NUS INVESTMENT SOCIETY

OVERVIEW OF FEDERAL RESERVE

MANDATE, INDICATORS, MARKET IMPACT

INTRODUCTION

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OVERVIEW

- The Federal Reserve ("Fed") is the United States' central bank—created in 1913 to provide a **safer, more stable monetary and financial system**.
- Controls the Fed funds rate—benchmark interest rate for the US

Core mandate:

1. Achieve maximum employment
2. Maintain inflation at its target rate of ≈2%

How decisions are made:

- The FOMC (Board of Governors + Reserve Bank presidents) sets the stance of monetary policy through regular meetings

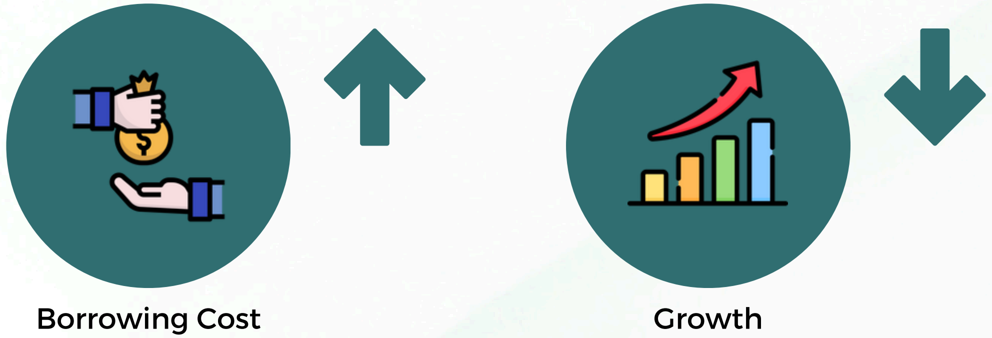
SHORT-TERM FUNDING RATES

- The interest rate charged to borrow cash for a very short period (overnight up to ~3 months) in money markets.

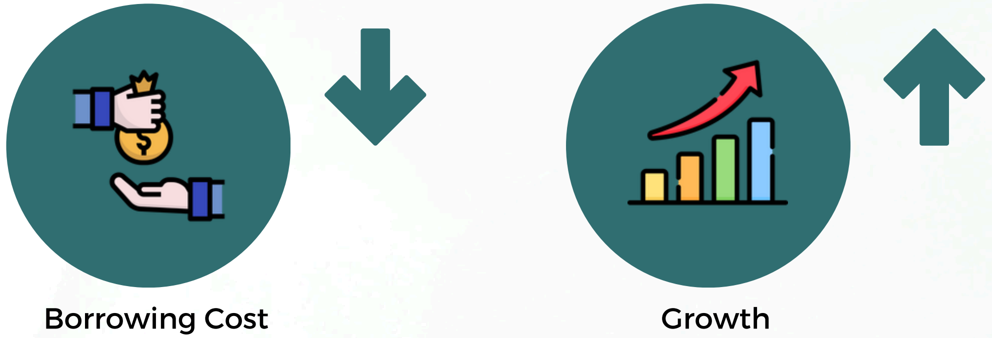
Why does it matter?

- Fed targets an overnight rate, so this moves first when the Fed shows up
- Many borrowing costs (Bank loans, T-bills, etc) are dependent on this rate
- Reads market stress—Jumps or drops signal how tight or loose cash is and what markets expect the Fed to do next

WHEN SHORT-TERM RATES RISE,



WHEN SHORT-TERM RATES DROP,



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INFLATION INDICATORS

- Consumer Price Index (CPI): Measures the average change over time in the prices paid by urban consumers for a **fixed basket of consumer goods and services**

- Core Personal Consumption Expenditures (PCE) Price Index: Broader measure of inflation that captures the price changes of all goods and services, **excluding volatile food and energy prices**, consumed by households. **The PCE index's composition changes to reflect shifts in consumer behavior**

- Producer Price Index (PPI): Measures the average change over time in the selling prices received by domestic producers for their output. It tracks inflation from the perspective of the producer, and is an **indicator for future consumer inflation**

How does the Fed measure inflation?

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EMPLOYMENT INDICATORS

- Nonfarm Payrolls (NFP): Represents the total number of paid U.S. workers, excluding farm employees, private household employees, and non-profit employees. This is the **primary indicator for the employment**. A strong NFP number indicates economic growth, while a weak number signals a slowdown

- Jobless Claims: A weekly report that counts the number of individuals who have filed for unemployment insurance for the first time. It provides **the earliest indicator of the labour market's health**, as the NFP report is released monthly. A sudden and sustained increase in claims is an early warning sign of rising layoffs and a potentially weakening job market

How does the Fed measure employment?

