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AUGUST 2024

Market Perspectives: End of the Fed Hike Cycle in *Sight*?

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"My colleagues and I remain squarely focused on achieving our dual mandate goals of maximum employment and stable prices for the benefit of the American people. Our economy has made considerable progress toward both goals over the past two years."

~ Federal Reserve Chair Jerome Powell, July 31, 2024

- After being slow to respond to the initial surge of inflationary pressures, the Federal Reserve (the "Fed") hiked interest rates aggressively starting in March 2022. Ultimately, the Fed lifted short-term interest rates from near 0% to approximately 5.5% by June 2023, where they remain today.
- More than two years since the initial rate hike, the market expects and the Fed is signaling lower interest rates may lie ahead (i.e., rate cuts).
- While there is merit for interest rate cuts, the timing of them is a key question for the market. Inflation remains north of the Fed's target of 2% and the outlook for inflation is uncertain. A series of rate cuts could stoke increased economic activity causing inflation to reaccelerate.
- Regardless, interest rates are a critical aspect of many facets of the economy and monitoring these developments is an important component of the current investment landscape.

The dog days of summer are upon us. The running commentary in August each year is that market trading slows as vacations are in full effect. Growth fears have emerged recently, and markets have experienced increasing volatility in recent weeks. This leaves economists and market participants to ponder what may lie ahead. At the top of their lengthy list of items to focus on today are interest rates. As inflation settles back towards more normalized levels, the Fed has begun a reevaluation of the rate path. While nothing is pre-determined, monetary policy may be about to shift from a year's long hike cycle to the beginning of interest rate cuts. Lower interest rates provide liquidity for economic activity and vice versa. With these factors in mind, we analyze the current state of interest rates, and as stated earlier, what may lie ahead.

