Market Commentary: The Fed "Eases" – Where Do We Go from Here?

September 2024

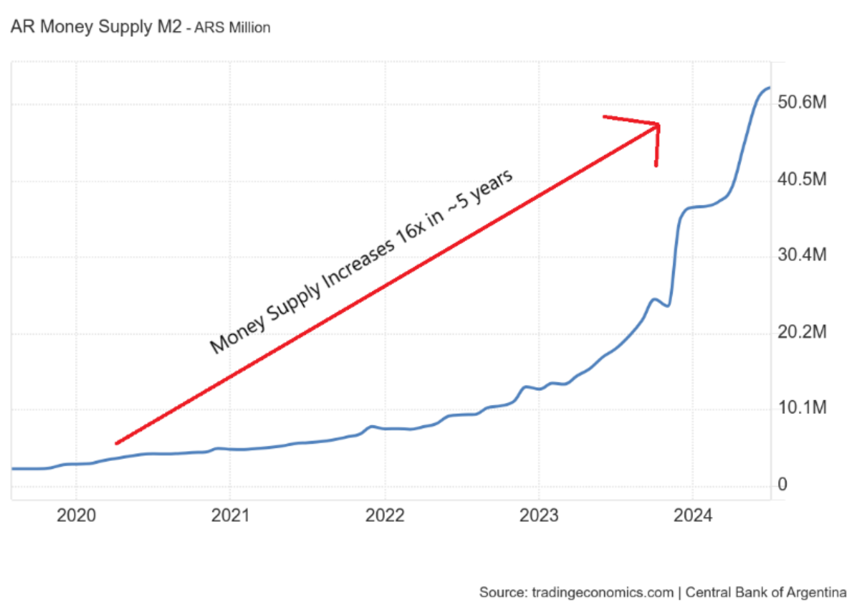
In mid-September, the Federal Reserve Board ("Fed") began an easing cycle, lowering the Federal Fund rate by 0.50%.[1] The move marks the end of what had been one of the fastest tightening cycles in recent history. The Fed gets credit for winning this most recent battle with inflation, which was primarily sparked by an increase in money supply and a temporarily broken supply chain.

The fact that inflation has been trending down towards 2%, the desired level of the Fed, provided the Fed comfort to begin an easing cycle. The expectation is that the Fed will continue to lower interest rates in order to now protect the US economy from ***de****flation*! Why is the Fed so sensitive to such a tight range of inflation, what are potential contributing factors, and how does this all affect the current interest rate environment?

Tune in to our recent podcast "Why Are Interest Rates Now Declining" featuring Lara Rhame, the Chief US Economist and Managing Director of FS Investments. Lara and I discuss what drives Federal Reserve decisions and how the latest decision to lower the Federal Fund rate may affect yields generally and the economy as a whole.

Why is the Fed so sensitive to inflation?

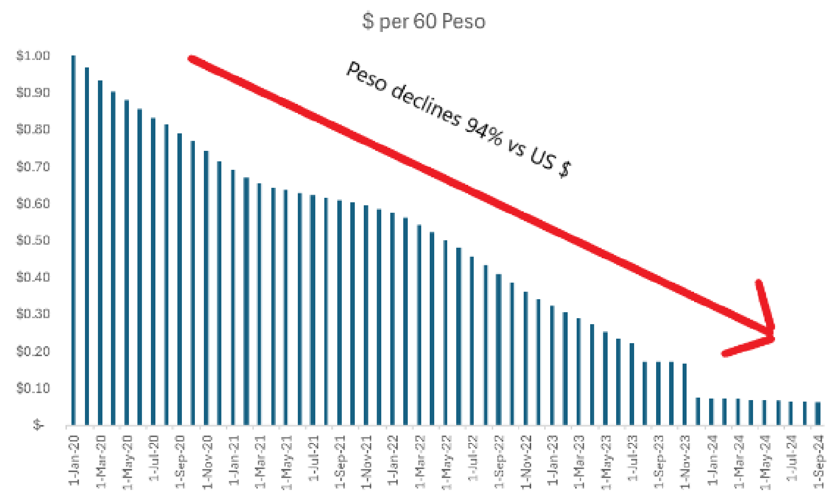
A recent barista in my favorite local coffee shop is from Argentina. He has memories as a kid of his grandfather walking around the grocery store, he owned with a sticker gun updating prices frequently through the day. Shoppers had to be quick! A primary reason for recent inflation in Argentina is the massive increase in money supply (essentially, out of control printing of currency).[2] This is exacerbated by logical human behavior: If one receives their paycheck in Argentine Pesos which immediately decline in value, one should exchange it for goods that can either be consumed or will maintain value (such as



