



Market Commentary
June 14th, 2024

English Version

Insigneo Weekly Dispatch

Flexibility is the Name of the Game

Our thoughts on the Federal Reserve's meeting this past Wednesday.

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Flexibility is the Name of the Game

The Federal Reserve held its June meeting this past Wednesday, leaving interest rates unchanged for the 7th straight meeting in range between 5.25%-5.5%. During the meeting and subsequent press conference, Fed president Jerome Powell convinced me that if he had not had the successful career that he has, he would have also found success as an intelligence officer or a priest. He told the markets everything he wanted to say, but not an ounce more. Even as he was pressed by reporters asking the same thing in different ways, prying at him for any hint of incremental information, he deftly danced around questions, providing concise, yet vague answers. It reminded me of ex-FBI Director J. Edgar Hoover's famous line "I will give you any information you want, as long as it is something that I want to give". This does not mean that Powell was hiding something, just that he was not going to be pinned down into giving concrete answers that could limit the flexibility of the Fed. If we think about it, it would not be outlandish to say that Powell got everything he wanted by providing nothing, as what he wanted was to retain a level of flexibility revolving around data dependency.

The Fed did provide its usual slew of economic updates, leaving GDP growth expectations for the US economy unchanged at 2.1% for 2024 and 2% in 2025. Inflation expectations, based on core PCE numbers, moved slightly higher, from 2.6% to 2.8% in 2024 and from 2.2% to 2.3% in 2025.

Unemployment forecasts remained unchanged at 4% for 2024 but did tick slightly higher to 4.2% in 2025. An interesting and important change came in the form of the dot-plot. After the last meeting, the Fed's dot-plot showed a median expectation of three rate cuts. This time, the dot-plot showed a median expectation of only one, 25 basis point rate cut in 2024. However, it is important to note that this is only a median expectation which was not represented by a unanimous vote, as seven officials expected one cut, eight officials expected two cuts, and four officials expected no cuts. Wall Street expects this cut to take place in December; however, it is also penciling in another cut to happen as early as September. As the numbers stand now, the Fed sees the median Fed Funds Rate at 5.1% at the end of 2024, 4.1% at the end of 2025, and 3.1% at the end of 2026, with the median rate over the long run at 2.8%, above pre-pandemic levels. In other words, unsurprisingly, rates will remain higher for longer.

We were never in the extreme camp that the Fed would cut seven times in 2024, as some on Wall Street believed earlier in the year. We have opted to listen to the Fed and instead believed that we could see two to three cuts this year. However, as the current data revealed, one cut seems more plausible, although we would also not be surprised by a preliminary cut in September, followed by one in December. In fact, although Chairman Powell refused to pin down an exact date as to when cuts would begin, stating that better confidence was needed that inflation was moving in the right direction, he certainly left the door open for the possibility of a cut in September, depending on the data. There is still a long time between now and

September. Powell did add that even if the Fed only cuts rates once in 2024, it would only be pushing the "other" 2024 rate cuts into 2025, going as far as stating that if we look out to 2025-2026, interest rates would be almost exactly where they would have been if the Fed would have cut more in 2024, only with the starting point pushed out a bit. In other words, it is the overall glide path of rate cuts that matters to the Fed, not the exact timing.

Despite this change in narrative, one theme that was clearly present was the need to retain flexibility. CPI data published Wednesday morning showed inflation cooling for a second straight month in May. The markets interpreted this data as positive, indicating that inflation was on the right path towards the Fed's long-term inflation target, increasing the probability of a rate cut. However, Powell attempted to rein in the markets' expectations, stating that although weaker inflation showed "progress", he added that "...we think it is not appropriate to reduce the target range for the Fed Funds rate until we achieve greater confidence that inflation is moving sustainably towards 2%. So far this year, it has not given us that greater confidence." When pressed further by another reporter, Powell stated "If the economy remains solid and inflation persists, we are prepared to maintain the current target range for the Fed Funds rate as long as appropriate. If the labor market were to weaken unexpectedly or if inflation were to fall more quickly than anticipated, we are prepared to respond...we will continue to make decisions meeting by meeting based on totality of data and implications on the balance of risks." This last statement perfectly encapsulates the Fed's position: retaining flexibility is key.

It is understandable that the Fed will need more than just a handful of prints of positive data in order to act. After all, the last thing it wants to do is prematurely react to data only to later have to reverse its decision. The Fed wants to maintain optionality, and rightly so. Mohamed El-Erian captured it best when he said "Certainly the uncertainty is making them data dependent; they took a strategic view on inflation in 2021 and they were wrong, so they do not want to be burned again." History may be preventing the current Fed from wanting to take a structural, rather than a tactical view on inflation. Adding more uncertainty to its decision process is the lack of clarity surrounding fiscal policy after the elections in November. Fiscal policy could be completely different in less than six months, depending not only on the future president, but also on the composition of the Senate and Congress. With an election year adding to the number of variables already in play, the Fed can hardly be blamed for choosing to be patient and kicking the can down the road.

By design, Powell remained elusive and did not solidify anything this Wednesday. Although the need to retain flexibility is perfectly reasonable, it is also leading to unintended consequences in the markets. Traditionally, market players have been accustomed to having the Fed act as an anchor in the sea, providing a degree of stability through a loosely predetermined path for monetary policy. The apparent lack of central planning from the current Fed on the direction of rates has left the markets to their own devices, trying to get a sense of direction. The idea of letting the data illuminate the path makes sense, but light can reveal different

things to different people. Bloomberg correspondent Michael Mckee encapsulated this idea when he said, "With no type of direction from the Fed, how are investors expected to anticipate what the fed is going to do, when the Fed doesn't know and won't give you any guidance?". It seems that the Fed is attempting to steer the markets' focus to the overall path of interest rates out through 2026. However, markets discount expectations of the future and interpret them in the present. Without a better sense of direction, markets players are reacting to every single data point, however meaningless it might seem, swaying markets up and down on an almost daily basis. As another Bloomberg commentator put it, there are lots of people in charge but no one in control. These are the consequences of data dependency.

Something that keeps me up at night is the strength of the consumer, which is highly dependent on the strength of the labor force. Powell himself acknowledged that the Fed is keenly aware of the risks for the labor market if it holds monetary policy tight for too long, saying that "the Labor market has a tendency to weaken quickly. Waiting for that to happen is not what we're doing... we need to be ahead of the labor market, it is not our plan to wait for things to break then try to fix them." The labor market appears to be gradually cooling from previously overheated levels. If it can remain on this gradual path, the Fed should be able to react accordingly. However, the labor market is a lagging indicator. As such, it can appear stable until it is not. Again, this is not lost to the Fed, as it remains focused on its dual mandate to promote maximum employment and stable prices. If inflation continues to moderate and the labor market

remains relatively strong, Powell might even be able to stick the elusive soft landing. However, we are aware of the difficulties of attempting to land on an aircraft carrier. Unlike most in the market that are betting on a soft-landing, Mohamed El-Erian sees only a 50% probability of this scenario. We share his opinion. We believe that the fed will cut rates and we have a high degree of conviction that it will begin doing so towards the end of this year. However, the reason behind the cuts will be key. If rates are cut in a proactive manner to maintain the balance between inflation and employment, this dynamic would be positive for the markets. If rates are cut in a reactive manner because the labor market and the consumer were weaker than

expected, this could have a negative impact on markets. Given this uncertainty, investors should follow the Fed's playbook, keeping an eye on the long term, while remaining flexible. Flexibility is the name of the game.



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