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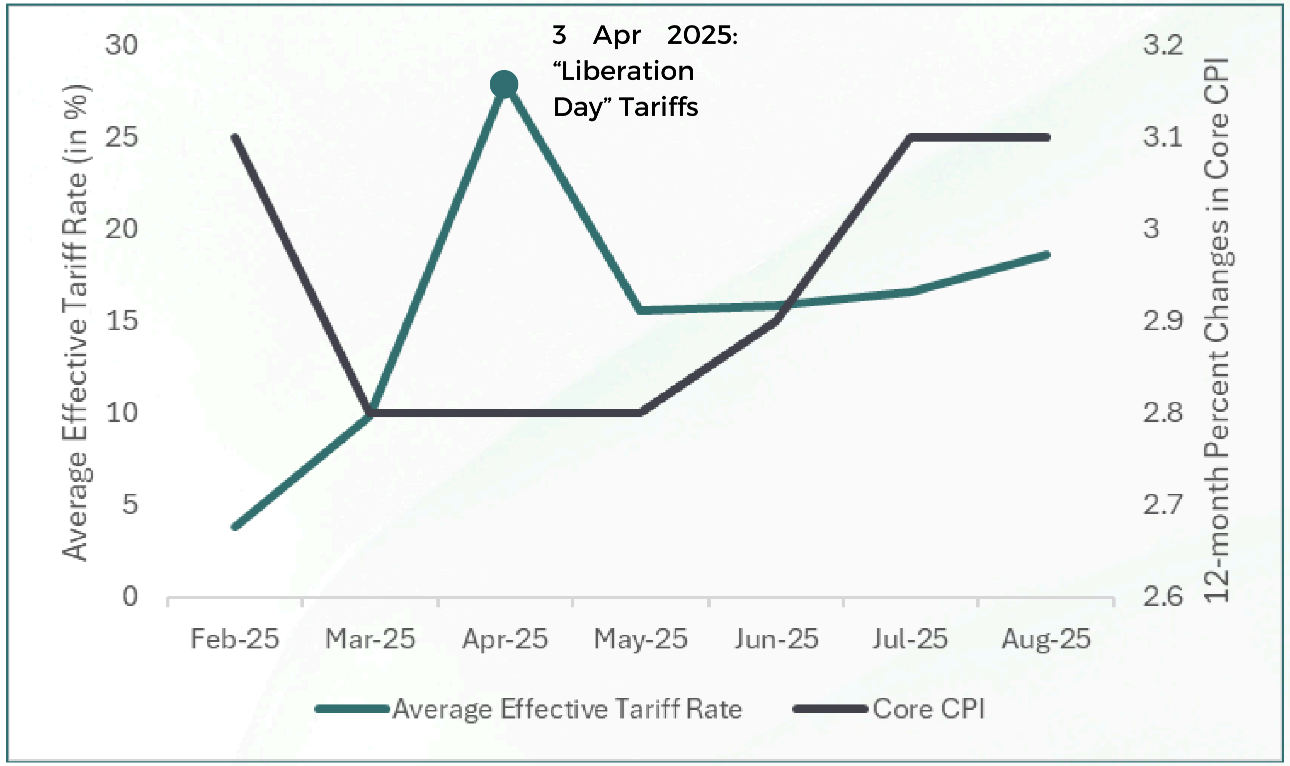
Fed: The Recent Picture

- Jobs are softening, and inflation is still above comfort levels
- Lowering rates boosts credit and hiring, **BUT** can reheat demand and prices. Recent higher tariffs can raise import costs, and some of that ends up in consumer prices
- Today, after their delayed response to the 2022 inflation spike, the Fed will only cut rates if inflation keeps cooling and the labour market weakens further

Figure 1: Tariff rates and core CPI inflation



Sources: Bureau of Labour Statistics, The Budget Lab at Yale

CONSUMER PRICE INDEX (CPI)

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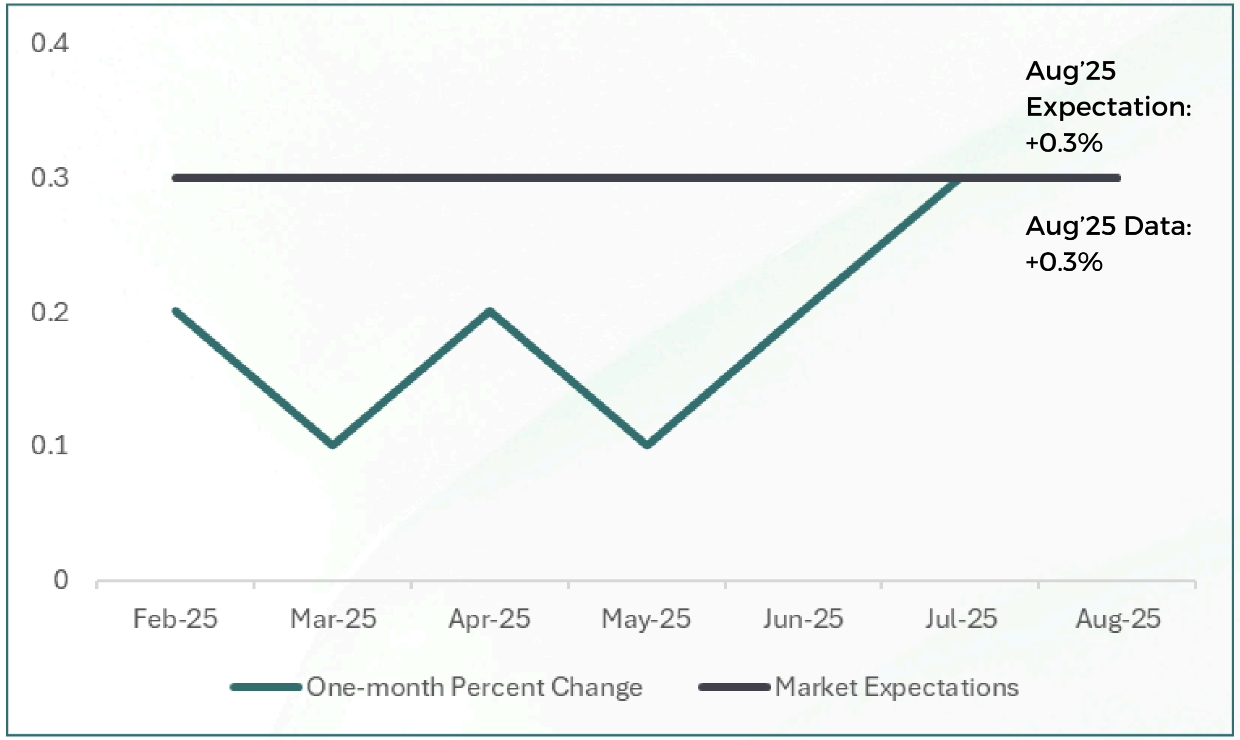
CONSUMER PRICE INDEX (CPI)

