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MACRO MUSINGS

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Is the Fed Finished?

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SUMMARY

- Our **micro**cast™ signal remains at a neutral allocation. The **macro**cast™ suggests the probability of a recessionary bear market remains elevated. While **micro**cast™ is currently at its baseline allocation, it would likely shift to a more defensive position if the market deteriorates further.
- As expected, the Federal Reserve raised the target interest rate by 0.25% earlier this month, marking what could be the end of this cycle's rate hikes. Should this prove to be the case, it would be the quickest rate-hike cycle in the past four decades.
- Despite Chairman Powell's insistence that no rate cuts are coming this year, futures markets are currently forecasting much lower rates by the end of the year, showing clear disagreement with the Fed's stance.
- In our view, the possibility of the Fed enacting rate cuts within the remaining half of the year hinges on two potential scenarios: 1) if inflation continues to fall rapidly toward the Fed's 2% target, or 2) if the economy were to enter a recession.

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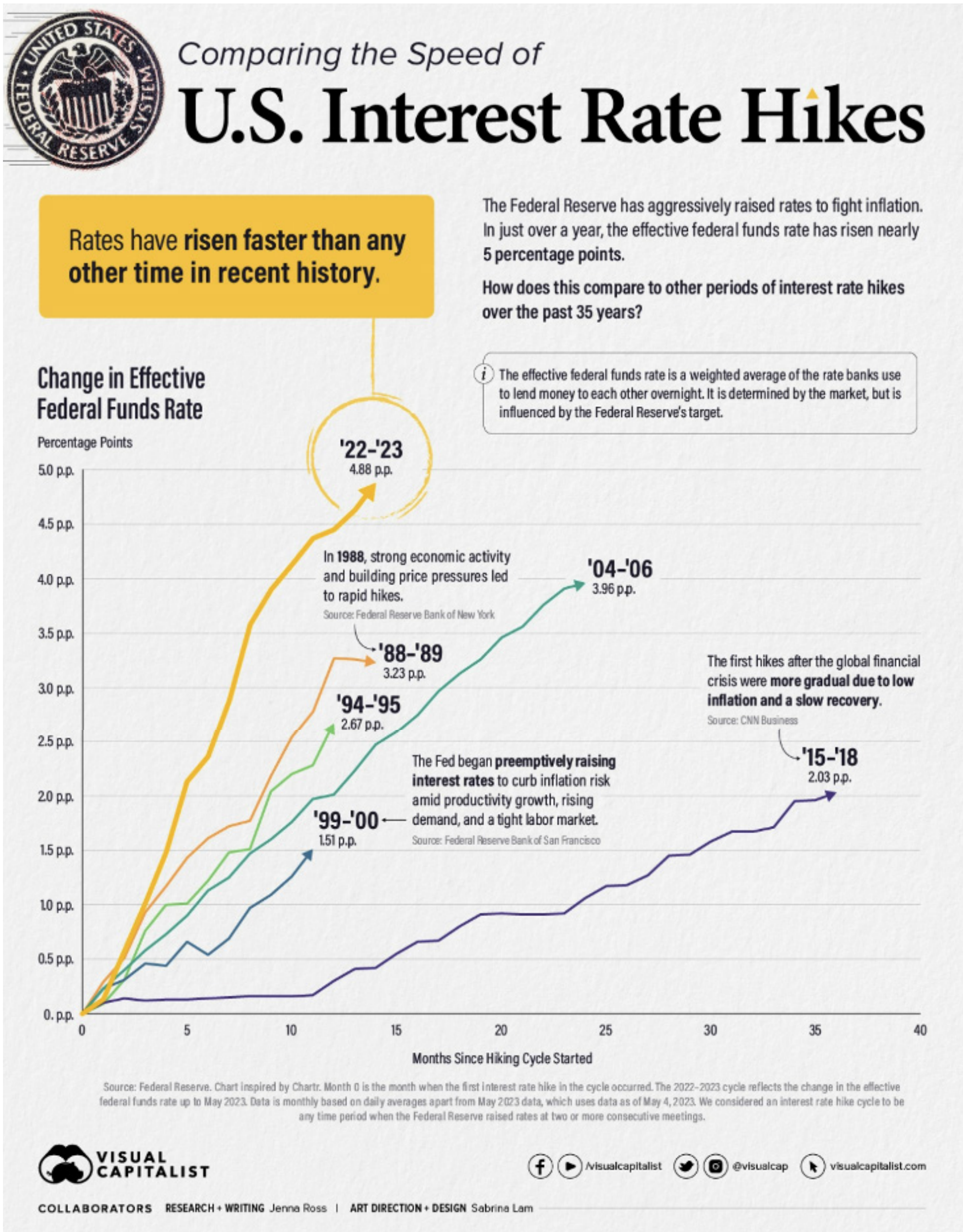
THE INTEREST RATE HIKING CYCLE **MIGHT BE OVER**