[1] Federal Reserve Board - Federal Reserve issues FOMC statement, "easing" is where the Fed lowers rates, making it cheaper to use credit. It is the opposite of "tightening."
[2] Argentina's Rampant Inflation, Explained (in One Chart) | AIER

food or physical assets like gold) as soon as possible. The converse of rampant inflation is deflation, where instead of immediately running out to purchase items, one waits as long as possible to spend or exchange money.

Companies would generally fall into the same cycle as individuals, though with the added burden of having extreme difficulties in budgeting for future events and general capital expenditures which will further negatively affect the economy.



[3]

Deep Thought: Slow Down!

"Too often, we optimize for the numerical thing, time and speed. We're not optimizing for the emotional state, which is disquiet or anxiety."

Most apps are calibrated for time or price. When we get in our car, our navigation system (e.g., Waze) finds the quickest route to your destination. E-mail platforms (e.g., Gmail) ensure you receive an e-mail sent in milliseconds – regardless of whether it's important or spam. Airline apps (e.g., Kayak) will provide the cheapest or fastest flights, based on your preference.

Apps are not calibrated for quality. Waze may have you zig-zagging crazily through a town rather than sticking to a slightly slower highway drive to save you a minute. E-mail does not do a great job collating your mail based on importance or urgency. Kayak does not guide you through a preferable airport based on a number of features when calculating a stop-over route.

"Are We Too Impatient to Be Intelligent" is an interesting, meandering article reviewing how we tend to focus on simple quantities in getting to a destination, rather than the experience of the journey. This has applications to both business (e.g., how often to check e-mails), and society more generally (e.g., focus on experience/happiness or just getting "there") and therefore the economy.

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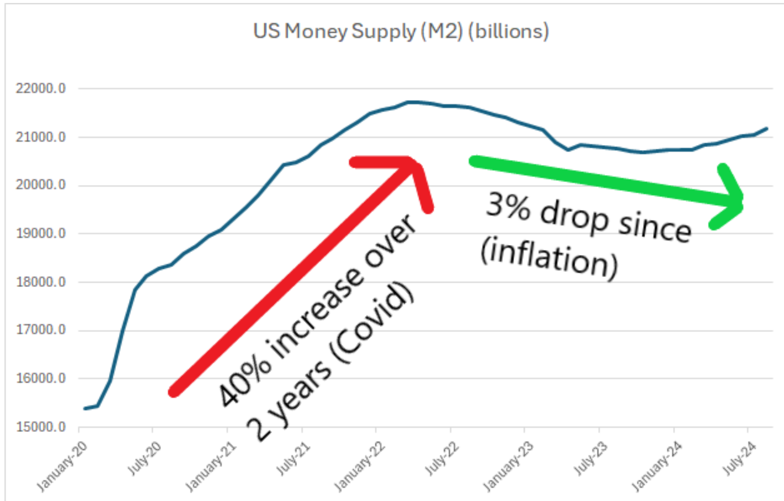
[3] Yahoo Finance Data, ~ 60 Argentinian Pesos = $1 in January 2020 and now = ~$0.06

What are contributing factors to inflation?