- Released on 11 September, headline inflation ticked up 0.4% month-over-month, slightly above expectations, while the annual figure met estimates at 2.9%
- Focusing on core CPI, which also excludes volatile food and energy prices, the **data came in exactly as expected** at +0.3% month-over-month and +3.1% year-over-year
- This tame reading on core inflation was essential as it signaled that the inflationary effect of tariffs was contained

Figure 2: One-month percent changes in core CPI



Source: Bureau of Labour Statistics

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CONSUMER PRICE INDEX (CPI)

- It provided the justification to cut rates and stimulate a slowing economy
- With inflation under control, the Fed was able to focus on the alarming employment data released before this August 2025 CPI report. It supported the narrative of a rate cut to address the weak labour market

Figure 3: 12-month percent changes in core CPI

Source: Bureau of Labour Statistics

PERSONAL CONSUMPTION EXPENDITURES (PCE)

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CORE PCE

- Core PCE is **the Fed's preferred indicator**
- Based on July 2025 PCE data, released on 29 August, we see the reasons behind the Fed's cautious approach. **Previous PCE data have came in higher than economists' forecasts**
- In July 2025, core PCE rose by 0.3% month-over-month, in line with forecasts. It rose 2.9% year-over-year, in line with expectations but up from 2.8% in June, and pushed inflation further away from the Fed's 2% target

Figure 4: Percent changes in PCE from preceding month

Source: Bureau of Economic Analysis

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CORE PCE

- While the July data was slightly hotter, the figures landed exactly in line with economists' expectations. Hence, the figures were viewed as "not alarming" enough to prevent a cut, and gave the Fed the permission to proceed with a 25bps rate cut

Figure 5: Percent changes in PCE from preceding month

Source: Bureau of Economic Analysis

PRODUCER PRICE INDEX (PPI)

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PRODUCER PRICE INDEX (PPI)

- Heading into September 2025, all eyes were on the August inflation data. The market was **bracing for persistent inflation**, with economists expecting the price indexes for final demand of goods and services to rise by 0.3% month-over-month and 3.3% compared to the previous year

Figure 6: Percent changes in final demand price index from preceding month

Source: Bureau of Labour Statistics

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PRODUCER PRICE INDEX (PPI)

- However, the data, released on September 10, came in weaker than expected. The headline PPI (which includes food and energy prices) fell by 0.1% for the month. The year-over-year figure came in at just 2.6%, much softer than the anticipated 3.3%

- This unexpected decline signaled that rising producer costs were moderating, and relieved worries that elevated inflation would create decision dilemmas for the Fed

Figure 7: 12-month percent changes in final demand price index

Source: Bureau of Labour Statistics

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PRODUCER PRICE INDEX (PPI)

