



Market Commentary
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English Version

Insigneo Weekly Dispatch

The First Cut is the Deepest

Our thoughts on the Federal Reserve's meeting this past
Wednesday and the resulting interest rate cut.

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The First Cut is the Deepest

It finally happened, and when it did, it arrived with a bang. After four long years of high interest rates, the Federal Reserve finally reduced the Fed Funds rate. The long-awaited Fed rate cut not only arrived, but it arrived with a deeper than expected reduction of 50 basis points, leaving rates in a range between 4.75% to 5%.

An interesting dynamic leading up to this cut was the amount of uncertainty surrounding its size. In early August, markets were mostly pricing in a 50bp cut, after weak unemployment numbers convinced investors that the Fed was not going to allow itself to fall behind in supporting the labor market. In early September, the narrative shifted, as a seemingly healthy economy once again convinced investors that the Fed was not going to get ahead of itself with an aggressive cut and risk stoking inflation higher. Two weeks ago, the market was divided almost perfectly down the middle. Last week, expectations tilted strongly to one side, pricing in a 70% chance of a 25bp cut and a 30% chance of a 50bp reduction. This week, the tables had turned once again, with the market pricing in a 40% chance of a 25bp cut and a 60% chance of a 50bp reduction. Confused enough? Frankly, so was Wall Street.

Let us look at it this way: An investor that would have been on vacation on an island with no internet connection over the past two months, last checking the S&P 500 on September 17th, then checking it again as of the time of this writing, would have

probably thought that nothing happened while he or she was away. On the surface, the market appeared to barely nudge higher, less than 1% over that period. However, this investor would be overlooking the fact that over this same period, the S&P 500 dropped close to 10%, then rose close to 12%, as Wall Street tried to find some sense of direction, especially regarding the intentions of the Fed. Given all this confusion back and forth in the market and investors' expectations alike, it is worth exploring a possible root for this uncertainty: the Fed's rather unsteady attempt to find the right balance between inflation and unemployment.

In 2022, the Federal Reserve embarked on a monetary tightening cycle that involved eleven rate increases, taking rates to the highest level in two decades. These moves were driven by an effort to tame inflation, which at the time found itself at the highest levels since the early 1980s. Let us remember that a year earlier, in 2021, Federal Reserve Chairman Jerome Powell had characterized inflation as "transitory", mostly caused by pandemic-induced supply chain disruptions. This was true, to an extent. However, the magnitude or "stickiness" of this inflation cycle was not fully appreciated by the Fed. To be fair, it was not appreciated by many on Wall Street either.

The Fed has the dual mandate of promoting maximum employment and stable prices. In other words, it is tasked with the difficult exercise of balancing the labor market and inflation. In a piece titled ["Between a Cold and a Heart Attack"](#), published in early August, we wrote: "The Fed's focus has been on fighting the economy's pressing 'cold', but the realization that its 'heart condition'

can no longer be left unchecked is coming to the forefront." In that piece, we compared inflation to a cold and the labor market to a heart attack, positing that one condition should not be left unchecked in favor of the other. We have long been proponents of the importance of keeping a close eye on the labor market, and not losing sight of it in favor of inflation. However, the Fed, unwilling to make the same mistake of undermining inflation as it did in 2021, appeared committed to not letting this happen again. This had been the message that had been telegraphed to the markets over the past four years. Between inflation and the labor market, the battle against inflation was more important.

However, the Fed's focus on inflation appeared to shift during August's FOMC meeting, when Chairman Powell stated that the signs of a slowing labor market were "unmistakable" and that the Fed "does not seek or welcome further cooling in labor market conditions." He also emphasized a shift in focus, from one mostly based on taming inflation, to one that also values strength in the labor market, stating that "upside risks to inflation have diminished and downside risks to employment have increased", going as far as saying "we will do everything we can to support the labor market". Based on the abrupt change in tone from the Fed, we can see why Wall Street would be divided and seemingly confused regarding the magnitude of the rate cut going into Wednesday's meeting. Would the Fed retain its tilt towards taming inflation or support its newfound commitment to the labor market?

Well, the Fed's 50 basis point cut appeared to represent a clear shift from fighting inflation

towards labor market stabilization. In fact, this month Chairman Powell appeared to double down on last month's statement regarding the labor market, stating that the Fed is "...strongly committed to supporting maximum employment". Although we are pleased to see that the Fed is no longer neglecting the labor market, the logical question that comes to mind is the following: given the magnitude of the cut, is the Fed seeing something that Wall Street is not? In other words, could the data be telling the Fed that it is in danger of falling behind in stabilizing the labor market. As analysts and strategists, it is our job to dig deeper and look for what we could be missing, especially as it pertains to our own investment theses.

In a statement referring to the rate cut this past Wednesday, Chair Powell stated "we do not think we are behind. We think this is timely." We do not believe that Mr. Powell is being disingenuous about this statement. However, we think that there might be more to the story. Mohamed El-Erian said it best when he stated this week on Bloomberg: "my question is, what has changed since July, when they decided not to cut rates, and now there's this very aggressive cut and aggressive signaling". Chairman Powell stated that the Federal reserve believes this cut is timely, but what could have caused the aggressive change in posture to make this cut timely, compared to taking a more gradual path of monetary easing? The Fed may just be trying to be preemptive, trying to prevent the labor market from becoming too weak and driving the economy into recession. However, history tells us a different story. As we stated in a piece published on [Wednesday](#) "historically, when the Fed makes a significant initial cut to the federal funds rate, such as 50 bps, it is

often in response to growing economic concerns. In many cases, such aggressive rate cuts have preceded recessions or significant slowdowns, as they reflect anticipation of worsening conditions". This is especially true when we consider the fact that cutting rates too fast too soon could potentially lead to an unwanted increase in inflation. In fact, the significance of this risk is such that on Wednesday, it led to the first dissent from a member of the FOMC in the last four years, when Federal Reserve Governor Michelle Bowman favored a smaller 25 basis point cut, stating that inflation remains "uncomfortably" above the Fed's 2% target range.

Some clues as to what the Fed is seeing could be gleaned from changes to several of its quarterly economic forecasts. The most important one would be the uptick in the median expectation for the unemployment rate for the end of 2024, which increased to 4.4%, from 4% in July. At the same time, although inflation expectations for 2024 declined to 2.3%, the committee does not expect inflation to approach its 2% target until 2026, leaving the door open to continued stubbornness in prices, and even the dangerous but very real possibility of future increases in inflation. What is certain is that volatility will remain, especially regarding the path of further monetary easing. After pricing in approximately 100 basis points in cuts for 2024 before the meeting on Wednesday, Wall Street is now pricing an additional 70 basis points of cuts this year. Some strategists are calling for an additional 50bps cut in November, while others see only two 25bps cuts during the last two meetings of the year. At the same time, equity markets so far have greeted the Fed's first rate cut with cheers. However, as we have seen in the past, even as

recently as the past two months, cheers can quickly turn into tears and vice versa.

In an allusion to singer Sheryl Crow's love song "The First Cut is the Deepest", the same appears to be the case for Wall Street's love for attempting to predict the path of interest rate cuts. This first-interest rate cut is the deepest, not in terms of its magnitude, but in terms of its

In this uncertain environment, the only thing that appears certain is increased volatility. In periods of high volatility, it is imperative to base our investment decisions on reason, not emotions.



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implications on the path of monetary easing going forward and Wall Street's interpretation of this path.

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