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The Fed Rolls Back Recession Risk

CAPITAL ACCOUNT

By Greg Ip

Whatever probability you put on recession a few weeks ago, it should be lower now that the Federal Reserve has cut interest rates.

The cut was just a quarter percentage point, to a range of 4% to 4.25%. Still, the mere fact of the cut and the likelihood of more to come show that the Fed is now prioritizing growth in a way that makes a recession much less likely.

Markets anticipated this. Economic growth through the first half of this year had been sluggish. Then on Aug. 1 came news that job growth had slowed to a crawl as hiring dried up, the sort of thing that often comes at the start of a recession. Fresh jobs data on Sept. 5 painted an even more dismal picture, with the unemployment rate drifting up to 4.3%.

Yet since that first bad jobs report, the S&P 500 has risen 6%. That's partly over enthusiasm about artificial intelligence. But AI can't explain why the Russell 2000 index of small stocks has risen even more, by 11%. Those companies are more sensitive to the ups and downs of the economic cycle, suggesting that investors expect a pickup in consumer and business spending.

This isn't because weak job growth is good for spending, but because investors correctly figured the Fed would shift priorities from inflation to jobs. As expectations of rate cuts grew, the benchmark 10-year Treasury note's yield tumbled from 4.4% to just above 4%, and the two-year yield fell even more. *Note*

On Wednesday, the 10-year yield briefly dipped below 4% on news the Fed cut rates and penciled in two more reductions this year. Then it reversed course and finished the day at 4.08%. This might seem odd, but actually makes some sense. If a recession is less likely, then so are really big rate cuts, and that limits how far bond yields should drop.

Market movements not only forecast economic conditions, they can create those conditions. Rising stocks have lifted wealth among the affluent, likely a reason consumption rebounded in July and August after a sluggish first half. Lower-income households have been constrained by weak pay.

Meanwhile, falling bond yields have dragged down mortgage rates. This should stimulate demand for new and existing houses, although how much is hard to gauge. Some homeowners may even get to refinance into lower rates, adding to their cash flow.

The sequence of events in recent months is eerily similar to what unfolded a year ago. The Fed had kept its short-term rate target at 5.25% to 5.5% out of concern inflation would get stuck above its 2% target.

Then, a run of bad labor market data suggested it was behind the curve. The bond market thought so, anyway: The 10-year yield was more than a percentage point lower than the Fed's rate target. That "inverted yield curve," a reversal from the more typical upwardsloping curve, has historically been a reliable predictor of recession.

The Fed cut rates half a point last September, after which bond yields started to rise because the jobs data improved, and with the Fed's rate cut, recession worries faded.

The risk of recession this summer was never as high as a year earlier. Unemployment has risen much more slowly. And with interest rates a full percentage point lower than last summer, monetary policy is simply not as tight. The yield curve has been slightly upward sloping for two months now.

On Wednesday, Fed Chair Jerome Powell said a halfpercentage point cut, like last year's, is justified "when you feel policy is out of place and needs to move quickly to a new place." There was no widespread support for a half-point cut this week, he said.

Fed Governor Stephen Miran did dissent in favor of half a point. That wasn't a surprise: Miran is in the unprecedented position of serving on the nominally independent Fed while remaining chairman of President Trump's Council of Economic Advisers—all while Trump has been demanding that the Fed cut rates much faster.

Projections released along with Wednesday's statement show one official—probably Miran—wants to cut rates 1.25 points more by year's end, compared with the median half point among Fed policymakers.

Miran is a minority of one for now, but might not be for long. Trump is trying to fire another governor, Lisa Cook, over allegations of mortgage fraud. Cook has denied wrongdoing. If he succeeds, he could add another loyalist pushing for similarly steep cuts.

The problem is that just because the Fed is focused on the labor market doesn't mean it can stop worrying about inflation. Its preferred gauge of underlying inflation has edged up to an estimated 2.9% now, compared with 2.7% a year ago, in part because of tariffs imposed by Trump on imported goods.

If demand takes off in coming months, as investors anticipate, that may make it easier for businesses to pass tariffs along to customers. Rebounding job growth would lead to higher wages. In dealing with one risk, recession, the Fed may have aggravated another: that inflation stays stuck above its 2% target.