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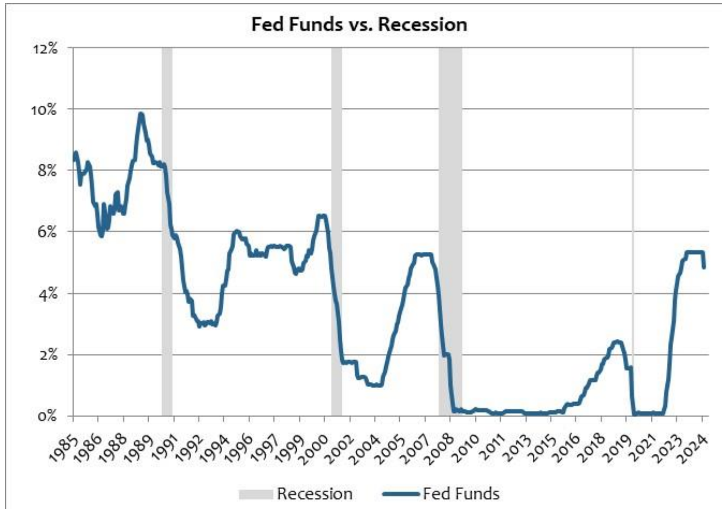
The Federal Reserve Takes a Big Step

The Federal Reserve today cut the Fed Funds interest rate by 0.5% for a new range of 4.75% to 5.0%. There was uncertainty as to whether the Fed would take the more aggressive 0.5% cut or a lesser 0.25% cut. They ultimately chose the more aggressive move. The Fed made this rate reduction as unemployment has risen to 4.2% in August, up from 3.7% in January. Furthermore, Fed officials raised their estimate for the unemployment rate to 4.4% this year and next year. Their apparent concern regarding unemployment is also evident in the forecasts they provided for the Fed Funds rate going forward. The so-called "dot plot" indicates further interest rate cuts of 50 basis points this year and 100 basis points in 2025.

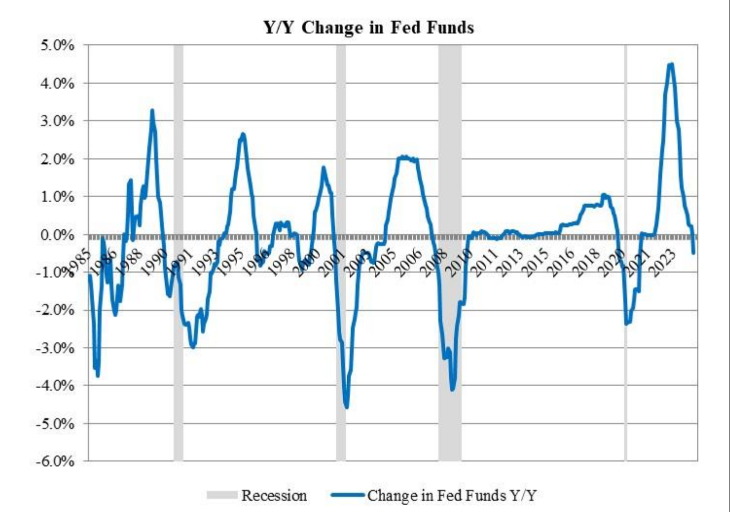
We expect volatility in the stock market to increase in the weeks ahead. Stocks initially reacted by moving higher immediately after the rate cut announcement, but then reversed course and closed 0.3% lower for the day. Now, the day after, futures contracts indicate that stocks will head sharply higher in early trading. This kind of volatility is symptomatic of a high degree of uncertainty about future business conditions. One uncertainty pertains to the issue of growth. As shown in the two charts below, a recession typically follows a series of Fed rate cuts preceded by a cycle of rising interest rates. Nonetheless, there are many still professing belief in the so-called soft landing. We are doubtful of that optimistic scenario and, therefore, remain defensive.