On May 3rd, the Federal Reserve raised the Federal Funds Rate by a quarter point, settling on a target range of 5.00% - 5.25%. All signs point to this being the last increase of the rate-hike cycle that began in March 2022.

The Federal Reserve has not been this aggressive in a long time. To put it into perspective, this marks the most rapid rate-hike cycle we've witnessed in at least four decades, as illustrated in the chart below from Visual Capitalist:



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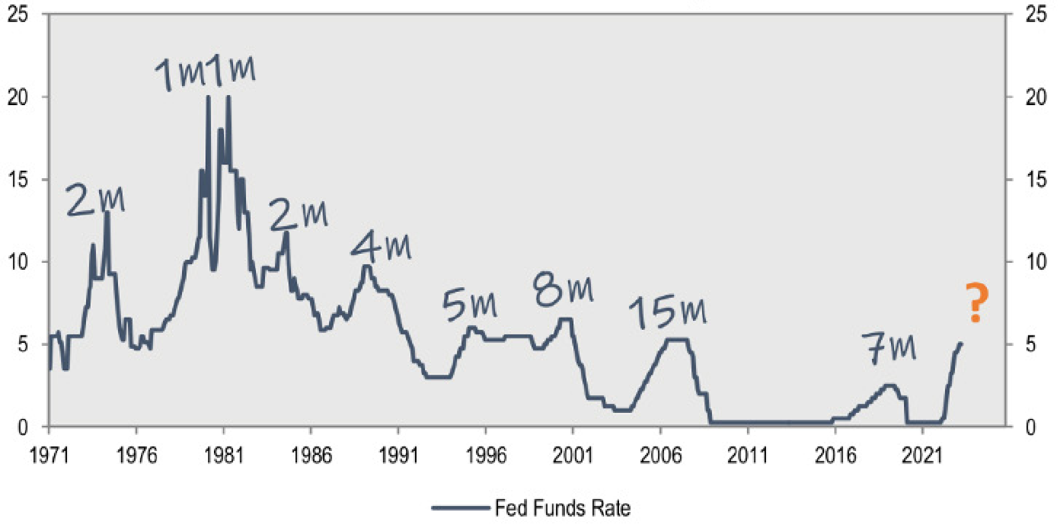
Despite this aggressiveness, or perhaps because of it, the market already expects rate cuts, with futures markets projecting the first rate cut as soon as September, approximately four months from now.

Historically, the Fed cut rates anywhere from 1-15 months after a rate hike (Chart from Piper Sandler):

