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Fed Cut Is Expected, but 2025 Turns Hazy

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Investors see an interestrate cut by the Federal Reserve this week as all but certain. Inside the central bank, the case for continued reductions will be less clear-cut if the economy continues to chug along.

Fed officials have signaled recently that a rate cut this week could conclude the first of a two-step phase of lowering rates. In that first interval, officials had a relatively low bar for cutting rates because they had held borrowing costs at such a high level. They had also waited several extra months to gain confidence that inflation was closer to their goal—and heading lower.

Officials began cutting rates in September with a big half-point cut. They cut again last month, by a quarter point. A cut this week would mark the third in a row.

Over the past year, officials have slowly raised their estimates of where rates will settle out, and they could continue to do so in projections this week.

Some have begun to signal that they would need to see more concrete evidence that inflation is improving or that the labor market is decaying before continuing to reduce borrowing costs. *

"We are at or near the point where it makes sense to slow the pace of rate reductions," Cleveland Fed President Beth Hammack said earlier this month. She approvingly cited two episodes in the 1990s when the Fed quickly cut rates by a total of 0.75 point, then moved to the sidelines.

Recent Fed communication has suggested officials will deliver a much more cautious tone about further cuts in quarterly rate projections and comments from Fed Chair Jerome Powell at a news conference on Wednesday.

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Powell is facing greater misgivings from colleagues who have been skeptical of cuts. The path of least resistance would be to pair a rate cut this week with guidance that suggests the Fed could go one or more meetings before it lowers rates again. Officials projected four rate cuts next year at their meeting in September but are likely to show one or two fewer cuts for 2025 in their latest projections.

Approaching neutral

This week's meeting is likely to deepen debates on two issues that could define where rates go over the next year: the location of the "neutral" rate of interest and the potential for policy changes by President--elect Donald Trump.

The so-called neutral rate is the holy grail, a level that neither spurs nor slows economic activity. But figuring out where that rate falls isn't straightforward, and economists have a range of estimates.

The closer the Fed moves to estimates of neutral, the weaker the case gets for cutting if inflation firms up and the labor market doesn't weaken.

For the moment, several officials have hinted that the logic supporting last month's cut is likely to be valid at least once more. "The case for cutting is that they still think they're quite a ways from neutral and…inflation does seem to be on a downward trajectory," said Dean Maki, chief economist at the hedge fund Point72 Asset Management.

Not delivering a cut that is now widely expected by investors could sow more confusion about what the Fed is doing * and why. Recent developments on inflation and labor markets likely haven't been meaningful enough to change officials' forecasts one or two years ahead, which are most relevant when considering where to set rates.

Moreover, even with another quarter-point cut, rates would still be above most plausible estimates of neutral, which run from around 2.5% to 4%. The Fed's benchmark federal-funds rate is currently around 4.6%.

Trump factor

Trump's proposed changes to trade, immigration, regulation and tax policy could reshape the outlook for growth, employment and inflation in the coming years. Officials will begin to grapple with those shifts at their meeting this week.

Deportations and a reversal of lax immigration policies, for example, could push up wages but depress demand. Tariffs could push up prices but might also crimp margins, strengthen the dollar or weigh on business sentiment. Any boost to energy production could help offset price hikes elsewhere.

"Oh, my God, there are just a lot of moving parts here," Donald Kohn, a former Fed vice chair, said during a recent interview.

Given those uncertainties, Powell has said the Fed shouldn't speculate or hazard guesses about the effects of these policies. In a talk earlier this month, Powell ticked off a list of unknowns about tariffs, including which products and countries will face them, how large they will be, how much warning businesses will get, and how other countries will respond. "We have to let this play out," he said.

Officials are likely to be briefed by staff economists about the potential effects on the economy under a range of scenarios. "We're modeling this....We're observing. But the decisions we're making right now are not about that," Powell said.

