morgan Guide to the Markets

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We have long held that the committee's monetary policy projections for 2025 were overly dovish, anticipating too many rate cuts. Recently Fed members shifted stance, bringing their expectations for less policy action in line with market pricing and migrating closer to our view that no rate cuts will materialize next year. At the December FOMC meeting, the central bank slashed their projections for rate cuts in half, anticipating just two this year. Additionally, they elevated their estimates for year-end inflation and GDP growth while lowering their forecasted unemployment rate. These updated projections clearly signal that Powell and his colleagues have a growing concern about upside risks to inflation in 2025.

Despite these higher expectations for both growth and inflation, they still cut rates in December, a puzzling decision. The explanation likely lies in their belief that policy remains "meaningfully restrictive on the economy" and well beyond what they estimate to be the "neutral level". However, the Fed's pursuit of this so-called neutral rate of interest, or r*, is like chasing a ghost. It's immeasurable, ever-changing, and impossible to pin down.

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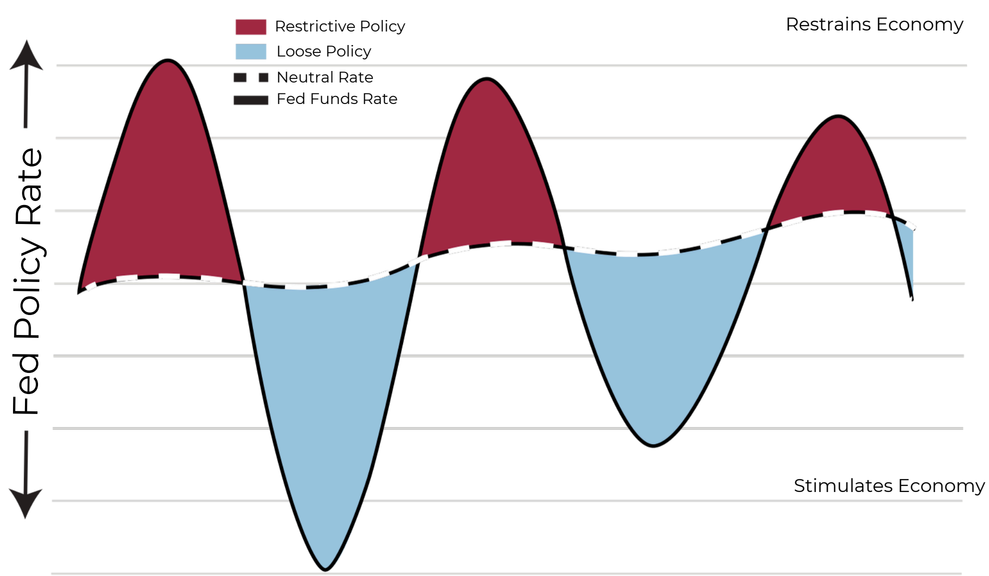
The neutral rate represents the "Goldilocks Zone" for monetary policy, where growth is neither restricted nor stimulated. This crucial benchmark is not static. It shifts over time in response to structural changes in the global economy and increasing evidence suggests that it has risen higher than previously thought. If that is indeed the case, the impact of today's elevated rate regime may not be as restrictive on business activity as it appears. This shift raises questions about how much easing, if any, is necessary heading into 2025 and beyond.

Impact of Neutral Rate on Monetary Policy



Source: Waterloo Capital

It's our belief in the rise of r* has been driven by a unique mix of forces reshaping the overall economy. The recent push for onshoring has spurred U.S. investment, while breakthroughs in AI are boosting productivity and fueling growth. Combined with stronger-than-expected economic data and persistent global deficits, these forces all point to a higher neutral rate. While r* remains elusive, more ghost than number, experts have refined their models to estimate it, with academics and investment professionals suggesting it could be as high as 4%. Such elevated readings are unprecedented in recent business cycles, leading to the true restrictive impact of current policy being less intense than predicted.

A telling sign that the Fed's monetary firepower has lost some of its potency lies in the state of financial conditions. Traditionally when the Fed raises rates, borrowing becomes more costly for consumers and businesses, tightening financial conditions and cooling economic activity. This effect should be hard to miss, yet despite the Fed funds rate sitting at a widely deemed restrictive rate of 4.25%–4.50%, financial conditions tell a different story.

