Divisions in US Fed opening up

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The minutes of the US Federal Reserve's October meeting released on Wednesday show that members of its governing body are deeply divided on the direction of interest rate policy and the widely expected further rate cut at its December meeting, previously regarded as a near certainty, is very far from a done deal.

The divisions reflect the highly uncertain direction of the US economy. On the one hand it appears to be powering ahead boosted by the massive capital investments, running into trillions of dollars, in the building of artificial intelligence (AI) data centers.

On the other, however, broad sections of the economy are either stagnant or experiencing a downturn while major corporations are carrying out mass layoffs often involving tens of thousands of workers in a single hit.

And even as the AI deals have produced a surge on Wall Street, there is increasing nervousness that the boom could be heading for a bust because revenues generated by AI will be insufficient to finance the massive capital investment.

The divisions at the October meeting, which decided on the second quarter point percentage cut in rates for the year, centered on whether another cut would be made at the next meeting. The *Financial Times* (FT) said the minutes underlined "the deepening schism over borrowing costs."

The *Wall Street Journal* (WSJ) report said the "minutes showed a committee as divided as any in recent years over what to do at its next gathering."

"In discussing the near-term course of monetary policy, participants expressed strongly differing views about what policy decision would most likely be appropriate at the committee's December meeting," the minutes of the Federal Open Market Committee meeting said.

The divisions were reflected in the October decision which saw a three-way split. While the majority backed the view of Fed chair Jerome Powell for a quarter percentage point cut, Trump ally Stephen Miran called for a half-point cut while Kansas City Fed president Jeff Schmid called for rates to be kept on hold.

At the time of the decision Powell pointed to the growing mood for a halt in rate reductions by cautioning the markets that a further reduction in December was not a "foregone conclusion."

The strengthening opposition to further rate cuts was indicated in the minutes. They showed that while "most participants judged that further downward adjustments to the target range for the federal funds rate would likely be appropriate," at the same time "several of these participants" indicated the December could be too soon.

The uncertainty was expressed throughout discussion as recorded by the minutes. They said that "several" members had said they would favor a reduction in December "if the economy evolved about as they expected over the coming intermeeting period." However, "many" suggested that "under their economic outlooks, it would likely be appropriate to keep the target range unchanged for the rest of the year."

The opponents of a rate cut, of whom Schmid has so far been the spokesperson, fear that inflation is starting to surge again with the rate remaining at 3 percent, significantly above the Fed's target of 2 percent.

Those in support of a further cut argue that inflation resulting from the tariff hikes of President Trump will be a one-off and the Fed should look through them. Their opponents maintain that, as in the pandemic, businesses will pass on the additional cost. Underlying this position is the concern that if that takes place it will induce further wage struggles by the working class.

The more hawkish members of the Fed, which besides Schmid include Boston Fed president Susan Collins and Fed governor Michael Barr, maintain inflation is too high at 3 percent and that growth remains resilient.

Their opponents, one of whom is Christopher Waller, a Fed governor and one of the leading candidates to become Fed chair when Powell steps down next May, maintain that a softer labor market warrants a further cut.

In remarks in London on Monday he said his “reading of the data” led him to favor a further rate cut in December. He said the labor market was “still weak and near stall speed” while inflation had only shown “relatively small effects from tariffs” and that expectations for prices over the next few months were “well anchored.”

New York Fed president John Williams has also expressed support for a further rate cut this year but has maintained that any decision has to be based on the data. But the 40-day government shutdown has meant that regular data has not been available and the Fed will not have the usual range of statistics at its December meeting.

Given the problems caused by the shutdown, September numbers released yesterday, which showed both a rise in job creation and an increase in the unemployment rate, are hardly a useful guide.

It is yet to be seen how the apparent pushback against a December cut will impact the markets under conditions where Wall Street had regarded it as a near certainty and how it may interact with other concerns.

One of these is that the AI boom has reached its peak. This week the Bank of America said that 45 percent of global fund managers identified an AI bubble as one of the biggest risks to the market.

The warnings have centered on “circular” funding arrangements, such as that developed by the leading chipmaker Nvidia in which it makes large capital investments in companies which then buy its products, the increasing role of debt in financing AI deals, and the widening gap between capital spending and expected revenue.

Earlier this week, Wall Street was on tenterhooks over the release of Nvidia’s quarterly earnings with the WSJ noting that “rarely has an earnings report from a single company been greeted with such nervous anticipation.”

Before the report was issued after hours on Wednesday, it was predicted if it came below expectations Nvidia’s shares would drop by more than 6 percent with a similar rise if they exceeded them.

In the event the company sales reached a record $57 billion for the October quarter with predictions they would go even higher as Nvidia chief executive Jensen Huang declared that “we have entered the virtuous circle of AI” and that it is “going everywhere, doing everything, all at once.” But even with the Nvidia result and the boosterism by Huang, the markets fell.

Besides having to set its monetary policy in increasingly uncertain conditions, the Fed is also having to deal with indications of possible financial turbulence centering on the ultra-short repo market. This is a market where in order to obtain cash overnight, financial firms use Treasury bonds as collateral repurchasing (hence the term repo) the next day.

In the recent period the interest rate in this market has risen above the federal funds rate indicating a tightening of liquidity.

Fed governor Lisa Cook, who is responsible for financial stability, said yesterday the debt-financed hedge funds involved in Treasury market trades were making it “more vulnerable to stress.” Her concerns focused on the so-called basis trade where investors borrow massive amounts of money to take advantage of tiny differences between the price of a bond in the cash market and its equivalent in the futures market.

Last week Williams held an unscheduled meeting with Wall Street dealers over the operations of the repo market. According to the FT it came at a time “when banks, investors and officials are concerned about the signs of stress in an arcane, but vital corner of the US financial system.”

Two days ago, a Reuters report noted that the cost of overnight borrowing in the repo markets had stayed “stubbornly high and is expected to remain elevated going into year-end despite recent Fed easing, adding another layer of stress to already fragile financial markets.”