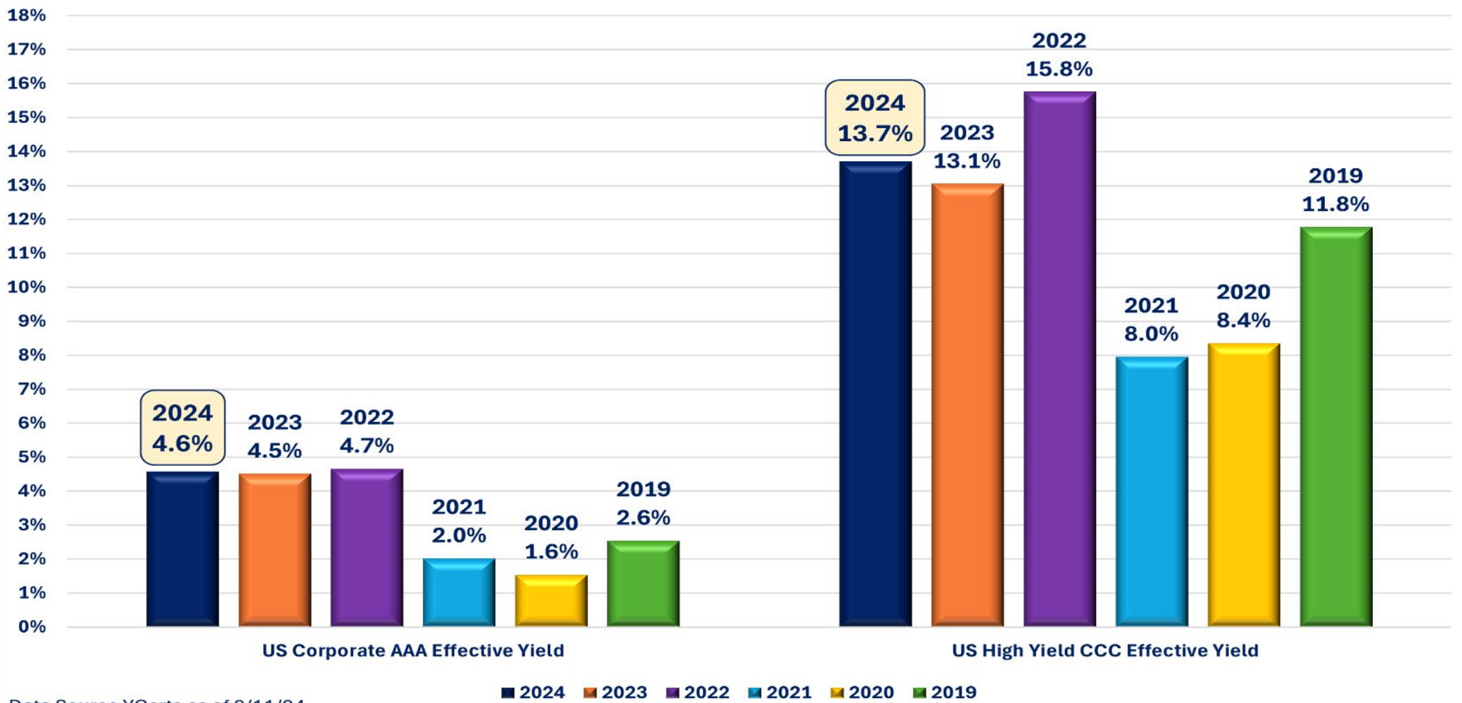
The Fed Mandate

As mentioned in the opening quote from Chair Powell's press conference on July 31, the Fed maintains a dual mandate, established by Congress, which directs the central bank to focus on two primary objectives: promoting maximum employment and ensuring stable prices. Regarding the former, the objective aims for a robust labor market – in other words, anyone who wants a job can find one. Interestingly, full employment does not mean 0% unemployment. There is natural friction in the labor market, with workers always in transition. Generally, roughly 4% or lower is