Table 1: Monthly and 12-month percent changes in final demand price indexes

Month	Total final demand	Final demand less foods, energy, and trade	Final demand goods				Final demand services				Change in final demand from 12 months ago (unadj.)	Change in final demand less foods, energy, and trade from 12 mo. ago (unadj.)
			Total	Foods	Energy	Less foods and energy	Total	Trade	Trans-portation and ware-housing	Other		
2024												
Aug....	0.3	0.2	0.0	0.7	-1.5	0.2	0.5	1.1	-0.7	0.4	2.1	3.5
Sept...	0.3	0.2	-0.2	0.5	-2.0	0.1	0.5	1.2	0.0	0.3	2.1	3.4
Oct.....	0.3	0.3	0.1	-0.6	0.3	0.2	0.4	0.7	0.3	0.3	2.8	3.6
Nov....	0.1	0.1	0.6	2.1	0.4	0.2	-0.1	-0.6	-0.2	0.1	2.9	3.6
Dec....	0.5	0.4	0.5	0.3	2.2	0.1	0.5	0.5	2.5	0.3	3.5	3.6
2025												
Jan.. ..	0.7	0.4	0.7	1.0	2.0	0.2	0.7	1.2	0.6	0.4	3.8	3.5
Feb....	0.1	0.4	0.3	1.6	-1.4	0.3	0.1	-0.8	0.0	0.5	3.4	3.6
Mar....	-0.2	0.1	-0.9	-2.2	-3.9	0.3	0.2	0.4	-1.7	0.3	3.2	3.5
Apr.[1]...	-0.3	-0.2	0.0	-0.9	-0.3	0.3	-0.3	-0.2	0.0	-0.4	2.4	2.7
May[1]..	0.4	0.1	0.1	0.0	-0.4	0.3	0.5	1.5	0.0	0.1	2.7	2.7
June[1]..	0.1	0.1	0.3	0.1	1.1	0.2	-0.1	-0.2	-0.8	0.1	2.4	2.5
July[1]...	0.7	0.6	0.6	1.4	0.7	0.4	0.7	1.0	0.9	0.6	3.1	2.7
Aug....	-0.1	0.3	0.1	0.1	-0.4	0.3	-0.2	-1.7	0.9	0.3	2.6	2.8

The "Trade" category measures the gross margins received by wholesalers and retailers

- The soft data would give the Fed confidence that a modest 0.25% rate cut wouldn't have immediate, unexpected consequences on the prices of goods and services

- A key detail in the report was a **0.2% decline in prices** for final demand services, which the Fed traced to a drop in margins for wholesalers and retailers

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PRODUCER PRICE INDEX (PPI)

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June[1]	0.1	0.1	0.3	0.1	1.1	0.2	-0.1	-0.2	-0.8	0.1	2.4	2.5
July[1]	0.7	0.6	0.6	1.4	0.7	0.4	0.7	1.0	0.9	0.6	3.1	2.7
Aug.	-0.1	0.3	0.1	0.1	-0.4	0.3	-0.2	-1.7	0.9	0.3	2.6	2.8

Source: Bureau of Labour Statistics

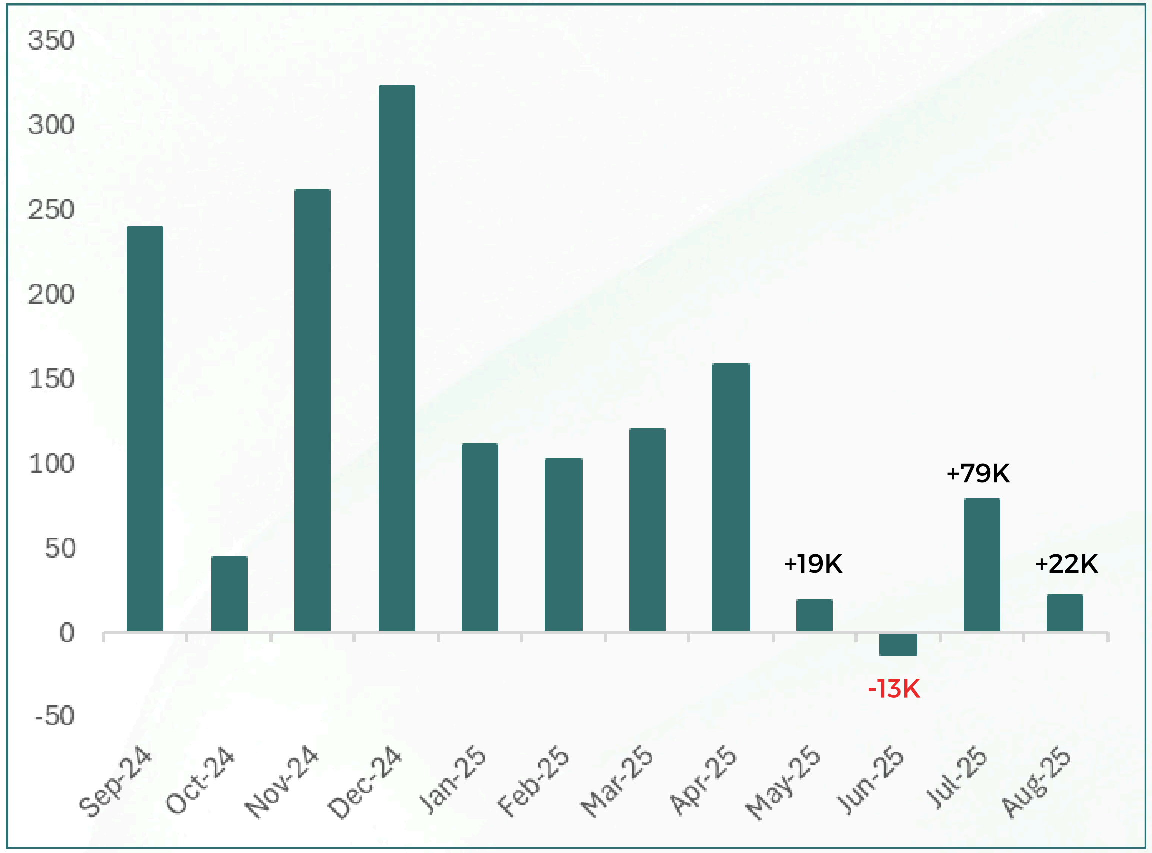
- The decline in prices suggests that **businesses may be absorbing the initial impacts of tariffs**
- Besides, faced with economic uncertainty, companies can be reluctant to raise prices to retain customers, and therefore absorb some of the higher costs themselves
- The cool PPI data reinforced bets on a rate cut by the Federal Reserve