Money Supply

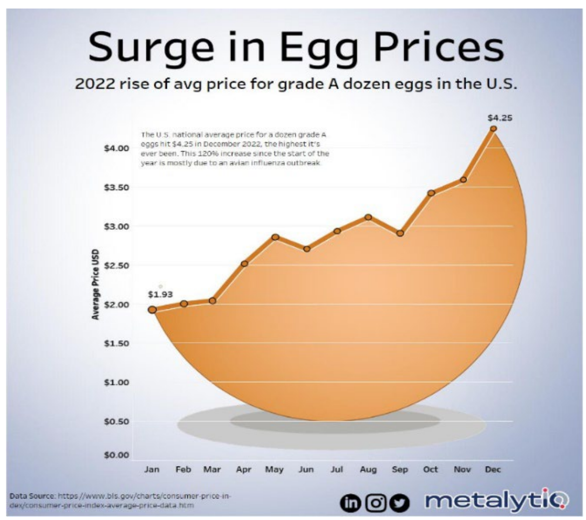
[4]



If the government provided every US citizen an extra $1,000 and demanded they immediately spend the extra money, prices for goods and services would most likely increase as demand rose by around $375 billion[5] over night. Money supply is a measurement of money floating around in our system. Given all the complexities of assessing the level of money supply in an economic system, it is very hard to state definitively whether the money supply of a country is too high or too low. It's pretty easy, though, to analyze the change in money supply from year to year. The example above ($1K per citizen) reflects the rate of change of the money supply, which should provide a better indication of potential inflationary or deflationary pressures as opposed to whether there's too much or too little. For example, the money supply in Argentina increased dramatically over the last few years with no reasonable justification such as a similar expansion of their general economy. This contributed to inflation. The Fed worked to lower our money supply over the last couple of years. This contributed to deflationary pressures.

Product Supply

[6]



From time to time, a product supply diminishes which results in inflation in that product. A good recent example is eggs which shot up in value due to avian flu that affected a material number of egg-laying hens in the US.[7] While there may always be shortages in an item or two, the diversification of products in our lives generally mitigates potential supply issues as well as the overall effect of inflation due to a narrow event.

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[4] M2 (M2SL) | FRED | St. Louis Fed (stlouisfed.org) data

[5] ~375 million citizens x $1,000

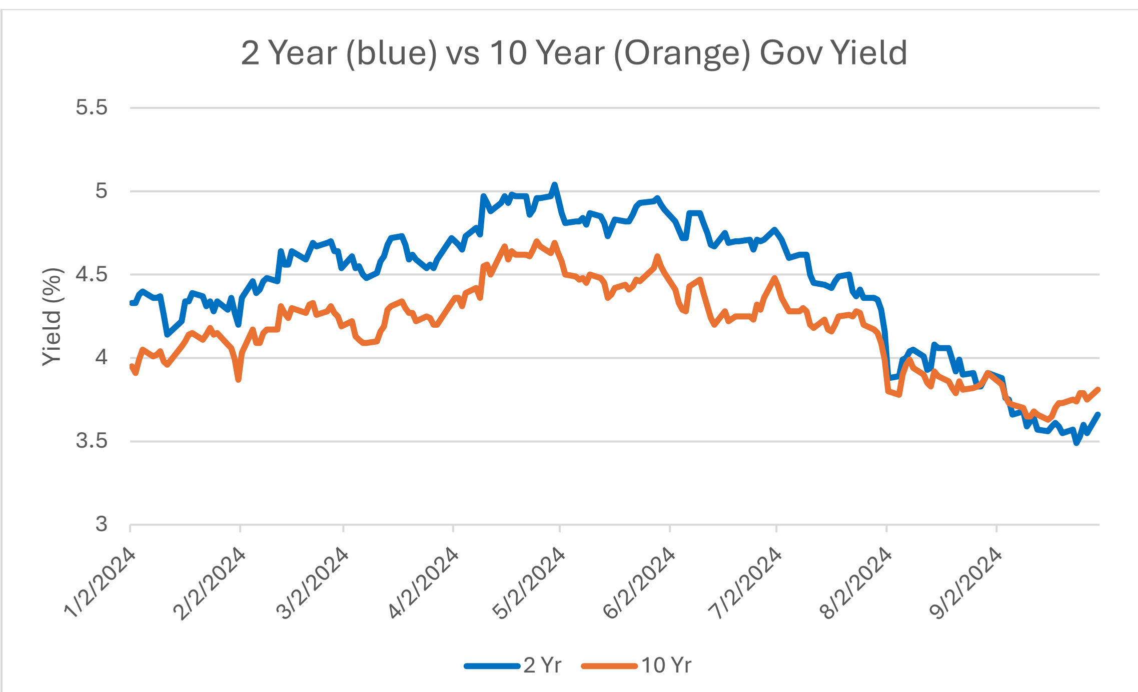
[6] Egg Prices Are Rising Again. Here's Why They're So Expensive - NerdWallet