thought to be an acceptable level of unemployment. This level likely balances the demands of workers and employers.

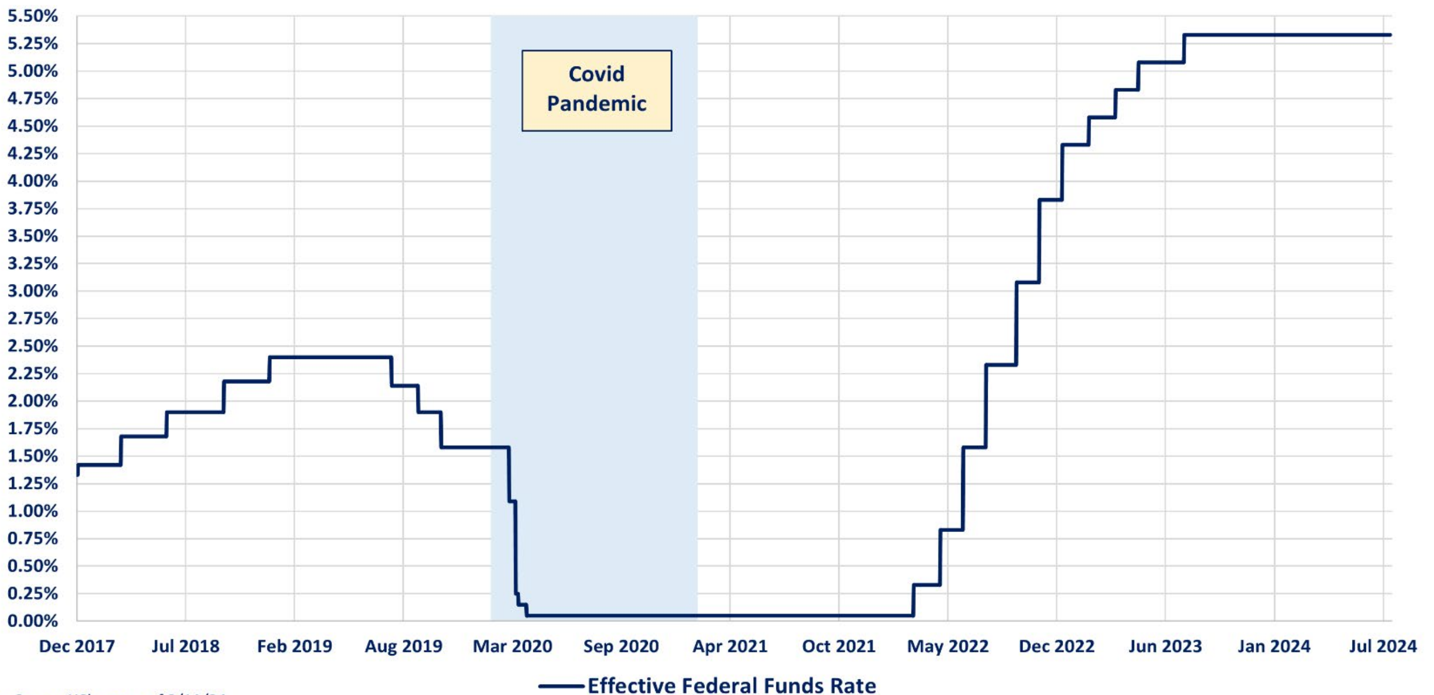
Regarding the latter, the Fed targets a low and stable rate of inflation of 2%. This level has been determined by the Fed to be a rate that may foster a stable economic environment. Much greater inflation causes consumers and businesses challenges in budgeting while lower levels of inflation than targeted may cause a delay of purchases as purchasers of goods and services delay consumption with the hopes that costs will go lower, thereby harming economic activity.