NONFARM PAYROLLS (NFP)

NON-FARM PAYROLLS

- Released on 5 September, the U.S. economy **added only 22K jobs in August, falling short of the 77K that economists had predicted**. Unemployment rate ticked up to 4.3%, the highest since 2021
- The initial figures for June and July were **revised down** by a combined 21K jobs, indicating that the slowdown had already begun
- After months of confidence, the data heightened market concerns about the durability of the labour market

Figure 8: Non-farm payroll employment over-the-month change (in '000s)



Source: Bureau of Labour Statistics

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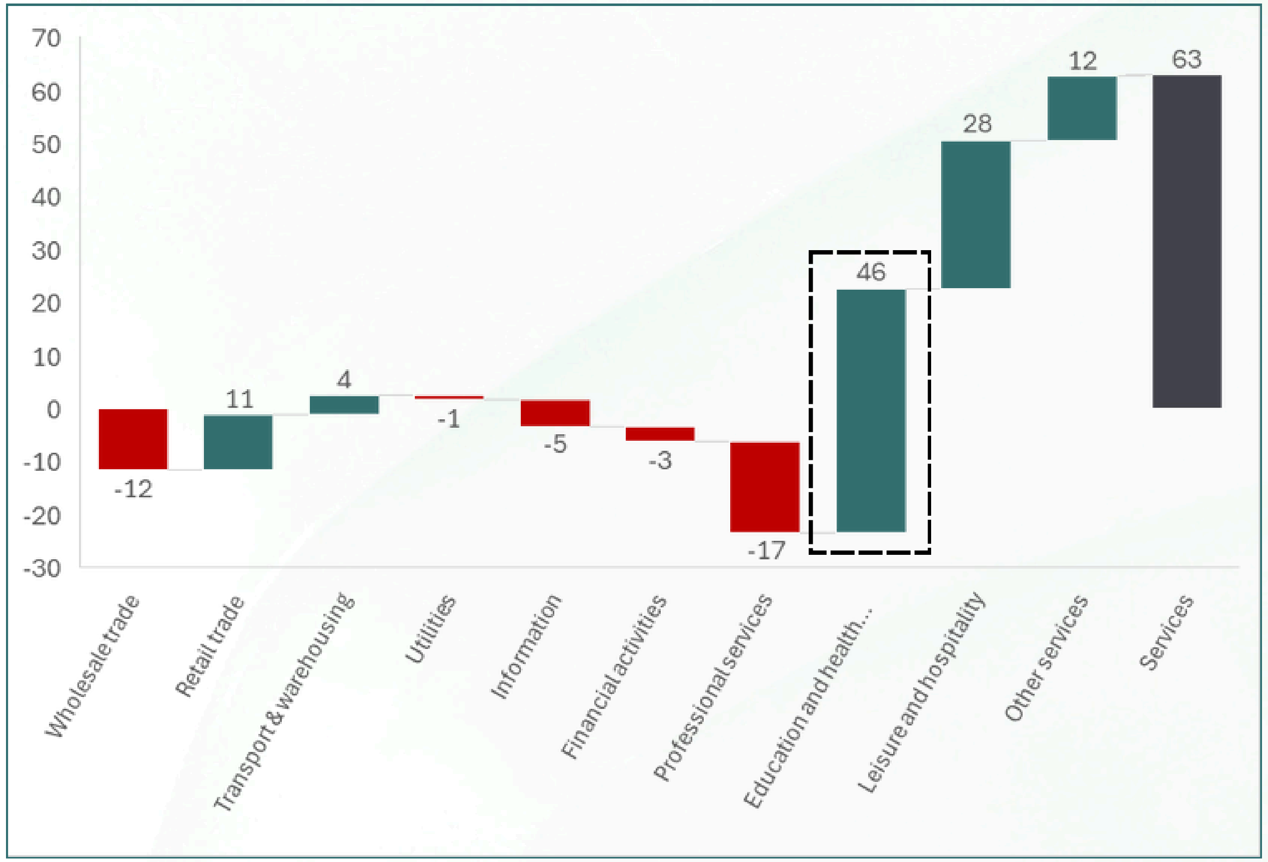
NON-FARM PAYROLLS

- Furthermore, the 63K employment gain in the service sector was propped up by the 46.8K jobs in healthcare. While significant, **healthcare is driven by long-term structural trends and is less sensitive to the business cycle**. Hence, it masks the slowdown in the growth sectors of an economy e.g. technology

