Caron's Corner Transcript – 11.25.2024

Working on a Dream? Low Inflation and Strong Labor Markets

- The Fed seems to be working on a dream. By preemptively cutting policy rates, they are trying to engineer a low and stable inflation outcome while keeping the labor market strong.
- More often than not **a strong labor market drives up wages**, which in turn drives up consumption, prices and eventually inflation.
- Starting with JOBS report, coupled with upcoming inflation numbers, the Fed will have more data to see if their dream is becoming a reality.
- We will learn more at the mid-December FOMC meeting and their Summary of Economic Projections (SEP).
- But why wait? The market is already taking positions through its pricing and has come to question whether the Fed will continue to cut rates at that meeting.
- These upcoming data points and the Fed decision and SEP forecasts **will set the tone going into 2025.**
- So how might the pricing and expectations of Fed policy impact markets? Let's get into it!

Jim Caron: Hello, this is Jim Caron, CIO of the Portfolio Solutions Group. Working on a dream, low inflation and strong labor markets. The Fed seems to be working on a dream. They are trying to engineer a low and stable inflation outcome while keeping labor markets strong by preemptively cutting policy rates. It is more commonly the case that a strong labor market drives up wages, which in turn drives up consumption prices and eventually inflation.

Starting with the JOBS report in a few weeks and the upcoming inflation numbers, the Fed will have a few more data points to see if their dream is coming through. We will learn more about this at the mid-December FOMC meeting and their published Summary of Economic Projections (SEP). Why wait? The market is already taking bets through its pricing and questioning whether or not the Fed will continue to cut rates at their December meeting. The upcoming data points and the Fed's decision and forecasts in their SEP in December, this will set the tone going into 2025. How might the pricing and expectations of Fed policy impact markets? Let's get into it.

First, let me discuss the words "why hurry." These were words a few weeks ago that Fed Chair Powell stated, namely that the Fed is not in a hurry to cut interest rates. The markets took this to mean that the Fed may skip a December rate cut. We think that's the wrong interpretation. Of course, we recognize that this statement from Powell took on extra weight given that the rate of decline for CPI inflation is slowing. CPI prints of 0.2% month over month or higher, like last time, is simply too high. We need to start seeing 0.1% month over month prints for the market to be comfortable with the continuation of Fed rate cuts. That said, I do not see Powell's comments about not being in a hurry to cut rates as anything different than what he said at his press conference at the November FOMC. He is simply conveying that Fed policy is not on a preset course in stressing data dependence. To be sure if the next inflation print is 0.3% month over month, then a December rate cut will be a close call.

So if you're not in a hurry, then why cut at all? Well, I think the main motivation for Fed rate cuts is because they have a fear that the unemployment rate may rise quickly if we enter into a modest slowdown or even if we have a soft landing. Certainly this can be discussed in terms of R*, the neutral policy rate, that Fed policy is currently in restrictive territory and that they are lowering rates to neutral, not easing policy. There's a big difference between those two things, but this doesn't explain their motivation to cut rates. As mentioned, it may be a worry about a fast deterioration of the labor market, something referred to as reflexivity. If this were to occur, it would be worsened if policy rates were restrictive when it happened. The fed may prefer to meet this risk head on and get to neutral as soon as they can. In other words, lowering rates now is an exercise in risk management for them. This means the Fed is likely on a mission to cut policy rates to 4% and maybe 3.75%. This may be the case even if the decline in inflation seems to be stalling perhaps temporarily because if they don't cut rates now, they may not be able to if there are some unfriendly inflation prints ahead. So cut now, while they can.

What does this mean for our portfolio positioning? Well, unless the fed switches their policy from cutting to hiking, which we do not think they will. But if they switch, then we think it would be, it would be difficult for the 10-year yield to get above 4.5 to 4.6% for any material length of time. More likely the case is that 10-year yields will range between 3.9 and 4.6%, all else being equal. We see the backup in yields as a buying opportunity given that it's closer to the top end of the range. Additionally, this this implies that owning bonds can also be a good hedge against equities. Equities should still find support and value from a stable and lower bond yield environment. We still find credit spreads to be extremely tight, especially in investment grade and high yield. But we find levered credit like bank loans more reasonably priced. We'll be reallocating our portfolio accordingly. Moving to increase equity exposure at duration to hedge and moving into levered credit, December carries with its special significance beyond the normal year end dynamics, it will set the stage for how Fed policy may move markets. But enjoy this monetary policy uncertainty while it lasts because in the first quarter, we'll start to have a wave of fiscal policy uncertainties. If you think things are confusing now, just wait, stay tuned and we'll be back with another Caron's corner to try to explain all of this.

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