The Advisor

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Market Update - Third Quarter, 2024

ALL EYES AND EARS ON THE FED – This afternoon, the Federal Reserve will conclude their July meetings where they are expected to hold their target rate steady at 5.25 – 5.50%. Current Fed Funds futures prices imply a 96% probability the Fed keeps rates where they are – leaving a 4% likelihood they cut by 25 basis points.

We highly doubt the Fed will shock the markets and cut rates today.

The real drama, and must-see TV, will be how the Fed communicates or signals possible rate cuts for their next meeting in September. If we look at what the market is pricing in for the September meeting, we find an 88% likelihood of a 25-basis point cut and a 12% probability of a 50-basis point cut. We rounded those numbers for simplicity but the market is actually pricing a 0.4% probability the Fed cuts by 75 basis points at the September meeting. Adding it all up, currently, the market is pricing a zero percent chance the Fed does NOT cut in September – and we agree, it's time to cut and here is why.

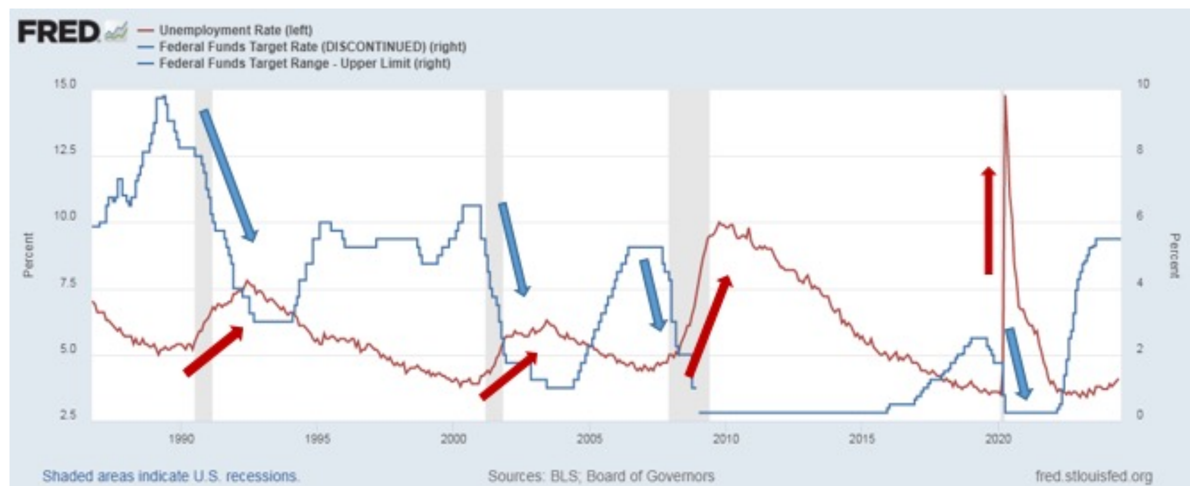
The Fed is under a statutory dual mandate to promote maximum employment and stable prices. In other words, take actions that promote a strong labor market and help to minimize inflation.

Maximum Employment

The most recent unemployment rate for June (July's will be released in early August) climbed to 4.1%, the highest level since November of 2021, but still within the range the Fed considers "full employment".

The reality, however, is the unemployment rate is trending higher and in fact sits at multi-year highs as does continuing jobless claims, a proxy for the number of people receiving unemployment benefits.

Here is a chart plotting the Unemployment Rate (Red) and the Federal Funds Target Rate (Blue) including the last four recessions. We added the arrows to help follow the big moves. Recessions are indicated by the shaded areas. A couple things stand out. First, it's common for the Fed to begin cutting rates and yet the unemployment rate goes UP and peaks months, if not years, later after a recession has been declared. Second, look at the depth of rate-cuts in a recession cycle with each subsequent cycle leaving the Fed rate lower and lower until reaching zero during 2009 and again in 2020.