- While other factors such as youth unemployment from AI, tighter immigration policies are considered, they are viewed as insufficient to explain the magnitude of these downside surprises

Figure 9: Over-the-month change in employment in the service sector, by industry (in '000s)



Source: Bureau of Labour Statistics

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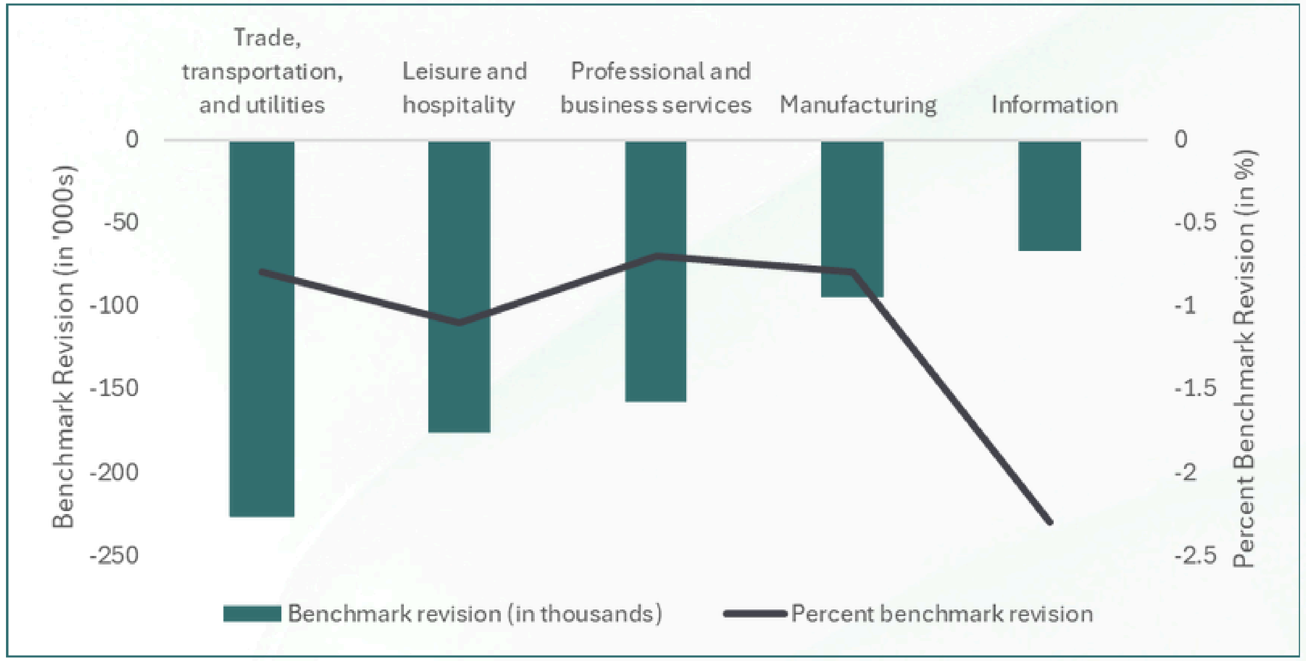
NON-FARM PAYROLLS

- Each year, the BLS "benchmarks" its monthly survey-based estimates against more comprehensive employment data derived from state unemployment insurance tax records
- On 10 September, the BLS announced that the US economy had **created 911K fewer jobs** in the year leading up to March 2025 than was initially reported
- This is a massive revision that suggests the labor market was much less robust than previously estimated

Figure 10: Industries with the Largest Benchmark Revisions (in '000s)



