Thinking Out Loud

Powell's Jump The Shark Moment

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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%. On Wednesday, September 18th, the FOMC will hopefully announce the highly anticipated start to the next rate-cutting cycle. The big questions for investors are, how much? 25bps or 50bps? Further, what is the cadence of future cuts, and how hawkish or dovish will the FOMC be? Is this Jerome Powell's "Jump The Shark Moment?" He can acknowledge that inflation is mostly contained and begin a long overdue easing cycle. Alternatively, he could "**Jump The Shark**" by doubling down on some inflation narrative in an attempt to maintain credibility and avoid the "transitory" mistake of early 2021.

Over the last several weeks, the common narrative observed across most financial news outlets was that a 25bps interest rate cut was sufficient and was priced into markets, especially considering the perceived resilience of the US labor market. Further, the conventional wisdom spread by pundits suggested that any upside deviation from a 25bp cut would signal that the economy is too weak. Conversely, leaving rates unchanged would imply the FOMC has failed to contain inflation.

Over the weekend, however, new messaging from several thought leaders, analysts, and investors emerged, suggesting that a 50bps cut would not cause economic or financial market alarm. At the same time, financial markets have now priced in almost a 70% probability that a 50bps cut is warranted, compared to a 34% probability a week ago.

We previously believed cutting by 25bps is the safest strategy, although a 50bps cut is what is needed.

By cutting only 25bps, the FOMC acknowledges the economic uncertainty observed in consumer spending, credit card defaults, continuing claims, and job revisions—among other things. In addition, the FOMC recognizes the political and policy uncertainty surrounding the Middle East, Iran/Houthis, China, Russia, the debt ceiling, and, of course, the 2024 Presidential Election. In a 50bps cut scenario, the FOMC quiets critics (like us), suggesting that the easing cycle should have started in July, and at the same time, shows financial markets that the Fed acknowledges the softening economy. A 50bps cut also gets in front of any potential "October Surprise," hence providing addition liquidity, if needed. The month of October has historically brought several surprises, potentially impacting markets – especially during election years. In our opinion, the most recent was when then FBI Director James Comey sent a letter to Congress on October 28, 2016, stating that the FBI had reopened the investigation relating to the former Secretary of State (and nominee) Hillary Clinton. However, a simple Google search will provide a laundry list of October Surprises dating back to the 1840 presidential election.

So now it seems the FOMC is boxed in…unless the Fed itself orchestrated the recent realignment of cut expectations (25bps to 50bps); priming the pump without drawing a need to fall on their sword. But regardless of what happens on Wednesday, too many question marks (and risks) remain.

We continue to believe the economy will further deteriorate through the remainder of the year, despite a significantly slowing inflation narrative. 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. The 2024 Election Cycle is proving to be more divisive than initially anticipated, while at the same time, international uncertainty has not subsided. As a result, we reiterate our caution regarding equity valuations. In doing so, we have recently made several changes to our managed equity models and ETF portfolios. Most notably, we now hold a bias toward higher quality companies and/or styles/sectors that exhibit lower price volatility. In addition, we are holding excess TBill/cash in several managed equity models and have generally reduced our exposure to large-cap Technology/AI. If you have any further questions regarding specific moves, please ring us.

We'd love to hear your thoughts!