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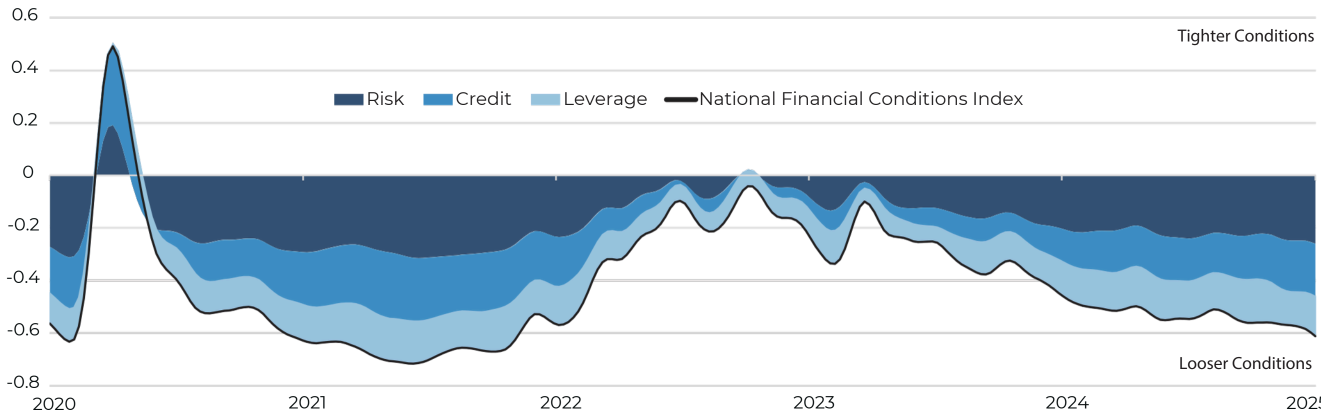
Financial Conditions Comparable to Levels Seen Before Fed Rate Hikes Began



Source: Federal Reserve Bank of Chicago. Data as of 01/03/2025

Rather than signaling significant restraint, conditions have remained loose, implying the economy has adapted to higher rates with relative ease. Despite some tightening along the way, conditions entering 2025 are nearly as accommodative as they were before the hiking cycle began in 2022. This raises a critical inquiry about the effectiveness of current monetary policy and indicates it has not been as restrictive as anticipated. While a higher r* plays a role, the massive fiscal stimulus from COVID response measures and other ongoing public policy actions has damped the impact of higher rates. With trillions of dollars pumped into the economy, the Fed faces a complex challenge in navigating persistently loose conditions, relying on the fed funds rate as its primary policy tool. Future policy decisions must account for these fiscal dynamics and the evidence of a higher r*.

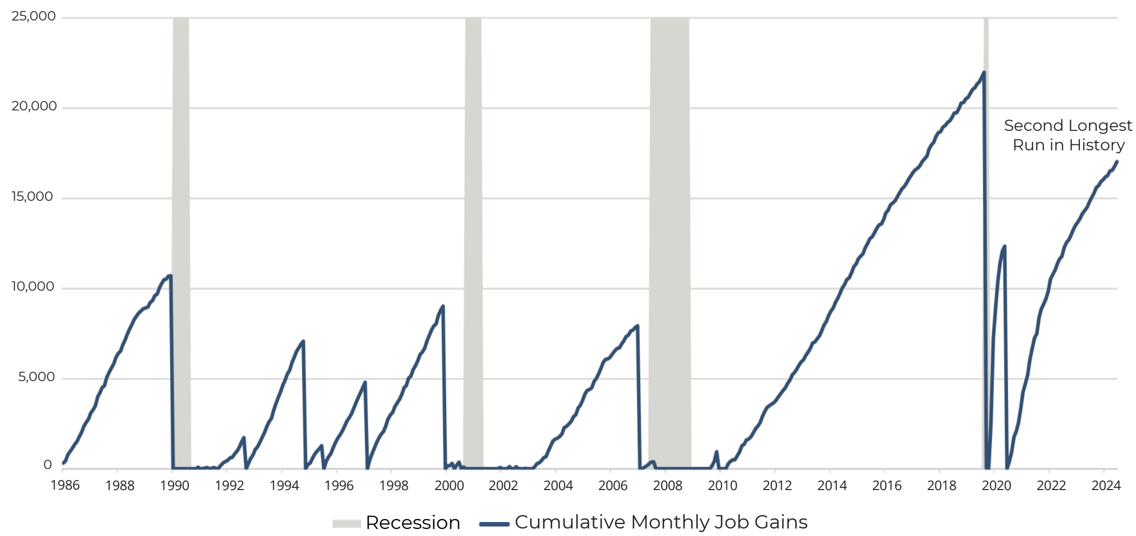
"A strong consumer and resilient economy further reinforce the case for the Fed to forgo rate cuts this year"

2025 presents a challenging balancing act for policymakers. Loose financial conditions risk undermining progress on bringing inflation back to 2.5%, let alone their target, a dynamic that rate cuts would only exacerbate. A strong consumer and resilient economy further reinforce the case for the Fed to forgo rate cuts this year. Complicating this is the potential for new policies under a Trump-led White House and a Republican Congress to place additional upward pressure on inflation.