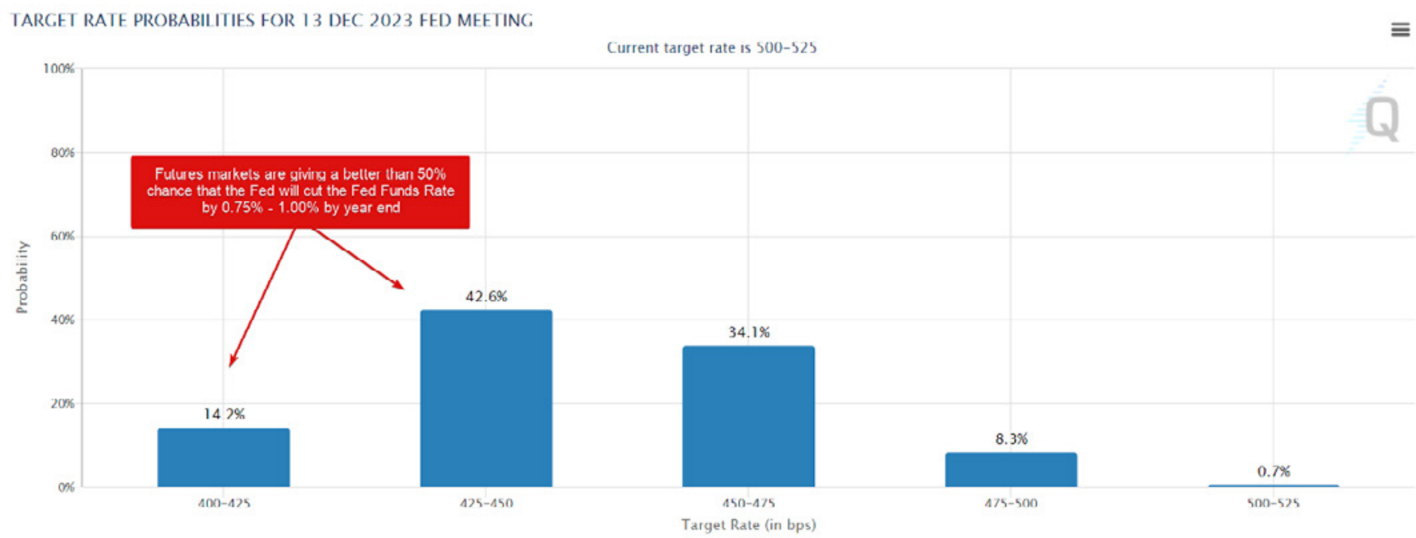
It Is Not Unusual For The Fed To Start Cutting Rates Soon After They Stop Tightening



Last Hike	First Cut Of Next Cycle	# Of Months
Dec-18	Jul-19	7
Jun-06	Sep-07	15
May-00	Jan-01	8
Feb-95	Jul-95	5
Feb-89	Jun-89	4
Aug-84	Oct-84	2
May-81	Jun-81	1
Mar-80	Apr-80	1
May-74	Jul-74	2

However, since 2000, the first rate cut has occurred a minimum of seven months following the last rate increase. Moreover, inflation today is more pronounced than any previous instance dating back to the early 1980s, so the Fed might hesitate until they are sure inflation is under control.

Meanwhile, futures market participants are pricing in more than one rate cut this year. As of Monday, May 15th, Fed Fund futures are pricing in more than a 50% probability that there will be at least 0.75% - 1.00% of rate cuts between now and December (Chart from CME Group):



