JSB Capital Management, LLC

Pro-active Wealth Management

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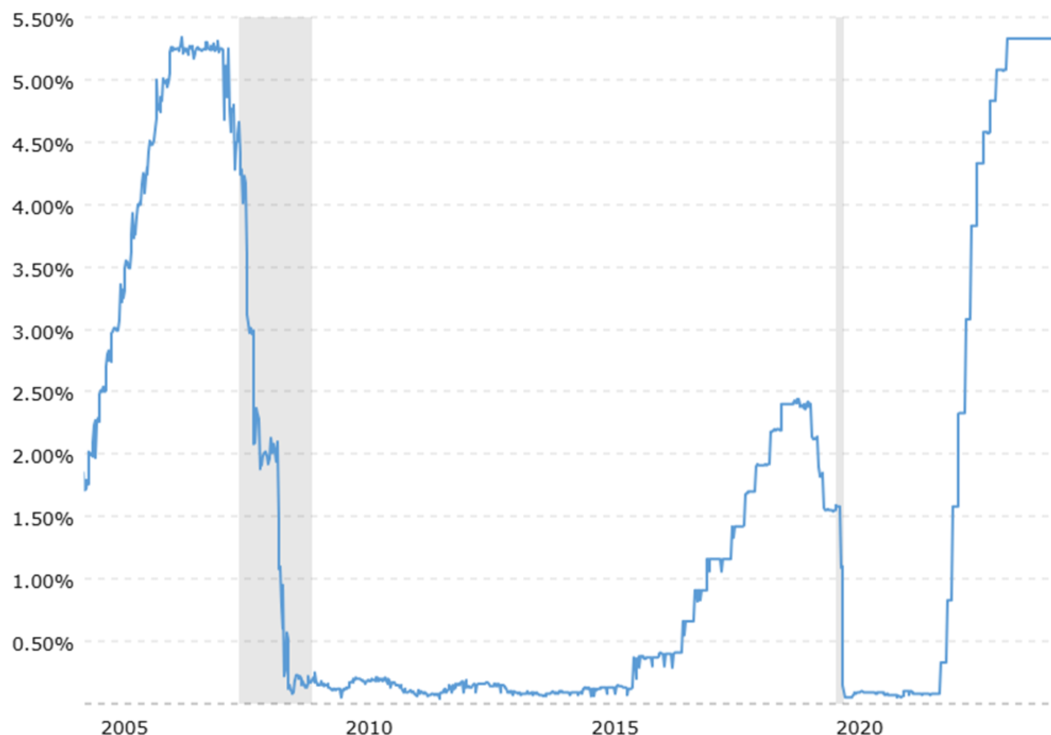
The Federal Reserve Bank

After maintaining a "Zero Interest Rate Policy" since 2008, the Federal Reserve Bank ("The Fed") began a series of aggressive interest rate hikes in March 2022 to combat soaring inflation, which had reached levels (around 9%) not seen in four decades. Starting with a modest 0.25% (25 basis point) increase that brought the Federal Funds rate to 0.25-0.50%, the Fed quickly accelerated its rate increasing pace. For perspective, the chart below depicts the Fed's interest rate policy over the last 20 years (recession periods are in grey):



By the end of 2022, the rate had climbed dramatically to 4.25-4.50% through a combination of 0.50% and several very aggressive 75 basis point (0.75%) hikes. The central bank continued its tightening cycle into 2023, albeit at a moderate pace, with several 25 basis point increases. The final hike in July 2023 brought the rate to 5.25-5.50%, the highest level since 2001. This rapid and substantial series of rate increases reflected the Fed's determination to bring inflation under control, even at the risk of an economic slowdown.

By September 2024, inflation had significantly moderated, approaching the Fed's 2% target, leading to speculation about potential rate cuts in the near future as the focus shifted towards maintaining economic stability and growth.

Referring back to the chart above, note that the recession periods in grey follow closely with the initiation of interest rate cuts. Does that mean we should expect a recession in 2025, for example? In fact, eight of the Fed's past nine tightening cycles have ended in a recession, so it's ultimately the higher interest rates for longer that lead to recession which historically tends to begin following the beginning of the rate cut cycle.

What Did The Fed Accomplish?

The FOMC's careful approach to monetary policy, maintaining a restrictive stance while closely monitoring economic data, allowed for a gradual adjustment in the labor market without causing major disruptions. By mid-2024, the Fed viewed the risks to achieving its employment and inflation goals as more balanced, with labor market tightness gradually easing.

Despite the cooling labor market, the overall impact was less severe than some had initially feared. The Fed managed to bring down inflation significantly without causing a sharp rise in unemployment or triggering a recession, a historically unusual outcome. By September 2024, the labor market conditions were described as less tight than just before the pandemic in 2019, a year when inflation ran below 2%.

A New Era of Rate Cuts Begins

Today, the 12 voting members of the Federal Open Market Committee (FOMC), the interest rate-setting body for The Fed, decided 11 to 1 (Fed Governor Bowman wanted a 0.25% cut) to reduce the Federal Funds rate by ½% point (50 basis points). This decision lowered the Fed Funds rate to a range of 4.75% to 5.0%.

