Caron’s Corner Transcript – 1.29.2024

A Rate Cut Named Desire

- The Fed meets this week with two goals in mind:
    1. Signal the end of their rate-hiking cycle.
    2. Discuss the possibility, and criteria, for when they will begin to cut rates.
- Our title is clearly a take on *A Street Car Named Desire*, the Tennessee Williams classic heralded as a social study on **fantasy's inability to overcome reality**.
- I can’t help but see the parallels with the Fed, who has a strong ***desire*** to cut interest rates, but is that merely a ***fantasy***?
- Life is easier for the Fed if they could start cutting in March, their ***desire***. But the ***reality*** of the economic data may stand in their way.
- So at this week's meeting, we need to see how the Fed may start to rationalize and communicate a rate cut in March to fulfill their *desire*.

Jim Caron: Hello, this is Jim Caron, CIO of the Portfolio Solutions Group. A Rate Cut Named Desire. The Fed meets this week with two goals in mind. Number one is to signal the end to their rate hiking cycle and number two is to discuss the possibility and criteria for when they will begin to cut rates. So the title of this podcast is clearly a take on the famous Tennessee Williams play *A Streetcar Named Desire*, which is heralded as a social study on fantasy's inability to overcome reality. Well, I can't help but see the parallels to the debate the Fed will have at this week's meeting.

The Fed has a strong desire to cut rates, but is that just fantasy or will it match the economic reality I have discussed in prior podcasts? Today's real policy rate is 2.5% which is derived from subtracting 3% inflation from a 5.5% nominal policy rate. In our estimation, this is 100 basis points too high. In all likelihood, the Fed is more likely targeting a 1.5% real policy rate, which means they need to cut rates by about 100 basis points this year, just to stay neutral. Life is easier for the Fed if they could get the ball rolling and start cutting in March, their desire, but the reality of the data may stand in their way. So at this week's meeting, we need to watch how the Fed may start to rationalize and communicate a rate cut in March to fulfill their desire. Let's get into it.

Fantasy versus reality. There's no doubt that inflation has made significant downward progress over the past year. While the Fed's favored measure of inflation, core PCE, is still rising month-over-month, it's doing so at a slower rate. This has had the effect of dropping core PCE below 3% to 2.9% as of the last reading, and this is down from a 5.6% peak over a year ago. Even better news is that the six-month annualized rate of core PCE, another key measure for the Fed, has fallen below the 2% target level to 1.9% for the past two months in a row, thus showing some persistency in early signs that inflation is becoming anchored. So far, so good.

But the plot thickens the Fed's other favored measure of inflation, the so called super core or non-core housing services, which makes up about half the weight in the core CPI, has remained elevated and contributed next to nothing to the to the decline in inflation. This is bad news. As repeatedly stated by the Fed, they need to see a larger contribution to the decline in inflation to come from lower wage inflation. The reason is that they want to ensure there is no remaining evidence of wage-price spiral inflation because if that were to take root, then inflation would become unanchored, which is something that the Fed wants to avoid at all costs. In this instance, the news is not overly encouraging. Wage pressures are falling, but perhaps not enough to give the Fed comfort, which forms the key basis of the argument against the Fed easing as soon as March. Labor markets remain tight and the supply of labor remains low, and this doesn't appear to be meaningfully changing anytime soon. This puts the employment cost index data that's going to be released on the same day of the Fed meeting on January 31 squarely into focus. Then Friday's payroll data release (February 2) will also come out as well.

Supply pressures are easing, attributing to a decline in inflation that's coming from the goods sector due to an easing of the supply pressures. However, as evidenced by the last six months of strong retail sales and consumption data, demand is still strong in the service sector and service sector inflation is holding up. But there may be future challenges on supply from events taking place in the Red Sea, although this is not yet being seen as material for inflation.

So it's time for a reality check. What gives the edge to Fed communications this week for a rate cut in March is that they have a strong desire to cut rates, but it's by no means a done deal and it will be messaged that way despite their bias to cut. The reality of the situation adds more complexity. The balance of evidence suggests the Fed should wait and take a more temperate approach by collecting enough evidence to assure the decline in inflation remains anchored. That said, expectations for six rate cuts this year may be too aggressive. If nothing else, the Fed seems more likely to proceed with cuts in a more measured pace, say three or four cuts this year. But not six.

If we find this to be the case, then bond yields may be too low. As I said at the start of the year, I think bond valuations are more expensive than equities. Nevertheless, default risks may stay low as economic conditions are steering further away from a recession. This makes high yield, credit, bank loans, emerging market hard currency and selective asset backed securities attractive to us. Credit is not cheap, but it may be preferred over interest-rate duration risk in your bond portfolio. Equities seem better supported by economic conditions that are cooling, but not collapsing, and can handle modest inflation risks better than bonds. We still maintain a neutral to slight overweight exposure to equities.

The debate for the Fed is clear. Some measures show improving inflation conditions that justify a cut as soon as March and others, well, not so much. The significance of the January meeting will indicate which way the scale is tilting. The Fed also wants to avoid keeping policy too tight for too long, lest the unemployment rate spikes, an unwanted outcome during an election year. Let's take our cue from how the Fed threads the proverbial communication needle.

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