The chart below highlights both the Fed's targeted levels, where those figures have been and currently are, respectively.

In the post-Covid world, it is important to note that the Fed has several tools to attempt to promote growth, or restrict it, but the level of the interest rate target set at meetings is one of the most powerful. By raising interest rates, the cost of borrowing for consumers and businesses alike increases. A car loan or a mortgage will become less affordable with higher rates as more cash flow will be required to pay interest. Similarly, a business seeking to begin a new project may delay that project if the loan has a higher interest rate. On the other hand, when unemployment was high and rates were near zero, businesses were incentivized to take out new loans for new projects. As rates have risen in recent years as shown in the graph below, industries with a heavy financing component experienced more challenges. High quality balance sheets and the associated borrowing costs are represented by the US Corporate AAA Effective Yield while lower quality lending is represented by the US High Yield CCC Effective Yield. 2020 and 2021 represented significant declines for both groups as the Fed dropped rates to near zero (the rates in the graph are based on Fed interest rate targets plus a spread).

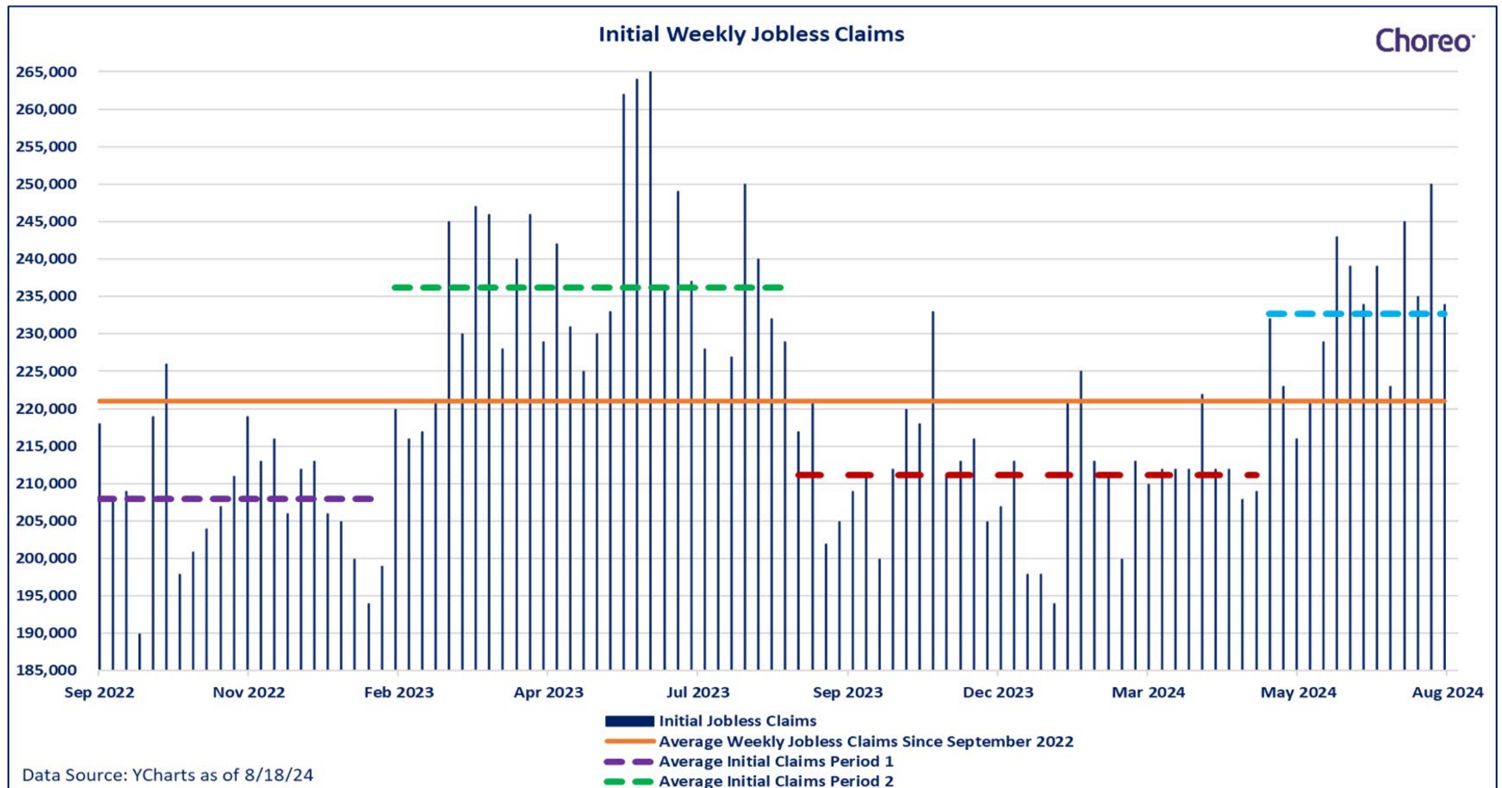


In recent years, the Fed has contended with economic volatility that has challenged their dual mandate. In 2020, Covid caused a surge in unemployment that took several years to return to normal. During that time, as mentioned the Fed lowered the cost of funds to near zero and maintained that level until it became clear that inflation had begun to rear its head beyond the boundaries of the Fed's 2% inflation rate target, perhaps too long in hindsight. This can be seen in the graph below.