Source: Bureau of Labour Statistics

JOBLESS CLAIMS

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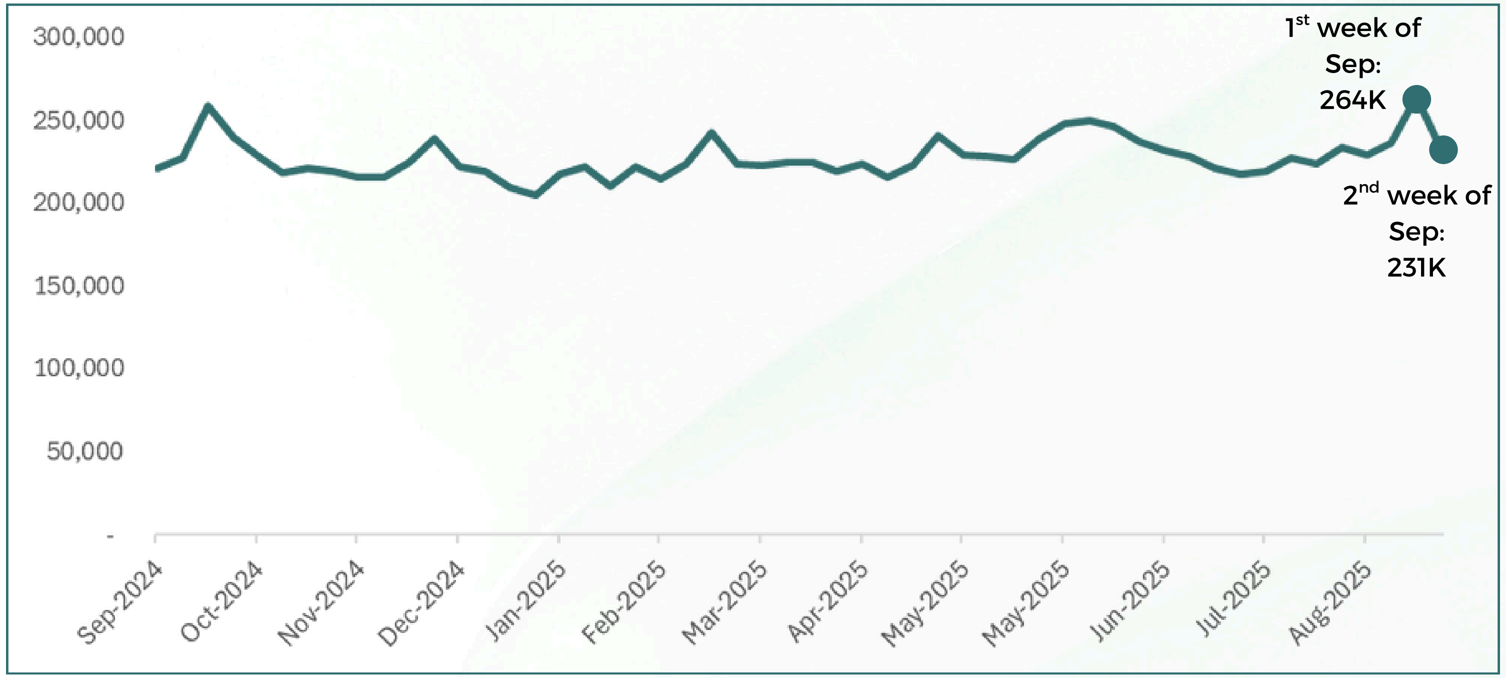
JOBLESS CLAIMS

- The data from the first week of September sent a clear warning signal. Initial jobless claims jumped by 28K to a total of 264K for the week ending September 6th, marking the highest level for initial claims since October 2021

Figure 11: Initial Jobless Claims in the last 12 months



Source: U.S. Department of Labor

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JOBLESS CLAIMS

- For the week ending September 13, claims fell by 33K to 231K. While this was a significant retreat, the data showed an **increasing trend over the past two months**, supporting the case of a weaker US labour market

- Nonetheless, the data points from non-farm payrolls were the drivers for a rate cut

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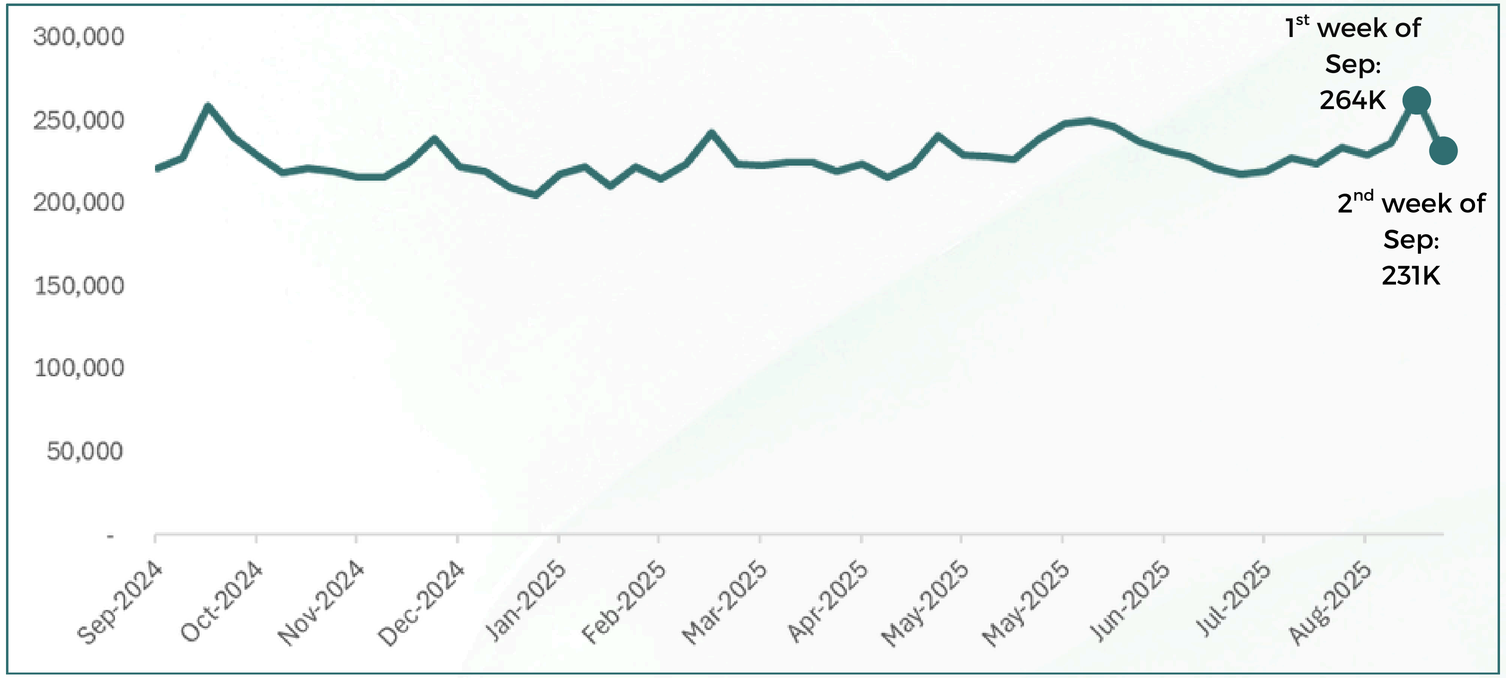

