

United We Stand, Divided Rates Fall

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- At last week’s FOMC meeting we saw **two dissents in the policy decision**, one for a deeper rate cut and the other for no rate cut at all. This implies the Fed is divided, not united.
- **Why is this significant?** Because a portion of the valuation of asset prices is counting on lower policy rates and bond yields across the curve.
- If these rates cuts don’t materialize, **then broader markets are in jeopardy** of repricing lower.
- As we see it, a united message from the Fed for lower policy rates is optimal, but even with a divided message **we still think rates fall**.

Jim Caron: Hello, this is Jim Caron, CIO of the Portfolio Solutions Group. Welcome to another edition of Caron’s Corner powered by The BEAT, our asset allocation framework across Bonds, Equities, Alternatives, Taxes and short-term Transitional (cash) investing.

The title of this podcast is “United We Stand, Divided Rates Fall,” a common phrase that means we are stronger together, but one that has a different meaning based on the latest Fed decision on interest rate policy. At last week’s Fed meeting we saw two dissents on the policy decision, one for a deeper rate cut, but the other for no rate cut at all. This implies that the Fed is divided, not united. Why is this significant? Because a portion of the valuation of asset prices is counting on lower policy rates and bond yields across the curve. If these rate cuts don’t materialize, then broader markets are in jeopardy of repricing lower. As we see it, a united message from the Fed for lower policy rates is optimal. But even with a divided message, we still think rates fall. Let’s get into it.

What we really want to highlight is that context matters in understanding Powell’s messaging. Powell surprised markets at the post-FOMC press conference when he said that “the Fed is not on a preset course to lower rates in December.” I think this needs to be understood as the chairman of the committee paying respect and deference to the debate around the policy decision. How hotly debated was this? Well, we really can’t measure that because there was no “dot plot” for this meeting, but we know at least one member voted to keep rates unchanged, and this raises three questions.

The first one is whether Powell is losing control of the committee? No, I do not think so. These are strange times in markets: tariffs, inflation, a government shutdown, limited data and large benchmark revisions to payroll data. There’s a lot of uncertainty. The second question is what about the pace of policy versus the path of policy? Well, there seems to be agreement on the path of interest rates. They will be lower. But how consistent and how fast will policy rates fall is in question, at least based on futures pricing. The third question is whether there will be more cuts ahead? Well, if the Fed can’t be sure about a cut in December, then what makes the market so sure about the consensus for the Fed to cut rates down towards 3% from the 4% policy rates today?

Where we start to square this circle is by looking at the labor markets and inflation to provide clarity. The reason I think that the Fed will resume rate cuts in December is because I expect when the U.S. government reopens, the data will show substantial weakness in the labor market. If we use alternative data from the conference board, which shows a widening of the spread between “jobs hard to get” versus “jobs easy to get” and you regress this widening against the level of the official unemployment rate with a lag, it shows that the unemployment rate is likely heading towards 5% versus the published 4.3%. As I see it, this means that labor data will show further deterioration in the months ahead, a trend that has already started and it's likely to continue. The Fed has already stated that their policy will err on the side of supporting the labor market, which means they are more likely to keep cutting interest rates. Said differently, weaker labor markets will unite the Fed's decision to unanimously support a rate cut in December. At least that's my view.

Now, as far as inflation goes, I will take my cue from the Fed. They're not worried about it for two reasons. One, they believe that the unemployment rate is heading higher. Thus, based on their Phillips Curve framework, by definition, this means that it puts downward pressure on inflation. The second is that Powell reiterated that tariffs are a one-time price shock, thus not inflationary, and by Fed measures tariffs increased prices by 0.5 to 0.6%. What you now need to do is subtract that 0.5 to 0.6% from core PCE and you'll get a tariff-adjusted inflation rate that's closer to 2.2 or 2.3%, not too far away from their target. Both labor and inflation data will be released in the coming weeks and months ahead, and we think both will be supportive of Fed rate cuts.

Let's talk about the markets and how we are positioning ourselves. If my thesis is correct, then we will move through the noise of no, fewer or slower rate cuts and get back to where we were prior to the Fed meeting, which is an expectation for further cuts into 2026. In other words, valuations are likely to be still supported by lower rates. However, I do see that the terminal policy rate ending up at 3.5% versus the consensus of 3%. As a result we remain a slightly underweight duration. Why? Because the rate cutting cycle that started at 5.5% back in September of 2024 and today is 4%, a 150 basis point decline in rates, actually had little influence on long-term bond yields. The U.S. 10-year yield today is a little over 4%, which is only 25 or 30 basis points lower than the average 10-year yield from that September 2024 period when Fed funds were 5.5%. In other words, 150 basis points of rate cuts didn't really have too much of an impact on longer-term bond yields.

The yield curve is also likely to remain steep. The 2-year/10-year curve today is around 50 basis points. This means if the Fed ends at 3.5%, which is what I expect, then the U.S. 10-year yield will have difficulty getting much below 4%. The risk is a bigger economic shock that flattens the curve, but this isn't our base case. The reason we think the Fed ends at 3.5% is because we expect an economic recovery in 2026. This keeps us invested in credit products because of lower default risks and we remain optimistic on equities.

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