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The Impact of Lower Rates

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This past week the Federal Reserve lowered the federal funds rate, the interest metric it controls, by a full half-percentage point. This was the first rate reduction since the Fed started raising interest rates in 2022. While a rate cut was well telegraphed, there had been debate pre-meeting on whether the Fed should increase rates by 0.25% or 0.50%. We view the 0.50% rate cut to be a more aggressive reaction to softer employment conditions and what appears to be the Fed's objective to get ahead of any pullback in the economy.

A few weeks ago, we wrote a piece that explored the market's adjustment, in advance, to a potential rate cutting cycle. We noted that Treasury bond yields and mortgage rates had already adjusted lower taking into account current expectations for the Federal Reserve to begin reducing interest rates. It appears the Fed's path forward with rate cuts was fully factored into Treasury yields, as we actually saw yields on Treasury bonds (two years and longer) move modestly higher following the Fed's decision to lower rates. As we look ahead, the Fed's forecasts around the direction of interest rates indicates roughly a full percentage point of rate reduction by the end of 2024 and another percent during 2025. Yields offered on Treasury bonds today not only embed these expectations, but our models would indicate they are even more aggressive in factoring in the pace and magnitude of Fed rate cuts over the next 12-18 months.

In fact, as we look at expectations across markets, we are beginning to recognize some conflicting messages across asset classes. As yields on Treasury bonds have begun to price in a more aggressive Fed, the implication is that there will be greater deterioration in the economy and therefore the Fed be more aggressive in reacting to it. This notion of a softer economy is echoed in commodity markets where goods such as oil and copper have retreated in recent months on fears of slower global economic growth.

Alternatively, riskier assets such as stocks and high yield bonds imply the opposite. This past week the S&P 500 hit yet another record high. Investors cheered the Fed rate cut, leaving many equity investors believing the difficult to achieve 'soft landing' may actually happen. Furthermore, high yield bonds currently price in yields that imply a below-average probability of default. At present, this expectation is not unreasonable as recent data indicates default rates have leveled off if not fallen slightly.

As we look ahead, we don't see the inflection toward a lower interest rate environment to be a material turning point. Since markets are forward looking, and the fact that a rate reduction cycle has been well telegraphed by the Fed, lower rates have already been reflected in Treasury yields and mortgage rates. Since peaking at the end of April, yields on 2-year and 10-year Treasuries have fallen by 1.4%. and 1.0% respectively, as the start of the rate reduction cycle have approached.[1] Rates on 30-year mortgages have already fallen from their peak of 7.8% in October of 2023 to 6.1% this past week. We wouldn't be surprised to see some additional downward pressure on mortgage rates, and given current economic conditions, would expect them to level off somewhere in the range of 5.50% and 6.0%.[2]

Lower mortgage rates will help some homeowners who may elect to refinance. It may also provide a jolt to the housing market as more families feel comfortable purchasing homes at rates that are considerably lower than a year ago. The significance of this, however, is unlikely to be material. Housing affordability remains a challenge. Moreover, while mortgage refinancing will pick up, over three-quarters of all mortgages outstanding today are at rates less than 5%. Therefore, an overwhelming majority of mortgage borrowers will be in a position where it does not make sense to refinance a mortgage.

While lower borrowing cost can serve as a tailwind, the economy will eventually need to grapple with the inevitable easing of the key drivers that have supported growth over the past year. For starters, elevated government deficits have helped to support consumer and business spending. Increased political pressure around the magnitude and direction of the federal budget deficit may impair the impact of government spending on economic growth. Second, consumers are electing to save an atypically low level of their income. As we've observed from similar instances in the past, consumers will eventually need to adjust their spending patterns. As this occurs it will serve as a headwind to the level of economic growth. Collectively, these considerations lead to the conventional give and take pressures that impact the economy.

We believe much of the benefits of lower rates are priced in. Going forward the market will now cater toward whether expectations on the pace and magnitude of future rate reductions out of the Fed are properly calibrated. We do believe the lower rates will, at the margin, have a positive impact. However, the benefits will translate alongside the dynamism that occurs across a variety of economic factors.

(1)Bloomberg, as of 9/20/24
(2) FRED Database (St. Louis Fed), Freddie Mac, as of 9/20/24

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