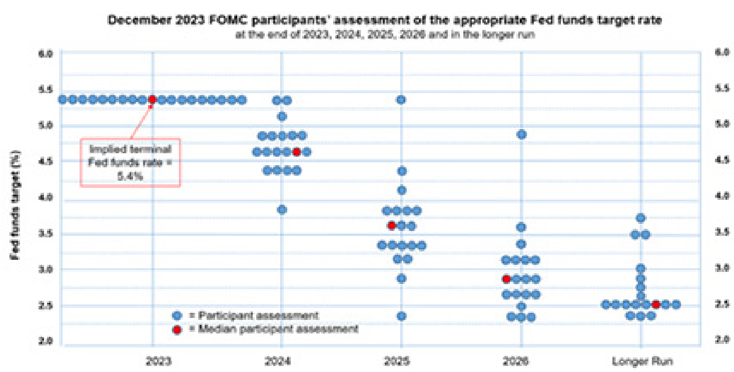
Market Insights: Anticipated Rate Cuts in 2024

KEY HIGHLIGHTS:

- The Federal Open Market Committee is likely to begin lowering its target interest rate in 2024.
- Equity markets have become strongly correlated to expectations for future rate cuts.
- Recent activity in the fixed-income market suggests that many investors are questioning the pace and extent of Federal Reserve Bank (FRB) rate cuts based on the current economic data.

In March of 2022, following two years of liquidity injections and economic stimulus resulting from policies surrounding the COVID-19 pandemic, the Federal Open Market Committee (FOMC) raised its target interest rate for the first time since December of 2018. This 25-basis point increase on March 16, 2022 would be the first of eleven rate increases over the following sixteen months that would raise the target interest rate by a total of 525 basis points, resulting in the most aggressive rate hiking cycle in the last four decades. Now, just twenty-two months after the first rate increase, many policymakers and economists are expecting the FOMC to pivot in 2024 and begin decreasing the target interest rate.

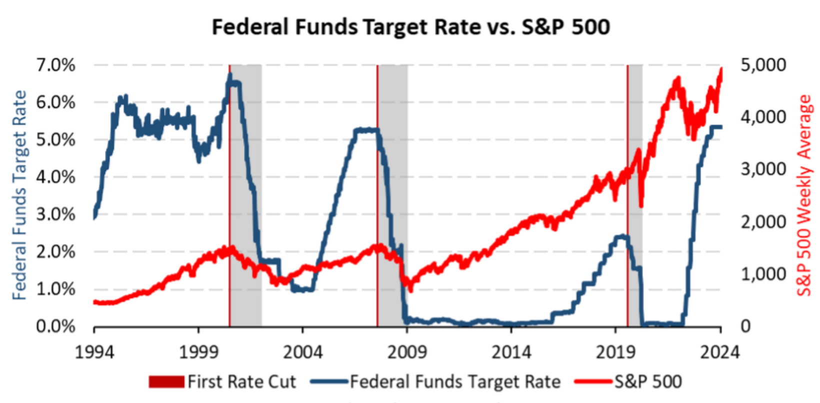


At the Federal Reserve monetary policy meeting in December 2023, the Federal Reserve Bank (FRB) signaled that it had completed raising the target interest rate and that it intends to reduce this rate throughout 2024 and beyond. In the dot plot that the FRB released at the most recent December meeting, the forecasted target interest rates were 4.6% for 2024, 3.6% for 2025, and 2.9% for 2026.

Equity markets responded aggressively to the near-term prospect of rate cuts by the FRB, triggering a strong rally into year-end 2023. Since November 1, 2023, the Dow has increased 16.8%, the NASDAQ has increased 19.3%, and the S&P 500 has increased 17.6%, including closing above 5,000 for the first time ever on February 9.