Human Supply!

Jobs, which we explored in our [last commentary](), are the key source of income for most Americans. If the job market is hot, companies need to increase wages. This in turn provides general confidence to the average consumer, as well as puts more dollars in their pocket. There are many reasons for the Fed to focus on "full employment," but maintaining a narrow range of inflation is one of them.

How does easing affect the current interest rate environment?

Financial markets are constantly looking ahead. In the beginning of 2024, the interest rate for a two-year treasury note was 4.33% as compared to a fed fund rate of closer to 5.5%. That was due to the belief that the Fed would start cutting rates relatively soon and lower that 5.5% rate to 4.5% by the end of 2024 and further in 2025. That two-year rate increased as high as 5% mid-year as some inflation numbers ran hot and the Fed continued to delay a potential cut. The market assessed current data and tried to extrapolate forward. There was a high degree of confidence that the Fed would cut rates in their September meeting. That expectation resulted in the two-year rate dropping to ~3.6% a couple of weeks *prior* to the announcement and staying stable through the cut. The market had already priced in the anticipated cut and the actual cut more or less matched expectations. If the Fed hadn't actually cut rates, or had cut them less than expected, market rates would have jumped back up.



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As the chart above shows, markets are continuously calibrating expectations of future rate cuts and hikes as well as the added risks that longer maturities have in terms of how the Fed will handle their balance sheet and what future governments may decide to do about our growing budget deficit and generally ballooning debt load.

The Fed has more control of some factors and levers, such as money supply and rates, that further affect consumer and commercial spending habits. However, they have less control of other factors, such as how many people may cross our borders, foreign policy, global and local events (e.g., Covid, avian flu, Russian-Ukraine war) and so on. In summary, the Fed is trying for a soft landing – but they do not have even close to complete control and that is what makes the markets so interesting and allows for reward in return for risk.

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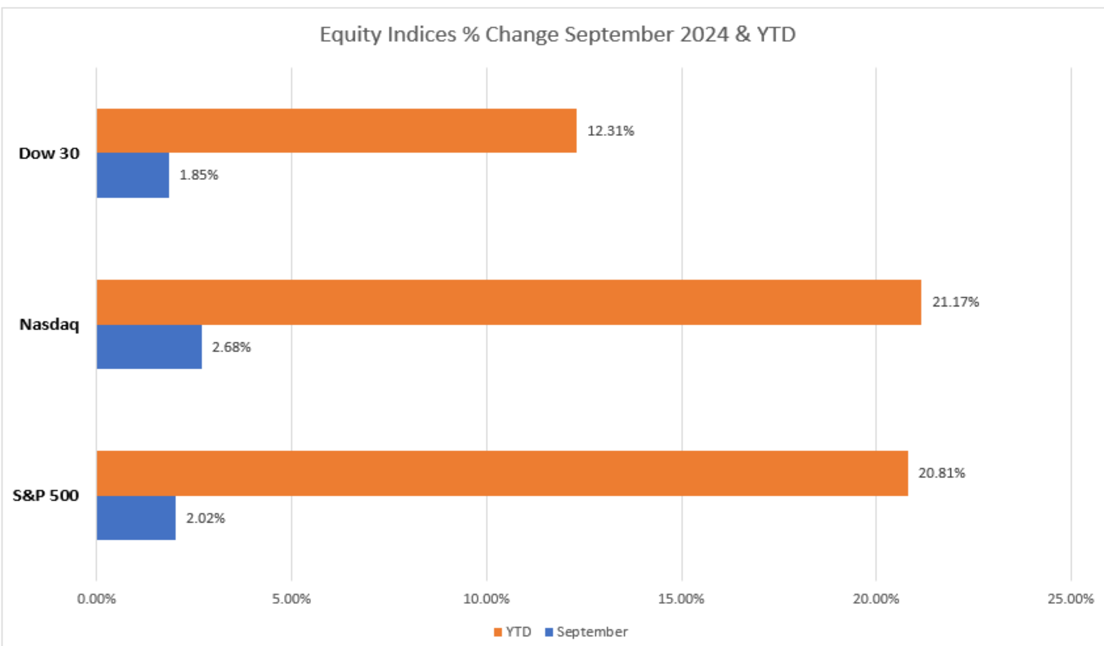
Talking Points: September 2024