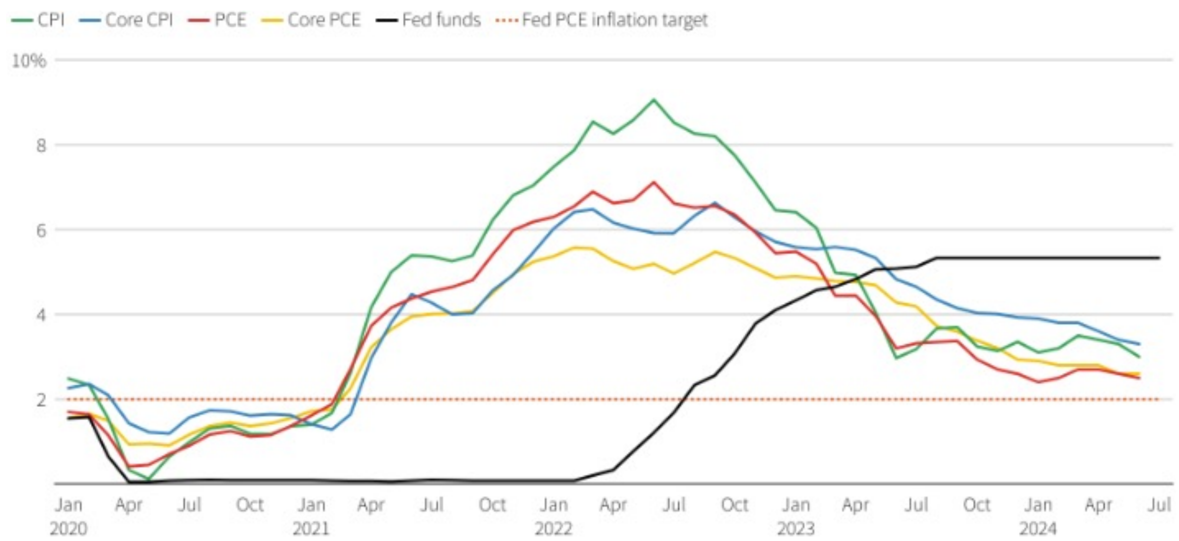


It's important to keep in mind that correlation is not causation. There were many factors that were in-play during each of these cycles which may help explain the drastic moves depicted in the chart. That said, it's also clear that Fed rate cuts appear pretty ineffective at saving the labor market once it begins to crack. If this time is not different, history suggests significant weakness in the labor market and a recession are the biggest threats we face. For this reason, we see the risk/reward out of balance for the Fed keeping their target rate at current levels.

Stable Prices

The Fed prefers to use the Personal Consumption Expenditure (PCE) index to measure inflation. The most recent PCE data came in at 2.5% for June, decelerating slightly from May's 2.6% and reaching the lowest level since February 2021. If we switch gears and look at Core PCE, which removes food and energy prices, it's 2.6%.

Below is a chart from Reuters to help visualize each measure of inflation alongside the current Fed Funds rate (black) and the Fed's 2% inflation target (dotted orange). The inflation trend is clear and the extreme levels have subsided. Here is Fed Chair, Jerome Powell, in a speech at the Economic Club of Washington D.C., "… if you wait until inflation gets all the way down to 2%, you've probably waited too long, because the tightening that you're doing, or the level of tightness that you have, is still having effects which will probably drive inflation below 2%."



Note: CPI = Consumer Price Index; PCE = Personal Consumption Expenditures Price Index; Core = excluding food and energy; Fed funds = Fed policy rate
Source: Federal Reserve (funds rate and target); Bureau of Labor Statistics (CPI); Bureau of Economic Analysis (PCE); inflation rates are annual
Reuters Graphics Reuters Graphics

Final thoughts

The labor market, measured by the unemployment rate, is trending in the wrong direction. Inflation, measured by the Fed's preferred PCE Index, is trending in the right direction. The risk/reward to the economy is now out of balance and no longer supports the case for the Fed to maintain their current target range.

We have written before that interest rate policy is a blunt force tool. Debating the effectiveness of such policy is for another time but its impact is clearly visible right now in consumer behavior such as the rise of credit card and auto loan delinquencies, a low personal savings rate and a frozen housing market. Not surprisingly, consumer excess savings have also been depleted.

Not to exclude the commercial front, bankruptcies are on the rise and the Mortgage Bankers Association reports that nearly $2 trillion of the $4.7 trillion commercial real-estate loans nationwide will mature over the next three years. There are only a few options: extend, forced sale, default. The challenge for many is this current rate environment is much higher and much more expensive than just a few years ago when the loans were originated.

Lastly, our view that the Fed needs to begin to lower their target rate is not about the stock market. There might be some sugar high and lift to markets when the Fed does communicate their plan but we expect

periods of volatility once they do. On the one hand, stocks rally as the rate burden of financing begins to fall. On the other hand, stocks sell-off because the Fed cutting rates historically signals the economy needs some oxygen, some breathing room to recover for the next phase of growth, if not avoid recession, and that brings a whole lot of questions, if true.

The other source of volatility is the November Presidential election in conjunction with a shift in Fed monetary policy if they do decide on a rate-cut in September. We don't need to spill much ink on this; it's politics, of course there will be differing opinions and that typically ignites volatility in markets. In the end, even considering Fed policy and a Presidential election, the markets will eventually settle into equilibrium that reflects the underlying economy, consumer and corporate earnings power - be that strong, or weak.

The bottom line here is this, our opinion the Fed should begin cutting rates is centered on increasing the tailwinds to the economy, the consumer and companies. Risking a proper recession, or worse, is not necessary after examining the Fed's dual mandate.

To our clients, thank you for the opportunity to serve your investment needs and please do not hesitate to contact us if you experience any material changes in your personal situation or would like to discuss any specific matters.

To our other readers, if you would like a complimentary review of your investment accounts or any other financial matters, please do not hesitate to contact us. As fiduciaries, we will happily provide you with an unbiased opinion based on your specific situation.

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