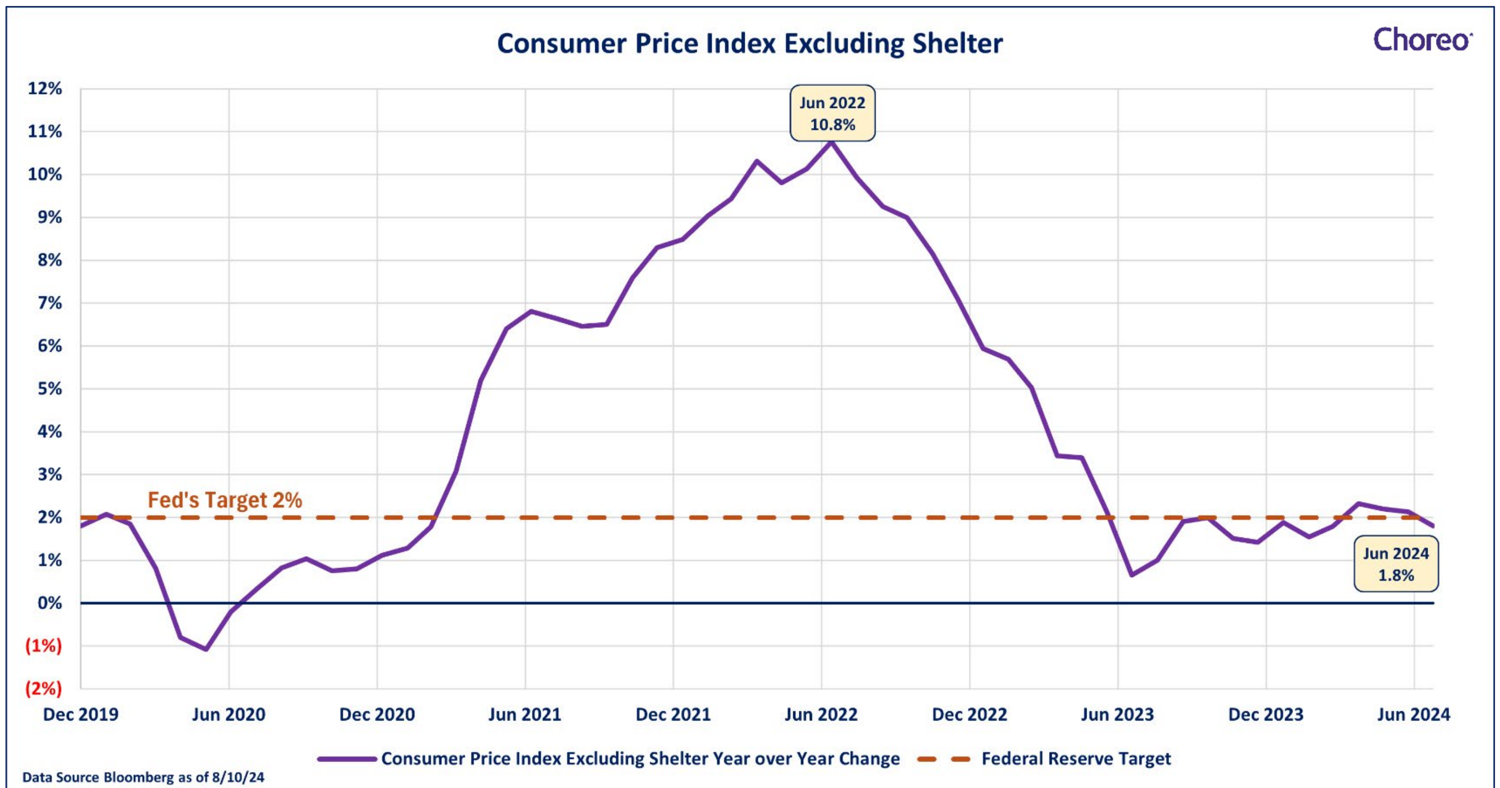


The Case For Rate Cuts

Inflation's retreat from the peak to much lower levels and recent softening of a resilient labor market has emboldened the Fed to consider cutting interest rates. The July jobs report showed unemployment rising to 4.3%, still in the ballpark of acceptable (and it is only one reading) but something the Fed is watching. The Fed is now looking at the potential that the employment picture may be less robust than it has been. The graph below regarding unemployment shows a trend of higher weekly jobless claims in recent weeks and months.