“The Committee has gained greater confidence that inflation is moving sustainably toward 2 percent, and judges that the risks to achieving its employment and inflation goals are roughly in balance,” the Fed said in its statement. “The economic outlook is uncertain, and the Committee is attentive to the risks to both sides of its dual mandate.”

“This recalibration of our policy stance will help maintain the strength of the economy and the labor market and will continue to enable further progress on inflation as we begin the process of moving toward a more neutral stance,” Mr. Powell said.

He added that this “is a good, strong start” that signals the committee is confident that inflation is heading towards its 2% target. Seventeen of the members of The Federal Bank Reserve Board projected 3 more rate cuts imminently and 10 members projected four more near-term cuts. The committee acknowledged in its announcement that while economic activity has continued at a healthy pace, “job gains have slowed, and the unemployment rate has moved up but remains low.” Mr. Powell said the committee had a median unemployment rate projection of 4.4% by the end of this year, and 3.4% at the end of 2025. He also noted a median projection of 2% GDP growth over the next few years. Powell said these projections are consistent with lower inflation and higher unemployment.

What to Expect Over the Next Twelve Months

- Historically, Fed rate cuts have been used to stimulate economic growth. The 50-basis point cut, followed by projected additional cuts, is likely to boost economic activity. Lower interest rates typically encourage borrowing and spending by both consumers and businesses. This could lead to increased consumer spending, business investment, and overall GDP growth.
- The housing sector, which has been struggling due to high mortgage rates, is likely to see a significant boost. Lower interest rates should translate to more affordable mortgages, potentially reviving home sales and construction activity. Historically, the housing market has been one of the most responsive sectors to interest rate changes.
- Lower interest rates typically reduce the cost of consumer loans and credit card debt. This could lead to increased consumer spending, particularly on big-ticket items like automobiles and appliances. With lower borrowing costs, businesses may be more inclined to invest in expansion, research and development, and capital expenditures. This could lead to increased productivity and job creation over time. In addition, Banks may become more willing to lend as their cost of funds decreases. This could lead to easier access to credit for both businesses and consumers, further stimulating economic activity.

What About the Markets?

Rate cuts have often led to rallies in the stock market. Lower interest rates make stocks more attractive compared to fixed-income investments. However, the market's reaction may be tempered if these cuts are viewed as a response to economic weakness rather than a proactive policy.

1. Immediate Response: The 50-basis point cut and signaling of further cuts are likely to trigger an initial stock market rally. Historically, rate cuts have been positive for stocks in the short-term as they lower borrowing costs and stimulate economic activity.
2. Sector Rotation: Rate-sensitive sectors like real estate, utilities, and consumer discretionary may outperform as lower rates make their dividends more attractive and boost consumer spending power. Conversely, financial sector stocks may face some pressure due to reduced net interest margins.
3. Increased Volatility: While the overall trend may be positive, the market could see increased volatility as investors react to economic data and try to anticipate the Fed's next moves. The unusual size of the initial cut (50 bps) may add to this uncertainty.

4. Support for Growth Stocks: Lower rates tend to benefit growth stocks more than value stocks, as they make future earnings more valuable in present terms. This could lead to the outperformance of technology and other growth-oriented sectors.

Potential for an extended rally: Historical data suggests that the S&P 500 has averaged gains of 9.5% in the six months following an initial rate cut, and 15.6% in the twelve months after. The S&P 500 Index posted positive returns 86% of the time in the year after the first rate cut. This points to the potential for sustained market gains over the next year.

Historically, rate cuts have led to a depreciation of the U.S. dollar against other major currencies. This could benefit U.S. exporters by making their products more competitive in international markets, but it might also lead to higher import prices. The chart below depicts the range of the dollar over the last month, and it indicates a closing price below 100.50 would probably portend a significant decline in the value of the dollar over the near-term.

Conclusion

It's important to remember that interest rate cuts operate with a substantial lag on their ultimate economic impact. One of the reasons is once the first rate cut occurs, the anticipation of further rate cuts causes many consumers to "sit on their hands" waiting for the next several rate cuts before reacting. For instance, a potential home buyer won't react to the initial rate cut to lock in a mortgage rate since they're convinced and patient enough to wait for the ultimate result of numerous, successive rate cuts.

The magnitude and speed of these projected cuts are reminiscent of the Fed's response to the 2001 recession and the 2008 financial crisis. In both cases, aggressive rate cuts helped stabilize the economy and financial markets, but the recovery periods varied.

The current situation is unique because the cuts are being implemented with inflation still above target and unemployment relatively low. In conclusion, while this and future rate cuts are likely

to provide a significant stimulus to the economy over the next 12 months, their effectiveness will depend on various factors, including global economic conditions, fiscal policy, and how well the Fed manages inflation expectations. The Fed's proactive approach suggests they are prioritizing economic growth and stability, but they will need to remain vigilant to prevent overheating or asset bubbles.

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