Monthly Market Recap

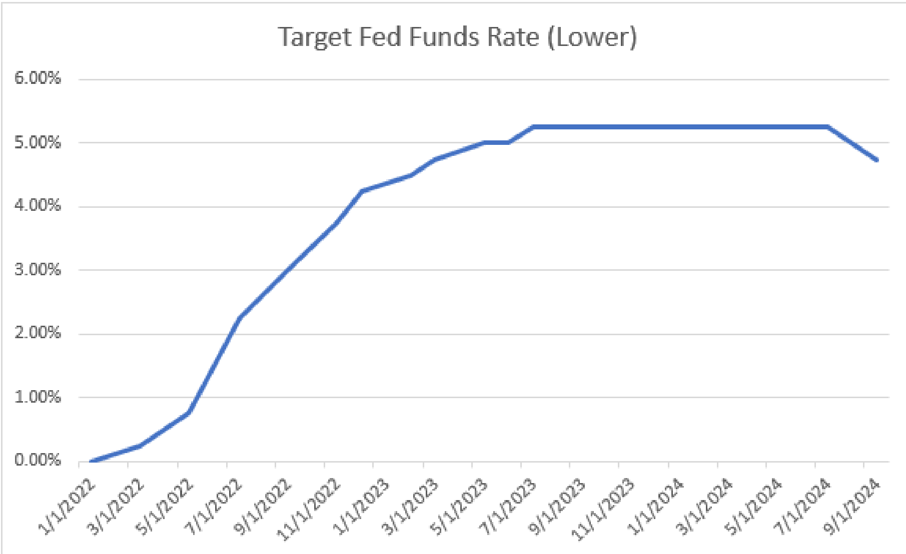
Markets remained volatile heading into September as participants attempted to read the tea leaves on the economy as a whole and an expected Fed action with respect to interest rates in their scheduled mid-September meeting. The Fed did not disappoint as they finally implemented their first interest rate cut of this cycle, opting to cut by 50bps rather than 25bps. It was the first interest rate cut since March 2020, when the Fed looked to support the markets at a time when the economy was effectively shut down by Covid. Through all the drama, equity markets managed small gains while yields fell materially.



[8]

Heading into 2024, markets were pounding the table for rate cuts, pricing in as many as six rate cuts even though the Fed was only forecasting three. Six 25bps rate cuts would have put the Fed's lower target rate at 3.75% (vs. 5.25% to start 2024). At this point in the year, it's safe to say they will not be hitting that level. That said, the move to cut 50bps and Powell's commentary after the decision was a step in the right direction as far as markets were concerned.

[8] FAM created from generally available financial data



[9]

Throughout August and September concerns were growing that the Fed was behind the curve when it came to rate cuts. Labor market data weakened quickly, and it was starting to seem like the economy was headed towards a recession ("hard landing") rather than a mild economic downturn ("soft landing"). Recall, the goal of the Fed this whole cycle has been to adequately lower inflation by raising rates without pushing the economy into a recession. Easy enough right? Sort of… but at least by ripping the Band-Aid off and cutting by 50bps, the Fed re-confirmed to markets that they are indeed serious about achieving a soft landing.