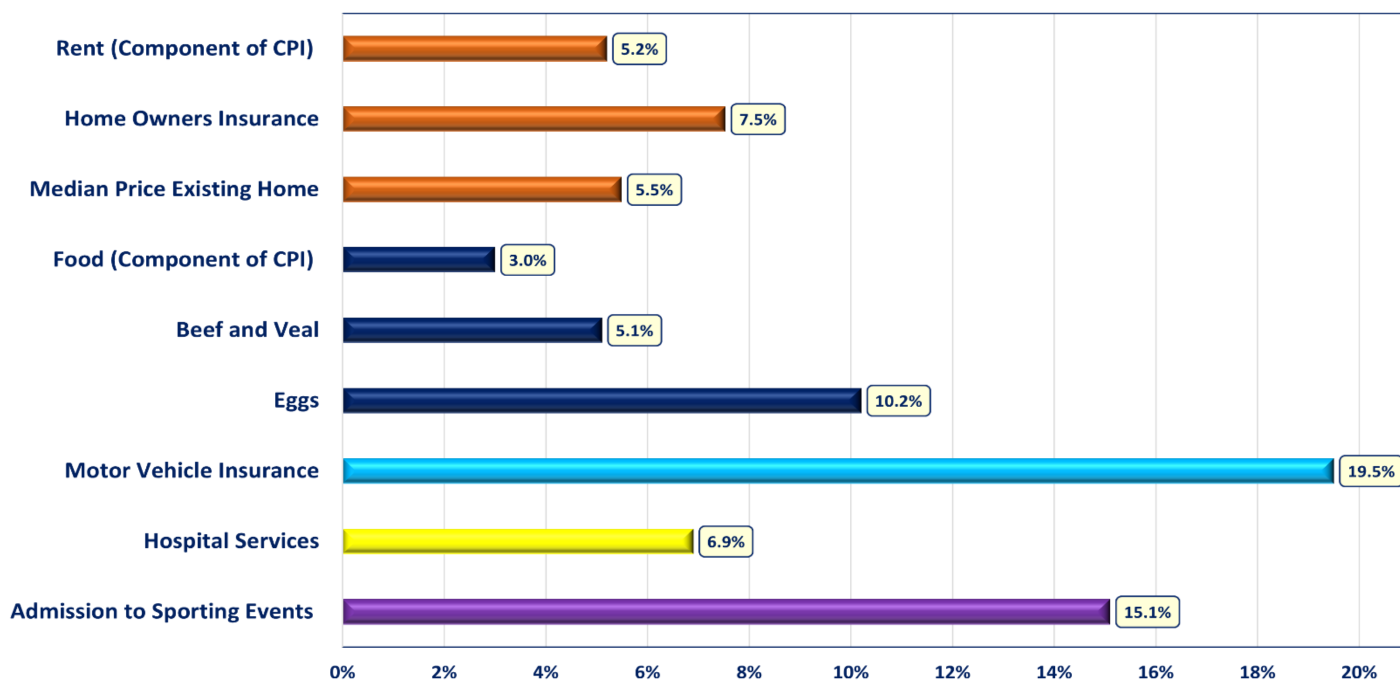


As mentioned, inflation is approaching more acceptable levels. Excluding the shelter component of the Consumer Price Index ("CPI") which tends to lag real time data, the Index has seen levels fall from peak and arrive near the Fed target levels. As the Shelter Index catches up, all else being equal, it is likely the broader inflation readings will decline further towards the Fed Target.



The Case Against Rate Cuts

Inflation is not yet a resolved issue in terms of being at acceptable levels. If the Fed cuts rates, the concern is lower rates could cause a boon in economic activity, thereby potentially exacerbating inflation. Take housing as an example. Inventory is low as homeowners wait for lower mortgage rates. It has been challenging for home buyers to trade a 3% mortgage they may currently have for a 7% mortgage. For most homeowners this would mean a dramatic increase in monthly payments. If rates dropped, home buying activity may heat up once again. Similarly, even a small drop in rates could yield a surge in borrowing across the economic spectrum, thereby raising inflationary pressures as fresh demand develops. As it stands now, many categories are not at Fed inflation target levels as shown below.



Another possible question relates to the other part of the Fed mandate, employment. This picture appears to be moderating somewhat from a very strong position but by no means is widespread weakness upon us, at least not yet. If the Fed concludes that the labor market is still in a position of strength, it may decide to be more patient with rate cuts. The Fed and economists alike continuously caution against overreacting to any limited data sets so a few weaker job reports may not change the rate picture much.

The broader question (and concern) for Fed members is if lower rates will cause inflation, without much growth, a condition that is often referred to as stagflation. Stagflation is when the economy "stagnates", but elevated inflation is present. This is a difficult challenge for fiscal and monetary authorities and one worthy of trying to prevent. While lower rates may encourage more borrowing, the traditional arguments that conditions are worsening are not present currently with any scale. The lagged data releases of many key factors may prove conditions are better or worse than currently assumed, so the Fed is attempting to figure out where conditions are headed.

Market Assumptions and Current Pricing

The market is now fully pricing in the beginning of the rate cut cycle with the first few cuts expected in the upcoming meetings. One of the most critical components of monetary theory is that rate movements take time to work through the economy. As an example, most Americans are locked into longer term fixed rate mortgages. Rate changes do not immediately impact those households unless they refinance or take a new mortgage. Similarly, companies who have financed their businesses with bonds have a fixed interest rate are not impacted significantly with rate movements until it is time for a refinancing. Some items move immediately such as credit card debt linked to prime rates, etc. Generally, though, it takes time for Federal Reserve policy to work through the economy.

This thinking will drive the Fed to make monetary policy moves ahead of when it may be needed. The data lags, the policy takes time to impact the economy, and the target and goals are often revised well after the fact. Therefore, the Fed may not and in fact likely will not wait until we are at 2% inflation or unemployment drifts to unacceptable levels. Fed governors will likely try to predict where the economy, inflation and unemployment may be headed, albeit with a heavy reliance on the current data sets and what conditions appear to be now. As mentioned, as of this writing, the current expectations are that the Fed will begin cutting interest rates in September and continue for some time. As of this writing (August 11, 2024), five 25 basis point rate cuts are currently baked into expectations through January (1.25% in total of rate cuts). The market has not been accurate so this can and likely will change, but the expectation of the first cuts is now present starting in September.

Conclusion

The Federal Reserve maintains tremendous power over economic activity through their toolkit, of which interest rate policy is amongst the most powerful. As the world awaits their next move, we maintain focus and think and plan across longer term cycles. Expectations are high that the Fed will finally begin to reverse the several years long policy of restrictive interest rates with cuts in the coming months. This is not the first time Fed policy has changed and will not be the last. Some level of volatility is to be expected during these monumental periods of change but the focus on long-term planning has traditionally served investors well.

We hope you and your families enjoy the final days of summer, and we encourage you to reach out to your Choreo advisor with any questions or comments.

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