Source: U.S. Department of Labor

CONCLUSION

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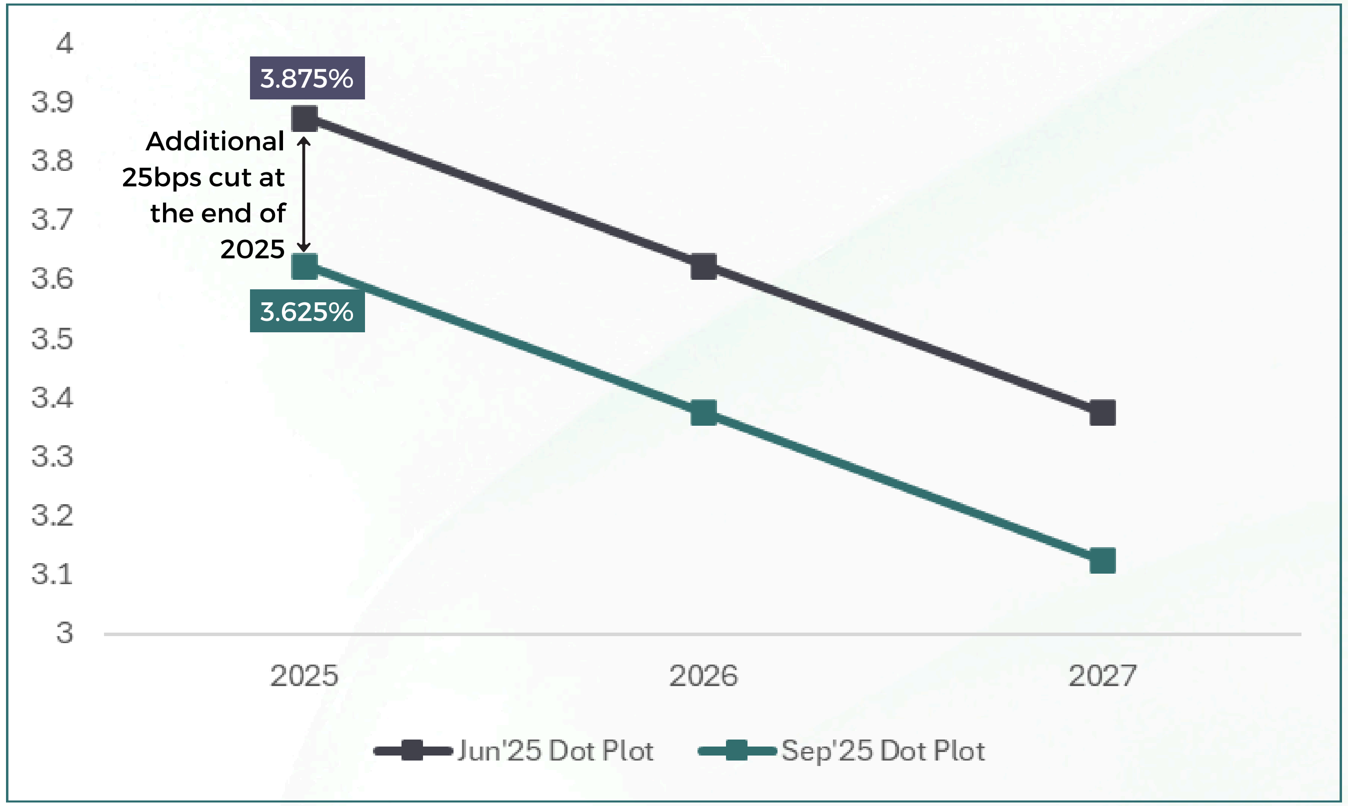
THE MEETING

- On 17 September, the Federal Reserve delivered a 25bps cut, referencing the recent labour market weakness and **the cut as a risk management measure**
- Powell offered no clear forward guidance, and recently emphasised that "two-sided risks mean that there is no risk-free path"
- Projections for just one additional 25bps cut in 2025 reinforced the Fed's cautious approach to balance both risks

Figure 12: Dot Plots of Planned Rate Cuts from the Fed



Source: Federal Reserve Board