A pro-U.S. growth administration and proposals like tariffs, reduced immigration, and tax cuts would almost certainly produce inflationary tailwinds, heightening the risk of reacceleration. In this scenario, fiscal actions could handcuff Powell & Co., forcing them to juggle elevated inflation risks with a diminished tool for doing so.

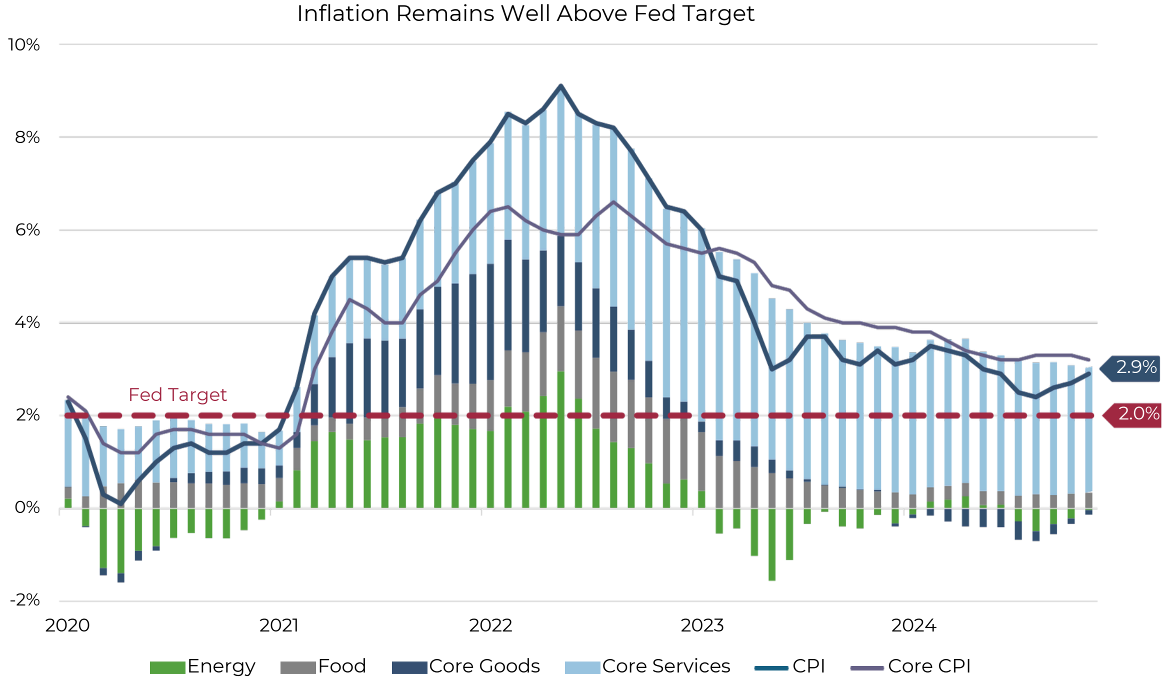
The Stage is Set for Fed to Forgo Cuts in 2025

Labor Market Has Gained for Past 48 Months



Source: Bloomberg, Waterloo Capital

Inflation Remains Well Above Fed Target



Source: Bloomberg, Waterloo Capital. Data as of 12/31/2024

While the Fed's elusive ghost may be hard to pinpoint, the evidence points to a higher r* than previously assumed. The economy remains remarkably resilient and financial conditions are loose, even with interest rates at relatively high levels - challenging the Fed's claim that current rates are truly "meaningfully restrictive." Barring a sharp labor market deterioration, a higher r* coupled with today's economic and political realities sets the stage for the Fed to hold off on rate cuts in 2025. Further cuts in this environment risk compromising their mandate of price stability, potentially reigniting upside pressures on inflation. In short, the Fed has caught up, but the perceived path forward leaves little room for loosening policy.

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2801 Via Fortuna #250, Austin, TX 78746 • (512) 777-5900 • www.WaterlooCap.com