Fed cuts interest rate but Wall Street slides

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The US Federal Reserve cut its base rate by 0.25 percentage points yesterday, as had been expected, bringing the total reduction since it started reducing rates in September to a full percentage point.

But there are indications that the rate-cutting process is going to be slowed in the year ahead, or may even be at an end, amid growing uncertainty.

It is being fuelled by unclarity over the path of inflation, differences in the Fed's governing body over the direction of policy, the impact of the incoming Trump administration and what effect its threatened tariff hikes will have on prices, and how the rising budget deficit and the mounting interest bill is going to affect the bond market.

In response to what was described as a "hawkish cut" and the signal that cheaper money is not going to come as quickly as it wants, Wall Street experienced some significant declines.

The Dow Jones had its 10th consecutive day of falls, the longest losing streak since 1974. It lost more than 1,100 points, a decline of 2.6 percent. The tech-heavy NASDAQ index had its worst day since September falling by 3.6 percent, and the Russell 2000 index, which tracks smaller companies, had its largest single-day decline since June 2020.

The broad-based S&P 500 index fell almost 3 percent.

In announcing the rate cut, Fed chair Jerome Powell said the decision was a "closer call." While there was only one dissenting vote—from Cleveland Fed president Beth Hammack who favoured no reduction—there were others on the Fed's policy-setting body also inclined to that view, but who eventually went along with Powell.

Their views were reflected in the so-called "dot plot" of Fed officials in which they set out their projections for interest rates. In September, the median projection was for four cuts in 2025. On this occasion, it was two and the projections for inflation were also increased.

Reflecting this shift, Powell said: "From here, it's a new phase, and we're going to be cautious about further cuts."

Previously Powell had spoken of a "recalibration." That word did not appear in his remarks this time, and the market clearly drew the implication that there had been a shift from the lowering of rates at the pace they had expected.

One of the major uncertainties hanging over the meeting was the effect of Trump's tariff hikes and the deportation of potentially millions of immigrants, who play a decisive role in the workforce, and the effect of both these actions on prices.

In the lead-up to the meeting, Powell said staff economists were modelling the potential effects of Trump's policies on the economy and the Fed was "observing... But the decisions we're making right now are not about that."

Other Fed officials echoed this view, telling the *Wall Street Journal* it was necessary to wait for as long as possible before incorporating an assessment of the policies of the incoming administration.

But there is opposition to this view because policies on tariffs and immigrants do not require legislation and can be implemented from day one.

Eris Rosengren, president of the Boston Fed from 2007 to 2021, told the WSJ: "It's hard to say you're going to ignore something that's supposed to happen on January 20 and you're making a forecast in the middle of December."

In his opening remarks to his press conference, Powell pointed to the strength of the US economy, which was continuing to expand at a solid pace with GDP rising at an annual rate of 2.8 percent in the third quarter, the same as the second.

While activity in the housing sector was weak, "growth of consumer spending has remained resilient and investment in equipment and intangibles [such as patents and intellectual property] has strengthened" and improving supply conditions have "supported the strong position of the US economy over the past year."

During question time Powell pointed to the contrast between the US and much of the rest of the world which was battling with low growth and continuing inflation.

The divisions in the Fed's policy-making body, expressed in the dissenting vote by Michelle Bowman to the jumbo cut of 0.5 percentage points in September—the first such dissent since 2005—and the latest decision by Hammack, are reflected more broadly.

In the lead-up to the decision, the WSJ published an editorial posing the question as to why a 1 percentage point cut since September was needed. It noted that Powell was pursuing this course even though progress towards the inflation target of 2 percent had "stalled" and the producer price index, which points to headline inflation in the future, hit a five-month high of 0.4 percent in November.

It said that possibly part of Powell's worry is "simply that markets expect a rate cut this week and might react badly if he doesn't deliver. Investors have placed big bets on the prospect of a cut" to judge from future markets.

While WSJ did not characterise it in these terms, the rate cut could be said to be an attempt to pump more air into the financial bubble to keep it afloat. Whether that happens or not remains to be seen, but the initial indications are it has not been successful.

In the longer term, it warned that the last thing Powell would want is to have to raise rates next year if inflation rebounded. Even a "hawkish rate" cut, in which the Fed indicates "that's it for a while" meant "the Fed is cutting rates despite a robust economy and continuing inflation."

The continuation of inflation is not the only warning sign. Another is the rise in the long-term bond yield. Since the Fed started cutting rates in September the yield on 10-year Treasuries has risen 0.8 points. Normally it would be expected to follow the Fed rate, not move in the other direction.

The spike indicates that there is rising concern in financial markets over how the government is going to finance its growing debt—almost $36 trillion. Or even pay the growing interest bill, heading towards $1 trillion and gobbling up one dollar in seven of government outlays, compared to around $300 billion just a few years ago.