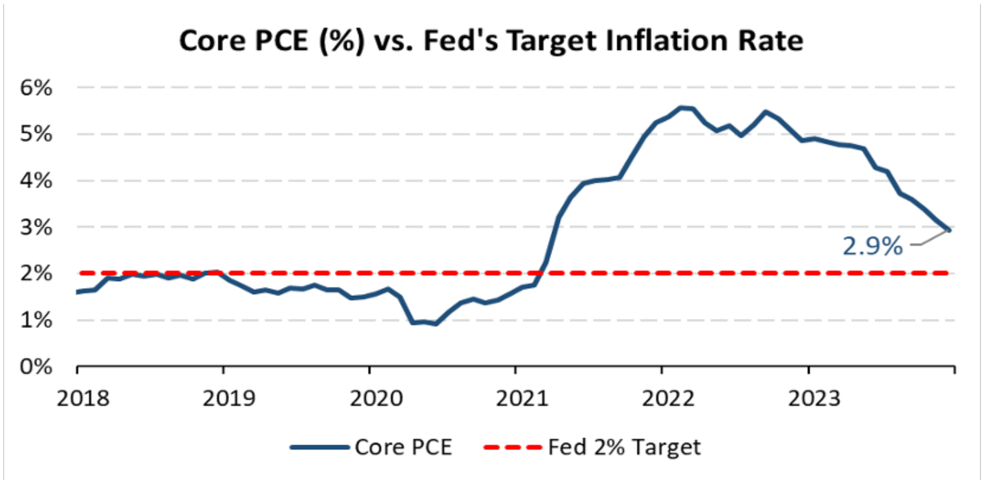
However, this optimism should be tempered by history and economic data. Historically, the equity markets actually sell-off after the first rate cut because traditionally the Federal Reserve reduces interest rates as a result of current or anticipated economic weakness.

This economic weakness will typically translate to lower consumer spending, lower corporate earnings and ultimately lower asset values. As economic weakness and interest rate cuts continue, the repricing of these asset values will ultimately create a buying opportunity when lower interest rates combined with lower asset values stimulates economic growth. However, the first interest rates cut is just the beginning of a much longer downward adjustment process for asset values.



The expectation for interest rate cuts by the Federal Reserve has caused medium to long-term interest rates to decline. The U.S. 10 Year Treasury decreased 93 basis points in the last two months of the year after the FRB announcement. As the velocity of rate cut expectations slowed in the past week, medium and long-term interest rates have rebounded slightly, increasing 46 basis points since the start of the new year.

Recent activity in the fixed-income market suggests that many investors are questioning the pace and extent of FRB rate cuts based on the current economic data. For example, the current unemployment rate, representing January 2024, is at 3.7% and just slightly above a fifty-four year low of 3.4% that was achieved in April 2023. However, as we outlined in last month's newsletter, the quality of the latest employment releases is questionable, and the labor market strength appears overstated. U.S. GDP grew 3.3% in fourth quarter 2023 and for the entire year, average annualized growth rate of 3.1%, up from just 0.7% in 2022. Amidst this healthy economic data, the FRB's preferred inflation measure, the PCE price index excluding food and energy decreased to 2.9%, falling below 3% for the first time since March 2021, but still above their 2% target. The combination of current employment market, ongoing economic growth (albeit likely slowing) and ongoing inflation pressure (albeit abating), is likely giving the FRB pause regarding the pace and size of rate cuts to return to a normalized policy level. Chairman Powell provided similar commentary during his recent 60 Minutes interview on February 4th.



The year ahead is setting up to be a very important year on all fronts. The national economic consensus has coalesced around the Federal Reserve engineering a soft or no-landing with their economic policy through COVID and this assumption will be tested through the remainder of this year and into 2025 as government stimulus, consumer spending and business investment are normalized. We are not as optimistic about the economic outlook and believe it is too soon to arrive at a conclusion. The Presidential and Congressional level elections in November will have a defining impact on legislation, the economy, national values and political future. Globally, there is more geopolitical instability in the world today than in recent history and this is adding greater negative pressure to the global economy. Though current economic data remains more resilient than many anticipated, there are many tail risks that may impact the domestic and global economy.

Amidst this complicated landscape, the FRB has created an expectation for interest rates being lowered in 2024, 2025 and 2026. This expectation has created a rally in equity and bond markets, as well as stabalized overall asset values in many sectors. As a result, values have become elevated through the expectation of a "goldilocks" economy where growth is slow enough to keep interest rates lower, but strong enough to ensure consumers, labor markets, businesses and overall spending remains good enough to maintain current asset values. With all this complexity domestically and internationally in the years ahead, we believe there is much less certainty than the Federal Resersve, economists and overall market are projecting.