Investment Watch

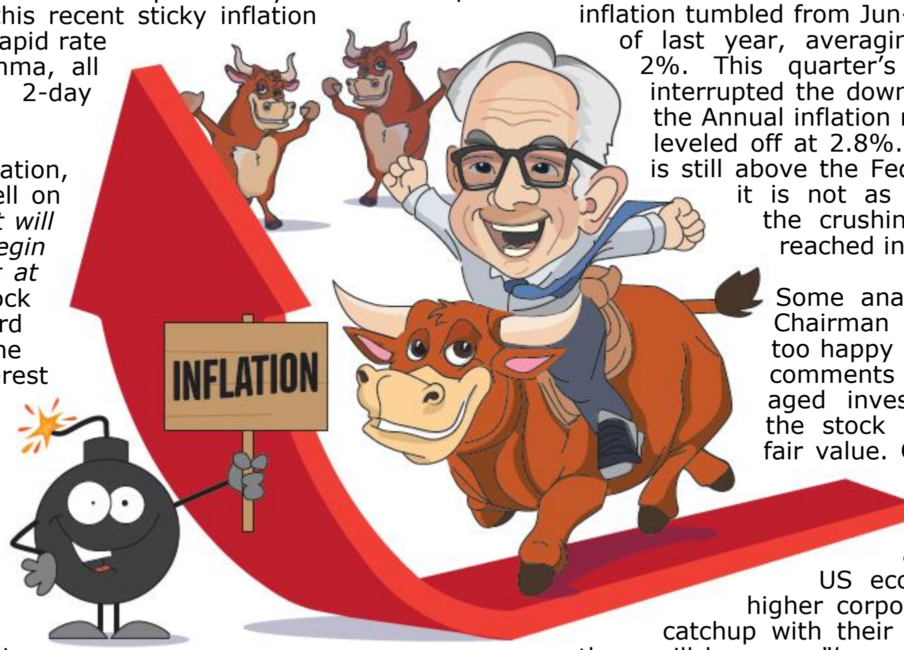
1st Quarter, 2024

The Fed's in Charge

As inflation tumbled around the world at the end of 2023, the pundits claimed the Fed's inflation fight was almost won and that many interest rate cuts would soon follow. However unexpected inflation spikes in both January and February interrupted the cooler trend reported in the second half of last year crushing the optimism for lower prices while rekindling the rise in interest rates and borrowing costs. Bond prices, which move in the opposite direction of interest rates, sank reversing the course of last quarter's strong rally ignited by the prospect of these lower interest rates. Stocks, on the other hand, climbed this *"wall of worry"* and bulled their way to new heights.

The Fed's record of sticking a soft landing has been dismal. Fed Chairman Powell dreads the prospect of one more inadvertent recession triggered by keeping rates too high for too long. He raised the Federal Funds Rate from near zero to a target range of 5.25% - 5.50%, the highest in over 23 years, trying to slow the economy and conquer the runaway inflation sparked by the pandemic shutdowns, but this recent sticky inflation has weakened his case for rapid rate cuts. In light of this dilemma, all eyes were on the Fed's 2-day March policy meeting.

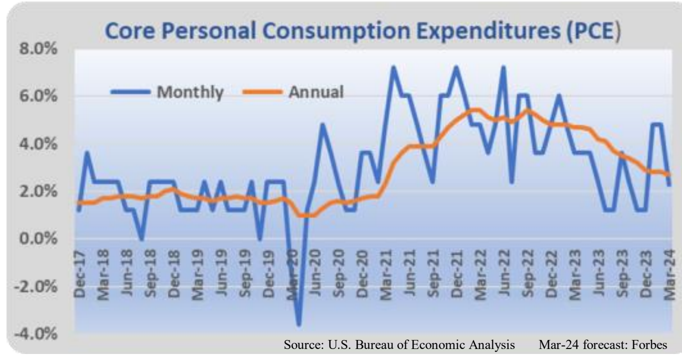
Despite the recent hot inflation, Fed Chairman Jerome Powell on March 20th signaled that, *"it will likely be appropriate to begin dialing back policy restraint at some point this year."* Stock prices surged setting record highs as Powell stuck to the Fed's forecast of three interest rate cuts this year. Bullish investors cheered his optimism driving major US stock indexes to all-time highs.



Investors' exuberance underscores their belief that the Fed will be able to curb inflation without causing a recession. The Fed raised rates to tighten credit and slow the growth of our economy. However, the US economy has not only withstood the Fed's restrictive monetary policy but has prospered, growing above trend bolstered by:

- Strong labor market with 250,000 new jobs per month this year and a low 3.9% unemployment rate
- Above average 3.1% GDP growth last year
- Consumer spending, which represents 2/3rds of the US economy, consistently exceeding expectations
- Resilient housing market undeterred by higher mortgage rates

Even though the Fed stuck to their guns, forecasting three rate cuts in 2024 and three more in 2025, each of these rate reductions are expected to be just 0.25%.



Therefore, the transition to a neutral rate will take time, but the Fed doesn't need to rush due to the underlying strength of our economy, in spite of high interest rates. It would take until the end of 2025 for six rate cuts to lower the Fed's Funds Rate to a more normal or neutral rate of 4%, hopefully without rekindling inflation.

The Fed's preferred inflation gauge is the Core PCE, and inflation is the only roadblock in the way of the Fed's anticipated rate cuts. As can be seen in the above chart, inflation tumbled from Jun-23 to the end of last year, averaging just below 2%. This quarter's price spikes interrupted the downward trend of the Annual inflation rate which has leveled off at 2.8%. Although this is still above the Fed's 2% target, it is not as worrisome as the crushing 7%+ rates reached in 2021-22.

Some analysts feel Fed Chairman Powell is way too happy and his dovish comments have encouraged investors to push the stock market above fair value. Others believe that the rate cuts will stoke the already robust US economy driving higher corporate profits to catchup with their prices. Surely there will be more *"bumps"* as the road ahead has become more steep.

Bond investors, on the other hand, foresee a much easier road ahead. The current rates of around 5% provide bondholders with stable, predictable income. In addition, just as bond portfolios lost ground as rates rose this quarter, lower future interest rates would add value to their bond holdings.

The Fed's in Charge. This time they have a better chance of achieving that elusive *"soft landing".* Let's all hope they succeed and no one lights the inflation fuse.

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