Probability of Upcoming Fed Interest Rate Decisions							
9/30/2024	***Hike***	***Hold***	***Cut***	***Hike 25bps***	***Cut 25bps***	***Cut 50bps***	***Cut 75bps***
November	0.00%	0.00%	100.00%	0.00%	65.30%	34.70%	0.00%

[10]

Looking forward, the consensus is that the Fed will lower rates again at its next meeting on November 7th. Once again, the question now becomes whether it will be another big 50bps cut or the standard 25bps? As of market close on the last day of the month, markets are pricing in a higher probability of a 25bps cut, but both options are very much on the table.

[9] FAM created from generally available financial data
[10] FAM created from generally available financial data

FAM Sentiment Summary[11]

2024	January	February	March	April	May	June	July	August	September
Fed	MILDLY BEARISH	MILDLY BEARISH	MILDLY BULLISH	BEARISH	MILDLY BEARISH	NEUTRAL	MILDLY BULLISH	MILDLY BULLISH	BULLISH
Interest Rate Decisions	NEUTRAL	n/a	NEUTRAL	NEUTRAL	NEUTRAL	NEUTRAL	NEUTRAL	NEUTRAL	BULLISH
Commentary	BEARISH	MILDLY BEARISH	BULLISH	BEARISH	MILDLY BEARISH	MILDLY BEARISH	MILDLY BULLISH	BULLISH	BULLISH
Economic Data	NEUTRAL	MILDLY BEARISH	MILDLY BEARISH	MILDLY BEARISH	NEUTRAL	MILDLY BULLISH	MILDLY BULLISH	NEUTRAL	MILDLY BEARISH
Inflation	NEUTRAL	MILDLY BEARISH	BEARISH	BEARISH	NEUTRAL	BULLISH	BULLISH	BULLISH	MILDLY BULLISH
Employment/Labor Market	MILDLY BEARISH	MILDLY BEARISH	MILDLY BEARISH	MILDLY BEARISH	BULLISH	NEUTRAL	MILDLY BULLISH	BEARISH	BEARISH
Housing/Real Estate	NEUTRAL	NEUTRAL	MILDLY BEARISH	MILDLY BULLISH	MILDLY BEARISH	MILDLY BEARISH	MILDLY BEARISH	NEUTRAL	NEUTRAL
GDP	BULLISH	n/a	NEUTRAL	BEARISH	MILDLY BEARISH	NEUTRAL	NEUTRAL	NEUTRAL	NEUTRAL
Consumer Spending	MILDLY BEARISH	NEUTRAL	NEUTRAL	MILDLY BEARISH	MILDLY BULLISH	MILDLY BULLISH	NEUTRAL	MILDLY BULLISH	NEUTRAL
Consumer Sentiment	MILDLY BULLISH	NEUTRAL	MILDLY BEARISH	MILDLY BEARISH	NEUTRAL	NEUTRAL	NEUTRAL	NEUTRAL	NEUTRAL
Global Events/News	NEUTRAL	NEUTRAL	NEUTRAL	NEUTRAL	MILDLY BEARISH	MILDLY BEARISH	MILDLY BEARISH	MILDLY BEARISH	MILDLY BEARISH
China	MILDLY BEARISH	NEUTRAL	NEUTRAL	NEUTRAL	MILDLY BULLISH	NEUTRAL	MILDLY BEARISH	NEUTRAL	BULLISH
Europe	NEUTRAL	NEUTRAL	MILDLY BULLISH	MILDLY BULLISH	MILDLY BEARISH	MILDLY BEARISH	MILDLY BEARISH	MILDLY BULLISH	NEUTRAL
Russia Ukraine War	NEUTRAL	NEUTRAL	MILDLY BEARISH	MILDLY BEARISH	MILDLY BEARISH	MILDLY BEARISH	NEUTRAL	NEUTRAL	NEUTRAL
Israel Hamas War	NEUTRAL	NEUTRAL	NEUTRAL	MILDLY BEARISH	MILDLY BEARISH	MILDLY BEARISH	BEARISH	BEARISH	BEARISH
US Politics	NEUTRAL	NEUTRAL	NEUTRAL	NEUTRAL	MILDLY BEARISH	MILDLY BEARISH	NEUTRAL	NEUTRAL	NEUTRAL
2024 Election	NEUTRAL	NEUTRAL	NEUTRAL	NEUTRAL	MILDLY BEARISH	MILDLY BEARISH	NEUTRAL	NEUTRAL	NEUTRAL
Budget Negotiations	NEUTRAL	NEUTRAL	NEUTRAL	NEUTRAL	NEUTRAL	NEUTRAL	NEUTRAL	NEUTRAL	NEUTRAL
Earnings	NEUTRAL	MILDLY BULLISH	MILDLY BEARISH	NEUTRAL	BULLISH	MILDLY BULLISH	MILDLY BULLISH	NEUTRAL	NEUTRAL
Banking Turmoil	MILDLY BEARISH	MILDLY BEARISH	MILDLY BEARISH	MILDLY BEARISH	NEUTRAL	MILDLY BEARISH	NEUTRAL	NEUTRAL	NEUTRAL
Crypto	BULLISH	BULLISH	BULLISH	NEUTRAL	MILDLY BULLISH	NEUTRAL	NEUTRAL	NEUTRAL	NEUTRAL