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IS INFLATION FAST ENOUGH **TO ALLOW THE FED TO EASE?**

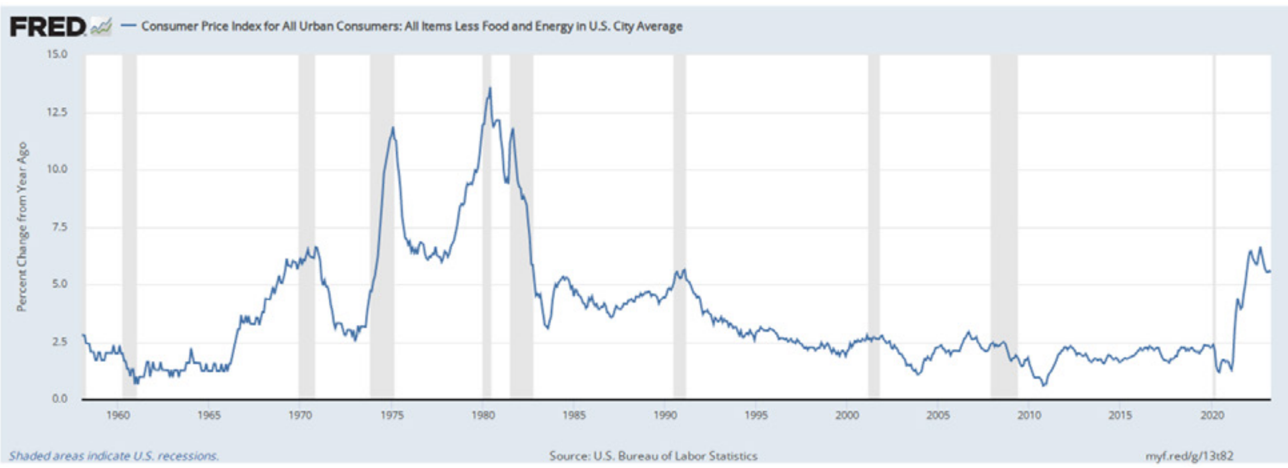
For the Federal Reserve to have the flexibility to reduce rates, it's critical that inflation continues its downward trajectory. The deceleration in the Headline Consumer Price Index (CPI), over the past ten months is a promising sign. However, core inflation, which excludes volatile food and energy categories, remains stubbornly high at 5.5%. This figure might be somewhat high due to the methodology used to calculate housing costs within the index, but even taking that into account, the current rate of inflation would still be a lot higher than it was when the Fed cut rates in the past four cycles.

Even if inflation continues to fall, it's not a foregone conclusion that the Fed will cut rates this year. The specter of the 1970s and early 1980s still haunts officials. During this era, the Fed cut rates because they believed that inflation was tamed, but the cuts were premature and resulted in inflation rearing its head once more. This forced the Fed to take an about-face, raising rates again.

So, what economic force could potentially prompt the Fed to consider rate cuts if inflation remains uncomfortably high? In a word: recession.

RECESSION IS THE ONLY THING THAT **HISTORICALLY CRUSHES INFLATION**

Inflation eventually comes down, but in almost every instance, recession is what did the trick (Chart from St. Louis Fed):



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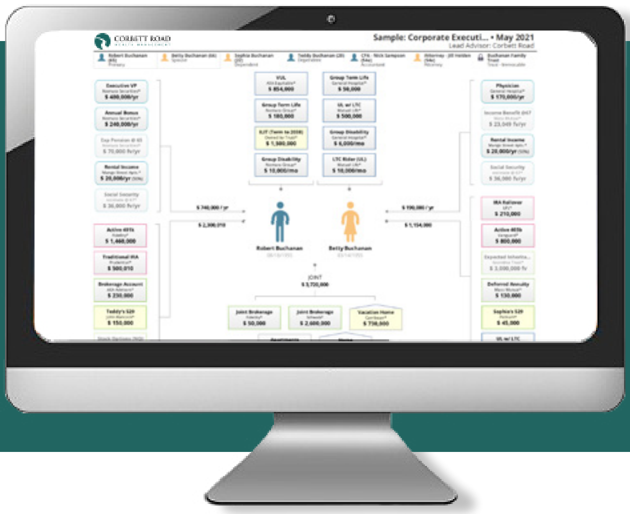
So, absent a recession, what are the chances the Fed cuts rates 0.50% - 1.00% by year end, as futures markets are predicting? In our view, lower than what is currently being priced in.

In summary, the Fed is likely done with rate hikes, and while rate cuts later this year are possible, historically, rate cuts happen when inflation is lower or when the economy is in or heading toward a recession. If we dodge a recession, the Fed probably won't cut rates due to fears of inflation returning, thanks to continued strong job growth and consumer demand. However, if a recession does occur, as we suspect it might, rate cuts are likely. This, in turn, will bring a different set of problems. As always, we will continue to monitor these critical developments in the months ahead.



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