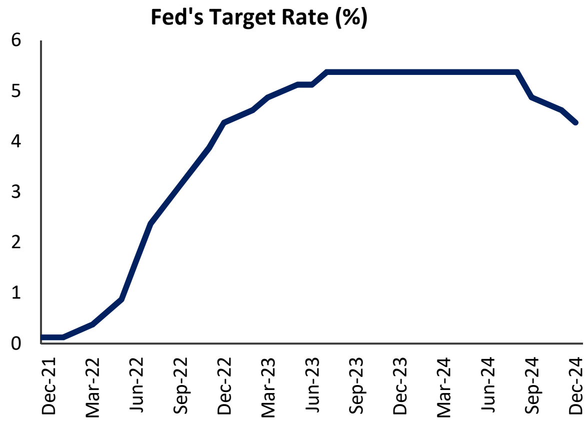
Fed: From Pause to Hawk…

19th December 2024

The Federal Reserve's policy meetings have become an increasingly complex and delicate balancing act as economic indicators, inflation rates, and labour market conditions continue to shift. Federal Reserve Chair Jerome Powell has been at the helm of navigating these challenges, particularly as the central bank has begun to lower borrowing costs after a prolonged period of tightening. In the summer of 2024, Powell led the Federal Reserve to initiate a larger-than-expected rate cut of 50 basis points, a move that caught the attention of market participants and sparked a significant debate among Federal Reserve officials. This decision, while bold, set the stage for subsequent discussions, including a quarter-point cut in November and the possibility of a third consecutive reduction at the latest meeting. However, as Powell and his colleagues navigate these decisions, they are also confronted with the delicate task of maintaining the Fed's credibility, avoiding inflationary pressures, and managing economic growth.



Source: Reuters

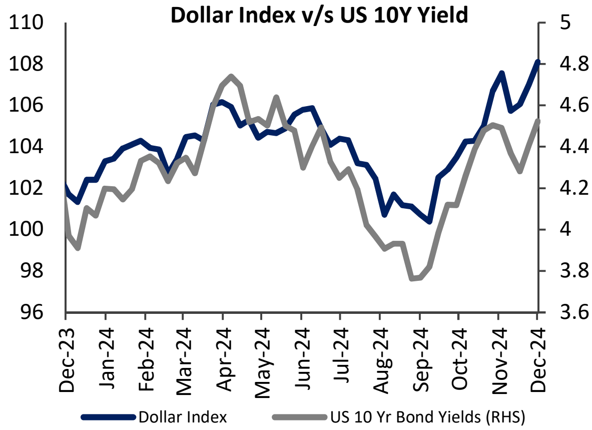
The decision to cut rates at the end of the summer in 2024 was surely argumentative. Some members of the Federal Reserve were sceptical about the need for such a large reduction, fearing that it might send the wrong message to the markets and signal distress. Officials were cautious about prematurely lowering rates when inflation was still above the Fed's target and economic uncertainty remained. Governor Powell in his comments, however, argued that the move was necessary to adjust policy in response to evolving conditions in the labour market and inflation. At that time, inflation had shown signs of stabilizing, and the labour market, while still strong, was beginning to exhibit signs of cooling. The argument cantered on the need to act pre-emptively, acknowledging the risk of overcompensating by keeping rates too high for too long, which could stifle economic activity. The decision to cut rates by 50 basis points, though aggressive, was ultimately framed as part of a careful recalibration to avoid unnecessarily constraining the economy.

The aftermath of the summer rate cut revealed the challenges the Federal Reserve faces in managing both public perception and internal consensus. While Powell's leadership was largely supported, some members of the committee, particularly the more hawkish officials, expressed concern over continuing to reduce rates. These officials, including Fed Governor Michelle Bowman and Dallas Fed President Lorie Logan, worried that the Fed was moving too aggressively and risking its credibility in the process. For these members, the issue was not just about the pace of rate cuts but about the potential long-term consequences of a prolonged period of low rates.

These hawkish members were also wary of the potential inflationary impacts of political actions, such as President-elect Donald Trump's proposals to impose tariffs and deport workers, which could reverse the favourable price dynamics that had supported the Fed's inflation forecasts.

The Federal Reserve cut its benchmark interest rate by a quarter of a percentage point to 4.25%-4.5% in its December meeting, marking the third consecutive rate reduction. This move comes as officials signal a slower pace of easing in 2025 to avoid undermining efforts to control inflation. The decision, although expected, was not unanimous, with Cleveland Fed President Beth Hammack dissenting. The Fed has adjusted its economic projections, forecasting fewer rate cuts in the future due to concerns about inflationary pressures, especially in the housing market and wage growth. Officials now predict a half-percentage point cut in 2025, down from prior expectations, and anticipate a steady unemployment rate at 4.3% through 2026.

While the rate cut aligns with the Fed's goal of cooling inflation, economic growth is expected to slow in the coming years. Despite inflation holding above the 2% target, GDP projections have been raised to 2.5% for the year, reflecting continued economic resilience. However, officials remain cautious, aware that too rapid a reduction in rates could stall the economy. The Fed has described its actions as a "recalibration" of policy after inflation peaked in 2022, but future rate cuts are likely to be more measured. Markets are reacting sceptically, with rising mortgage rates and Treasury yields suggesting limited future cuts, as officials weigh the balance between growth and inflation control.



Source: Reuters

In addition to domestic monetary policies, geopolitical risks have added a layer of complexity to the market dynamics. The Middle East, in particular, has become a focal point for rising tensions, particularly with the ongoing conflict between Israel and Hamas and broader instability in the region. Recently, Israel's defence minister told troops to fortify their position in newly seized Syrian territory, marking plans to send in reinforcements and equipment's despite UN demands that country retreat immediately. Since rebels attacked the capital Damascus and toppled Bashar al-Assad's regime over the weekend, Israeli ground forces have crossed beyond previously demilitarised buffer zone in Syria. Post the victory of President- Elect Trump, market participants have started discounting possible ease off in these tensions. There have been a lot of updates as well regarding cease fire deal between Israel and Hamas however, concrete evidence will be required for the same for any major impact on the market.

Fed Projections (%)						
	Sep'24 projection	2024	Sep'24 projection	2025	Sep'24 projection	2026
GDP	2	2.5	2	2.1	2	2
Unemployment rate	4.4	4.2	4.4	4.3	4.3	4.3
PCE inflation	2.3	2.4	2.1	2.5	2	2.1
Core PCE inflation	2.6	2.8	2.2	2.5	2	2.2
Fed funds rate	4.4	4.4	3.4	3.9	2.9	3.4

Source: fed.gov

Outlook:

The Federal Reserve's cautious approach to rate cuts, coupled with persistent inflationary pressures, is likely to support bullion prices in the near term. Gold and silver may benefit as safe-haven assets amidst economic uncertainty. Additionally, geopolitical volatility, particularly surrounding President-elect Trump's potential policy shifts, could further drive demand for precious metals. His proposed actions, such as raising tariffs and slashing regulations, may heighten market instability, fueling investor interest in bullion.

However, the prospect of fewer rate cuts in 2025, combined with solid economic growth, could limit significant gains, while rising yields may exert some downward pressure on prices.

Market could take some time to digest this "Hawkish cut", we continue to believe some more consolidation in prices is possible. We maintain our outlook from the latest quarterly report on gold, where we projected a 5–7% correction, which is underway, before the next upward move. Hence for both Gold and Silver, "Buy on Dips" is advised.

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