Notable Changes from the Month Prior:

- Fed Interest Rate Decisions - Neutral to Bullish
  - This month markets finally got the cut they have been looking for all year after being neutral on interest rate decisions throughout 2024.
- Economic Data - Neutral to Mildly Bearish
  - This sentiment adjustment was the result of material weakening in labor market data (employment/labor market - remained bearish) and inflation data not being as strong as recent months (inflation - changed from bullish to only mildly bullish).

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[11] FAM Sentiment summary is a FAM created table highlighting what we perceive as the major themes affecting market movement along with our qualitative view of how those themes affect the market. The qualitative view ranges from bearish to bullish.

- China - Neutral to Bullish
    - Markets have been mostly mildly bearish or neutral on China throughout most of 2024. This changed this month after the country announced a large stimulus package to help jump start their economy.

Key Indicators:

- ***BEARISH***
    - Highly anticipated August jobs report pointing to labor market weakening (US added fewer jobs than expected and the overall unemployment rate rose)
- ***MILDLY BEARISH***
    - Manufacturing activity and construction spending for the month of August coming in below expectations
    - US job openings in July hitting lowest level since 2021
    - Retailer Dollar Tree raising concerns over the current state of the US consumer as, "households with more than 125k in annual income had started shifting to buying for need rather than buying for want"
    - August Core CPI coming in higher than the month prior (although, in line with expectations)
    - Ally Financial warning markets that consumers are starting to really feel the pressures of elevated rates
    - Israel conducting a series of attacks against Hezbollah starting with targeted explosions through handheld devices - followed by attacks on Hezbollah rocket launchers and operations against senior Hezbollah leadership
- ***NEUTRAL***
    - Oil prices hitting recent lows in the beginning of the month as concerns over weakening US and China demand grow
    - The yield curve no longer being inverted for the first time since July 2022
    - August CPI coming in lower than the month prior (and in line with expectations)
    - PPI for the month of August coming in as expected
    - Markets pricing in a higher probability of Harris winning the election after she outperformed Trump in their first debate according to most polls and pundits

- FBI announcing that they were investigating a second potential assassination attempt of former President and current Presidential candidate Donald Trump
- Existing home sales coming in lower than the month prior
- Bank of England announcing that they would be keeping rates unchanged this month

- ***MILDLY BULLISH***
  - Reports surfacing that the Fed was still undecided on how much to cut by post CPI release
  - Bank of Japan announcing that they would be keeping rates unchanged this meeting
- ***BULLISH***
  - Fed announcing a 50bps cut
  - Powell's commentary post interest rate decision where he said that the Fed is committed to not getting behind on supporting the labor market
  - China surprising markets by announcing a large stimulus package to help shore up their economy

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