1/4/2024

Reading the Fed's Tea Leaves

Robert G. Kahl, CFA, CPA, MBA
https://SabinoIM.com

Financial markets price securities based upon future expectations. Based on the shape of the yield curve, financial markets reflect anticipation of the Federal Reserve (Fed) cutting rates aggressively in response to a recession. Given the recent market rally and high equity valuation levels, US equity markets anticipate another round of "quantitative easing" by the Fed and strong economic growth to follow. According to multpl.com, the S&P 500 currently sells at 26X trailing 12 months of reported earnings.

Bloomberg reports that short-term market rates reflect a 75% probability of a 0.25% reduction in the fed funds rate starting in March and a total of six rates cuts (1.5%) for 2024. At this point, the financial markets have gotten ahead of the Fed as reflected in their public statements.

During a press conference on December 13, 2023, after the Federal Open Market Committee (FOMC) announced that they would maintain the fed funds rate within a 5.25-5.50% range, Chairman Jerome Powell said:

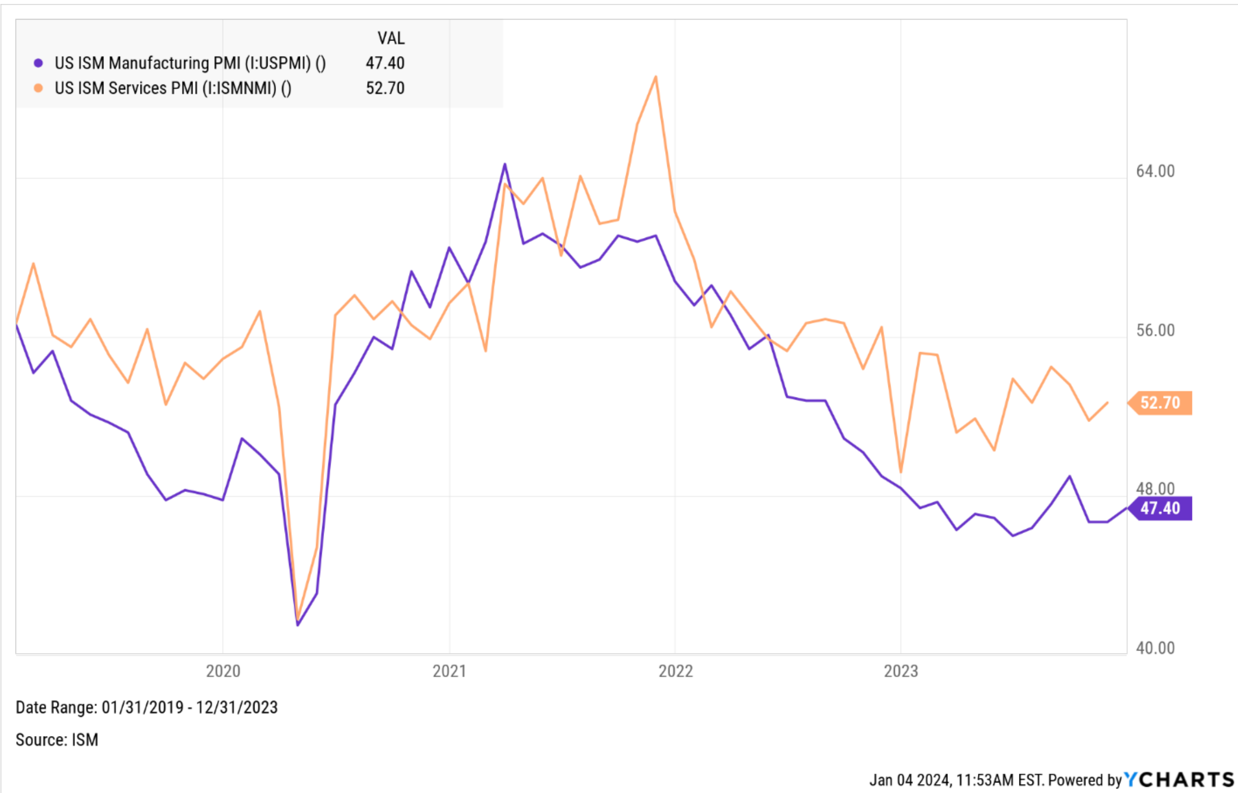
> While we believe that our policy rate is likely at or near its peak for this tightening cycle, the economy has surprised forecasters in many ways since the pandemic, and ongoing progress….toward our 2 percent inflation objective is not assured. We are prepared to tighten policy further if appropriate. We're committed to achieving a stance of monetary policy that is sufficiently restrictive to bring inflation sustainably down to 2 percent over time and to keeping policy restrictive until we're confident that inflation is on a path to that objective.

However, Chairman Powell's comments during the question-and-answer period have been described by many as "dovish" in nature.

The minutes of the FOMC meeting do not reflect any sign of imminent rate cuts. In fact, the survey of FOMC members summarized by the Fed's "dot plot" shows an expected decline of only 0.50% in the fed funds rate by the end of 2024.

The US economy is stable for now with no need for aggressive rate cuts by the Fed. The Atlanta Fed's GDP Now model currently estimates GPD growth of 2.5% for the 4th

quarter of 2023. The Institute of Supply Management (ISM) purchasing managers index (PMI) for manufacturing remains in a contraction mode at 47.4 while the PMI services index is in expansion mode at 52.7. The US job market remains healthy with 8.79 million job openings, which is 2.5 million higher than the number of unemployed persons. Some job openings are not filled because the skill set of the unemployed may not match the requirements of the job openings.



A new consideration for the Fed in the future is how interest expense on the federal debt will impact the federal budget. The federal debt just surpassed $34 trillion and interest expense on it has been rising at a rapid pace as US Treasury debt matures and must be financed at higher interest rate levels. A good summary of the situation is on this website: https://www.usdebtclock.org/. Per the St. Louis Fed, the annualized interest expense of the US government reached $981 billion in the third quarter. https://fred.stlouisfed.org/series/A091RC1Q027SBEA

As we start 2024:

- The US economy is stable, showing modest growth.
- The Fed remains vigilant in targeting a sustainable 2% inflation rate.

- Congress shows no sense of urgency to address the growth of federal debt and interest expense.
- Financial market prices reflect a very optimistic scenario for interest rates and the economy.

If you have any questions or comments, please contact me.

Sincerely,
Robert G. Kahl
CFA, CPA, MBA