September 3, 2024

September 2024 Update

Great Expectations

By Michael Crook, Chief Investment Officer

> "I expected 18 months of rate cuts against reason, against promise, against peace, against hope, against happiness, against all discouragement that could be."
>
> --2024 market participants (probably).

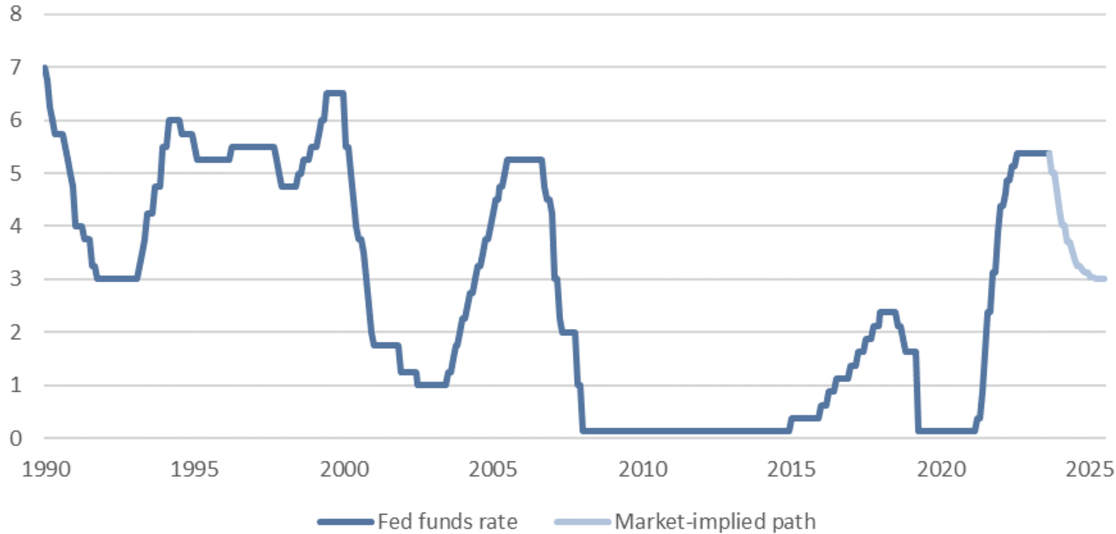
While we're just having a little bit of fun with the above (slightly modified) passage from Charles Dicken's "Great Expectations," the global financial community waited with bated breath for Fed Chair Jerome Powell's August 23rd speech at Jackson Hole to confirm their hopes that a rate cutting cycle was just around the corner. For Powell's part, he fulfilled their hopes and dreams:

> "The time has come for policy to adjust. The direction of travel is clear, and the timing and pace of rate cuts will depend on incoming data, the evolving outlook, and the balance of risks."

In plain English (my words, not his): the Fed is going to start a rate cutting cycle in September, but we don't know how quickly we will cut nor do we know when we will stop.

Mr. Market, of course, has a guess. The Fed funds rate is currently 5.375%. Market participants expect it to fall to 4.375% by the end of this year, 3.375% by mid-2025, and plateau around 3% as we head into 2026 (Fig. 1). These are, in our opinion, Great Expectations.

Fig. 1: Fed funds target rate



Source: Bloomberg, Mill Creek.

Buy the rumor, sell the news?

Markets have benefited over the last few months from the pricing in of rate cuts, but there are also risks that emanate from a rate-cutting cycle that we should consider.

For example, Powell's clear guidance that the "timing and pace" of cuts will be data dependent has been unheralded by markets and a fairly-aggressive and uninterrupted rate cutting cycle has been priced in. At the same time, US economic growth remains at or above trend and inflation couple remain stubbornly above 2%. Unfulfilled rate cut expectations are now a *risk worth watching* for investors. A Fed pause would likely lead to another leg up in bond yields, and as we've seen numerous times in the recent past, higher yields would likely lead to a temporary risk-off period in equity markets.

We've experienced a nearly uninterrupted risk-on environment since last fall and frankly we expect rate cuts from developed country central banks to (at least initially) provide additional fuel to the cycle. As we discussed in our last Livestream, the three-legged US economic stool of households, firms, and banks remains very stable. We wouldn't "sell the news" of rate cuts, but the temporary market stress from the unwinding of the yen carry trade in early August was a wake-up call for complacent investors. We've been in an abnormal, very low volatility environment; going forward the overhang of geopolitical risk, domestic economic and fiscal policy risk, and monetary policy uncertainty could result in a much more *normal* market than we have grown used to.

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