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FROM THE CIO'S DESK

MARKET COMMENTARY

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From Rate Hikes to Rate Cuts

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KEY TAKEAWAYS

- **Federal Reserve Chairman Jerome Powell signaled a potential rate cut at the upcoming September 18th meeting, with the market now expecting the Fed to cut rates by a full percentage point by the end of 2024 and two percentage points by mid-2025.**
- **Bond yields have already adjusted to account for expectations around future Fed rate reductions. We could foresee upward pressure in bond yields, and lower prices, should the Fed move slower than expected with its rate cuts.**
- **In light of these uncertainties, we are making adjustments, where appropriate, to reduce interest rate risk and exposure to riskier segments of the bond market, ensuring portfolios align with the current and projected economic landscape.**

Since March, the U.S. economy has witnessed a steady decline in inflation. This, along with a moderation in employment data, has led to expectations that the recent episode of elevated interest rates may begin a slow, but gradual, reversal.

Last week, Federal Reserve Chairman Jerome Powell affirmed that interest rate policy is at its precipice, and that it may now be time to cut rates. His comments alluded to the likelihood that the Fed would initiate a reduction in its target interest rate at its next meeting, which concludes on September 18th.

While lower rates are expected to offer some level of benefit to the economy over time, the open question is how quick and aggressive the Federal Reserve will be in reducing rates. The market has already anticipated this, currently projecting that the Federal Reserve will cut its target interest rate (the federal funds rate) by a full percentage point by year end and two percentage points by the summer of 2025. This is not an unreasonable expectation, nor is it conservative. Today, the market implies a 70% probability that the Fed will cut rates between seven and nine times (or roughly 2%) by June of 2025. Prior to the disappointing jobs report released in early August, the probability of this outcome was only 20%.[1] This shift illustrates how fickle investor expectations can be.

Should inflation show signs of rebounding, or employment and consumer spending remain abnormally strong, the Fed could elect to deliver a slower pace of rate cuts than the market presently projects. Remember, the Fed has a precedence for being data-dependent and therefore less prescriptive with its cadence. For example, in December of 2016 the Fed began gradually increasing interest rates, roughly on a cadence of a 0.25% rate increase every other meeting, with no meeting's rate increase being assured. We note this as an example to highlight that the Fed may not necessarily act in as dogmatic a manner as the market expects when it moves into a rate cutting cycle.

Given the uncertainty around the pace and cadence of rate cuts, we prefer to examine what expectations are priced into bond yields today and the likely probability of this scenario playing out. As we noted, current expectations aren't unreasonable. Therefore, we think bond yields, particularly among shorter maturities, are fairly valued based on economic data to date. We do, however, believe the risk is to the downside where bond yields could move higher (and bond prices move modestly lower) if the Fed doesn't lower rates as quickly as the market expects.

Given this awareness around what expectations are priced into bond yields today, we've elected to reduce interest rate risk in client portfolios, where appropriate. Moreover, in some instances, we've taken action to downsize exposure to riskier segments of the bond market, as we don't believe the incremental return is sufficient to compensate for the added risk.

As we look out longer term, we think the Fed's success in taming inflation indicates that they have won the battle against inflation, but we are still cognizant that there may be a broader war against inflation left to fight. Higher interest rates have slowed the development of new construction and led to a large pullback in capital expenditures. As Fed policy eases, we could see a resurgence in capital spending, which could, in and of itself, lead to inflationary pressures. Moreover, a key component to softer inflation year-to-date has been lower commodity prices. Long-term secular trends suggest there could be upward price pressures on some commodities in the years to come, which could add to inflationary pressures. As an anecdote, consumers will feel a small pinch of inflation this fall when they go to buy Halloween candy. Cocoa prices are up 265% thus far in 2024,[2] and wildfires in the sugar cane fields of Brazil add risk of a surge in sugar prices. As a firm rooted in financial planning, we offer a bit of guidance to buy your candy early.

As we build portfolios, we consider not just current market and economic conditions, but also think about what lies ahead over the next several years. While news headlines will be focused on the Fed cutting interest rates, we believe markets have already reacted to and incorporated this expectation into prices. Therefore, our focus is on the risks surrounding these expectations and how rates could evolve in the years ahead.

[1]: Bloomberg. As of August 27, 2024
[2]: Bloomberg. Year-to-date through August 27, 2024

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