Cuts, Dips and Rips

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Between March 2022 and July 2023, the Federal Open Market Committee (FOMC) increased the Federal Funds Rate 11 times, from a range of 0.25-0.50% to 5.25-5.50%. This represented the most aggressive tightening cycle in the last half-century. This past week, the FOMC met for the fifth time in 2024, leaving the overnight borrowing rate unchanged for the ninth consecutive meeting. However, dovish commentary in both the prepared FOMC statement and during Chairman Powell's press conference gave markets the fodder needed to price in at least one 25bps rate cut at the upcoming September FOMC meeting. As we sit here today, markets are now pricing as many as three cuts (in line with our previously stated expectation) for 2024, compared to the Fed's last assessment of only one (1) interest rate cut. Combined with a widely accepted notion that the U.S. is poised for a soft landing, a stout rally in the equity markets was sparked, **returning close to 3% during the next two trading sessions**.

We strive to be neither a Debbie Downer nor Chicken Little. But as the tagline to our 2023 Outlook states, **"*Take nothing on its looks; take everything on evidence*,"** we believe further investigation and skepticism may be warranted. Based on our assessment of macroeconomic conditions, we continue to believe the economy will further deteriorate into 2024 amid a significantly slowing inflation backdrop. In addition, we reiterate our belief that the U.S. will fall into a shallow, short, but hard landing in the near term – if it is not already in one.

Hence, we believe the FOMC will now need to focus keenly on the first mandate specified in the Federal Reserve Act: "**maximum employment** and stable prices." Unfortunately, we also feel that the FOMC has again painted itself into a corner and has waited too long to cut **rates**. Readers and clients will remember when we outlined the potential for a similar (but opposite) policy mistake in our 2022 Outlook when we suggested the central bank **was too late in tightening** rates. When we examine research rate tightening cycles, we come to a few conclusions. First, trying to truly identify a "soft landing" is elusive. There have been three (3) tightening cycles whereby a recession did not follow (roughly 25% of the time). But in our opinion, the period following the tightening cycle between December 1993 and April 1995 **can be argued to produce the only soft landing.** Typically, the FOMC starts cutting interest rates to help resuscitate a faltering economy. This sometimes results in a recession, like following the Great Financial Crisis (GFC) or the COVID-19 pandemic. However, these rate cuts were not in response to a FOMC tightening cycle but rather to stem systemic/global financial risks. In other cases, the FOMC is countering its actions to combat inflation and drive stable prices.

And while we acknowledge our inability to do a better job than Chairman Powell, we fear a potential policy mistake in the offing and reiterate our caution regarding equity valuations, especially given the **fluidity of the current geopolitical backdrop. We note the average drawdown for the S&P 500 in any given year is 17%. For non-recession years, the average drawdown is only 13%, while for years with a recession, the S&P falls by roughly 24% at some point, on average. So regardless of how you look at things, we suggest that "Passengers, Fasten Your Seat Belts,"** and reiterate our near-term expectations outlined in our 2024 Half-Time Update for the S&P to trade between 5,200 and 5,300. ***We'd love to hear your thoughts!***

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