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The Fed Acts – Finally!

Market Talk with Mike Skoric

On September 18, 2024, the Federal Open Market Committee (FOMC) decided to finally cut the fed funds rate for the first time since it last did so during the Covid crisis in March 2020, after which the FOMC held rates steady at a 23-year high. Furthermore, while the rate cut had already been telegraphed, the size of cut was 50 basis points (1/2%) rather than the usual 25 basis points (1/4%.) This was also not a huge surprise given that expectations were evenly divided between the larger and smaller cut. Nevertheless, the news was warmly received by equity markets, but equally important was the Fed's outlook for future rate cuts. Based on the Fed's "dot plot" which shows the future rate projections of all FOMC officials, we will likely see two more cuts totaling 50 basis points during the remainder of 2024 and then another 100 basis points (1%) over the course of 2025. One thing that is now clear is that the Fed has shifted the focus of its "dual mandate" monetary policy from maintaining stable prices to that of ensuring maximum employment.

Over the last two and a half years the FOMC has clearly focused on the price stability front, hiking rates eleven times for a combined 500 basis point increase. The result has been a slow but steady drop in inflation as measured by the Consumer Price Index (CPI) from around 9% during Covid to around 3% currently, slowly getting back down to the Fed's 2% target. Now though, with increasing signs of a worsening labor market, the Fed feels the need to switch to a monetary easing regime as a nod to its maximum employment mandate and to avoid a possible recession. While Chairman Powell made a significant effort to comfort the public that while there are no signs of an impending recession, weaking labor conditions do warrant monetary loosening. These worsening conditions can be summarized as generally negative trends with respect to rising unemployment, slower wage growth, and a slowdown in new job creation.

A rather simplistic way of thinking about what the Fed wants to achieve with its dual mandate policy tools is to focus on the following three numbers: 2-4-2. These numbers refer to what the Fed likely views as currently being almost ideal levels of inflation, unemployment, and economic growth as measured by Gross Domestic Product (GDP). As mentioned above, the Fed's long-term inflation target is 2%, and we have already seen it come down to around 3%. Next, unemployment was recently as high as 4.3% (now 4.2%.) This was still above the 4% likely target, which was a key driver of the recent rate hike decision. Lastly, the GDP goal of at least 2% has been achieved over the first six months of 2024 (1.4% and 3.0%, respectively, in the first two quarters) and is generally expected to be in the 2%-3% range for the entire year. The overall picture seems reasonably positive and suggests that the Fed has a good chance of achieving the "soft landing" it hoped for – raising rates high enough for long enough and thus getting inflation under control, but without pushing the economy into a recession. Corporate earnings growth for the remainder of 2024 and in 2025 will now be in focus, especially after another strong year of equity market returns. The forward P/E ratio for the S&P 500 is now at around 21x, which is towards the higher end of its historical range. This requires meaningful growth in the P/E denominator (earnings) to justify current valuation levels. The present outlook for 2025 is for 15% earnings growth, and any significant downward revisions represent a risk over the next 6-12 months.

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