Chart 1



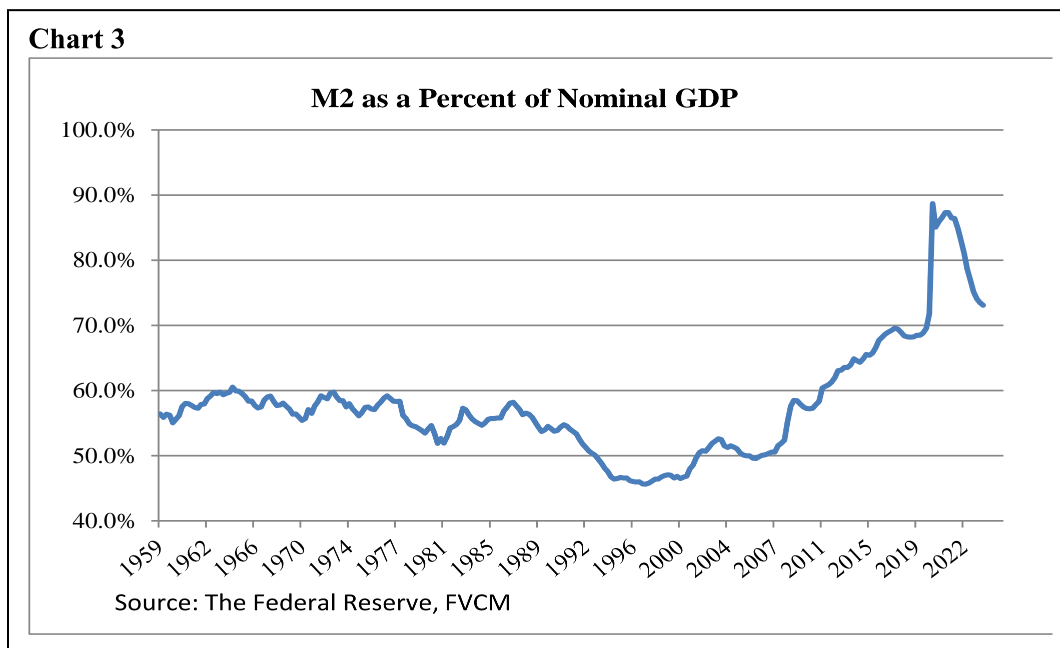
Source: Federal Reserve, FVCM

Chart 2



Source: Federal Reserve, FVCM

Another significant area of uncertainty resides in the future of inflation. In his discussion following the rate cut announcement, the Fed Chairman expressed confidence that the inflation rate would continue to fall to the target rate of 2%. Consumer prices were up 2.6%, year-over-year, as of August 2024, and far below the 9% peak in June 2022. We certainly hope the Chairman's confidence is correct, but if inflation remains above target, the risk to Fed credibility will be considerable. Such a scenario would make the task to get inflation under control all the more difficult. Keep in mind that inflation arises when nominal spending grows at rates that exceed the economy's ability to supply goods and services. Nominal spending growth over long periods is fueled by money creation. Since the Fed started tightening monetary policy in 2022, they did a good job of getting money supply growth under control. However, broad M2 money, which includes checking accounts and various savings accounts, is still at a historically high level of GDP (see Chart 3), so there's still plenty of fuel if someone starts a fire. This is why the Fed so closely monitors "inflation expectations." If people start to become concerned about inflation, they will move to reduce their money holdings, and money velocity along with spending will increase. Money can become a hot potato that no one wants to hold onto. Are we predicting such an inflation scenario? No, we're merely pointing out the high level of uncertainty due to factors that cannot be predicted.



Our long-term outlook for stocks remains bullish. The U.S. and other market economies have always gone through various economic and business cycles. Uncertainty always exists in varying degrees. Wars and recessions have always been with us. And yet, human ingenuity, as long as a free business environment endures, continues to generate new and better ways to produce. Material progress and profitability is prevalent over the course of time. Business owners—meaning stock market participants, take on the risk of the cycles and are rewarded as a result. As shown below, equities have significantly outperformed bonds and cash securities over the past century. As we have noted, risks are currently elevated, but we manage

portfolios in ways to reduce volatility. We believe exposure to the stock market is prudent for investors with a longer investment horizon.

	Nominal Returns on Investments (AR)				Real Returns on Investments (AR)		
Time Period	*S&P 500*	*3-month T.Bill*	*10-year T. Bond*		*S&P 500*	*3-month T.Bill*	*10-year T. Bond*
1930s	-0.9%	0.9%	4.0%		1.4%	2.8%	5.9%
1940s	8.5%	0.5%	2.5%		2.6%	-5.2%	-3.3%
1950s	19.3%	2.4%	0.8%		17.1%	0.3%	-1.3%
1960s	7.8%	4.3%	2.4%		5.3%	2.0%	0.0%
1970s	5.8%	6.5%	5.4%		-1.6%	-0.6%	-1.8%
1980s	17.4%	8.5%	12.0%		11.7%	3.0%	6.2%
1990s	18.1%	4.7%	7.5%		15.0%	1.7%	4.5%
2000s	-1.0%	2.3%	6.5%		-3.7%	-0.2%	3.9%
2010s	13.6%	0.6%	4.0%		11.8%	-1.1%	2.2%
2020-2023	12.0%	2.4%	-2.8%		7.0%	-2.1%	-7.6%
1930 - 2023	9.7%	3.4%	4.6%		6.4%	0.2%	1.3%

The long end of the fixed income market looks less attractive following the Fed's 50 basis point rate cut. The yield on the 10-year U.S. Treasury bond recently fell to 3.6% from the high of 5.0% about a year ago. That decline in the long end of the curve reflected the Fed's success in bringing about a declining trend in inflation, and the expectation that cuts in short-term interest rates would at some point begin. There is an old Wall Street adage: "Buy on the rumor, sell on the news." The long end of the yield curve has done well in anticipation of the rate cuts, but now that cuts have begun, long term fixed income investors have less to look forward to. Consequently, for our fixed income portfolios, we have reduced target weights for the long end of the curve and increased targets for the short end, which could see yields decline 2% in the year ahead as a result of further Fed cuts.

In summary, the Fed's interest rate cut reaffirms our belief that a conservative investment posture remains prudent. There are many analysts now forecasting a soft landing for the economy and continued growth, but based on historical relationships, there is some risk of recession. In the fixed income markets, more conservative positioning in the short end of the curve would seem to make sense. From a tactical perspective, we would change our position and take on risk if prices were to decline, making securities more attractively priced. From a strategic perspective, we remain very confident in inevitable progress and positive investment returns.

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