STRATOS
INVESTMENT MANAGEMENT

WHAT IF THE FED DOES... NOTHING?

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The markets entered 2024 with expectations that the Federal Reserve Open Market Committee (FOMC) would cut rates, with some pundits expecting as many as six rate cuts during the year. We thought, then, six cuts seemed a bit extreme given current (at that time) economic conditions. From our experience, six cuts would likely mean that the domestic economy was headed for a rather hard economic landing (i.e., traditional recession) – not something the market had expected. For that reason alone, we felt it much more realistic that if the FOMC felt the need to cut rates, about half that number was likely more prudent – and that was assuming that the economic conditions warranted the move(s).

As we moved into 2024, the expectation for rate cuts has been pushed out and the expectation for the number of cuts has also declined. The market is now expecting roughly three cuts, with the first one beginning with the June meeting (see charts below that lay out the rate expectations at each FOMC meeting through November 2024).

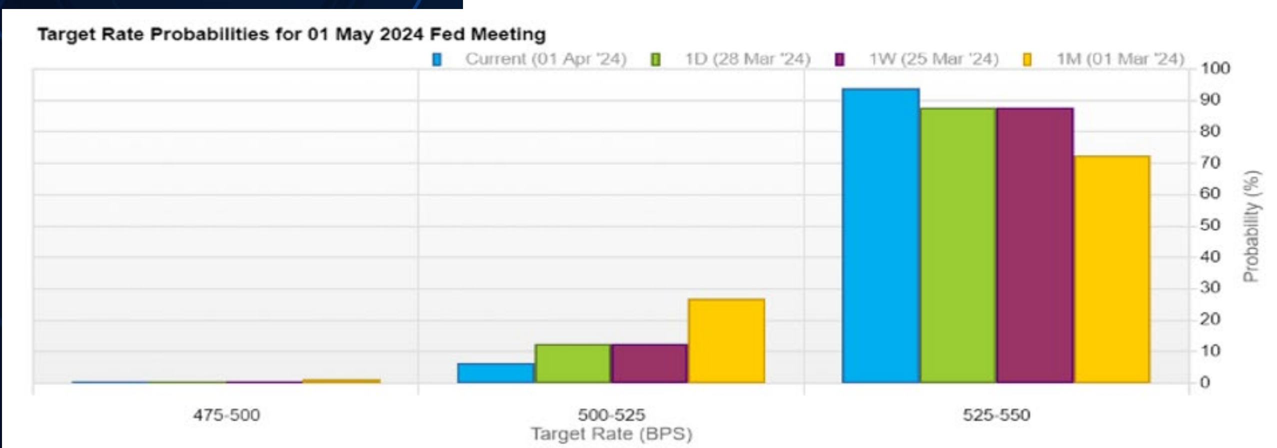


Figure 1 - Source: FactSet

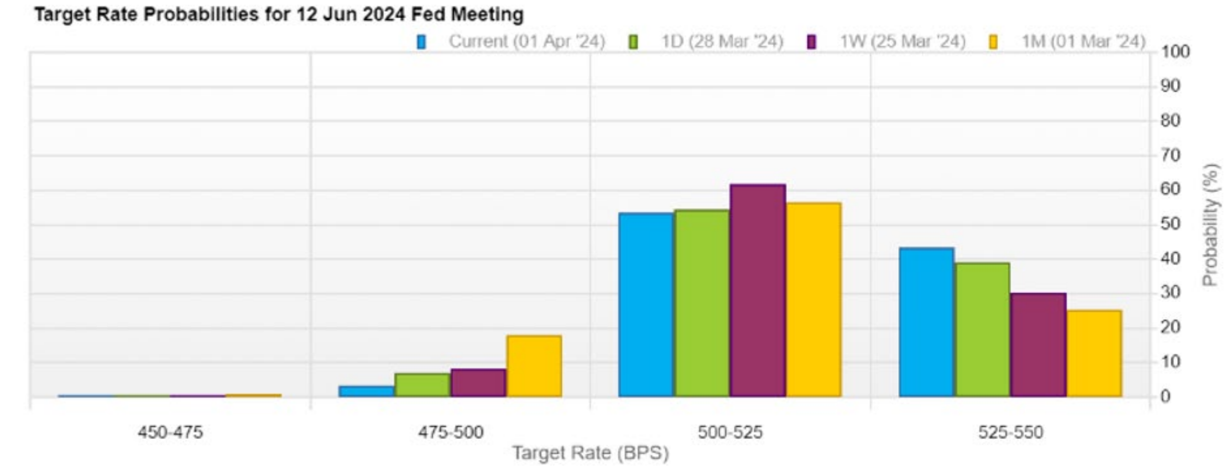


Figure 2 - Source: FactSet

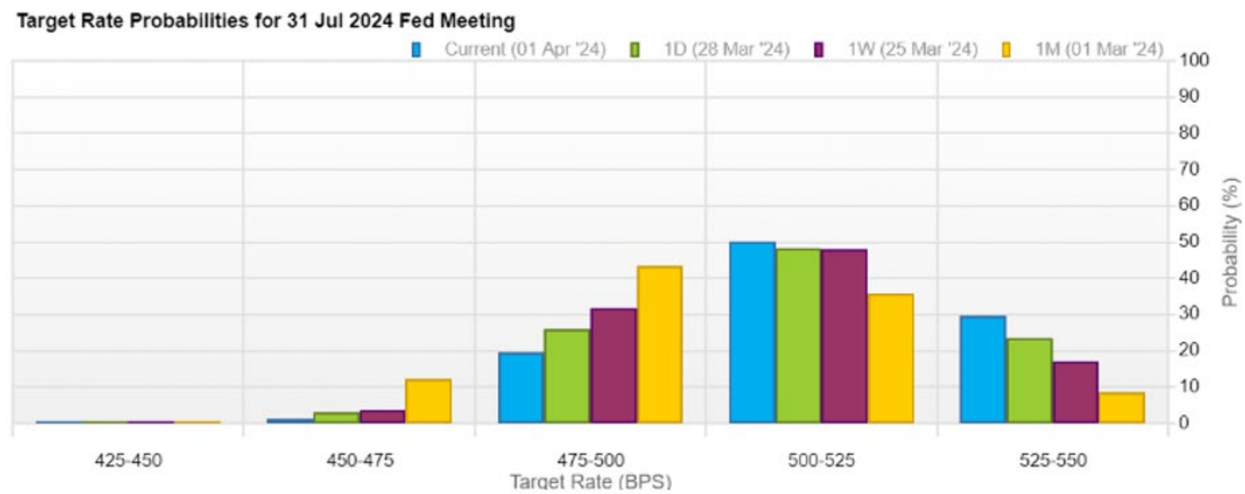


Figure 3 - Source: FactSet

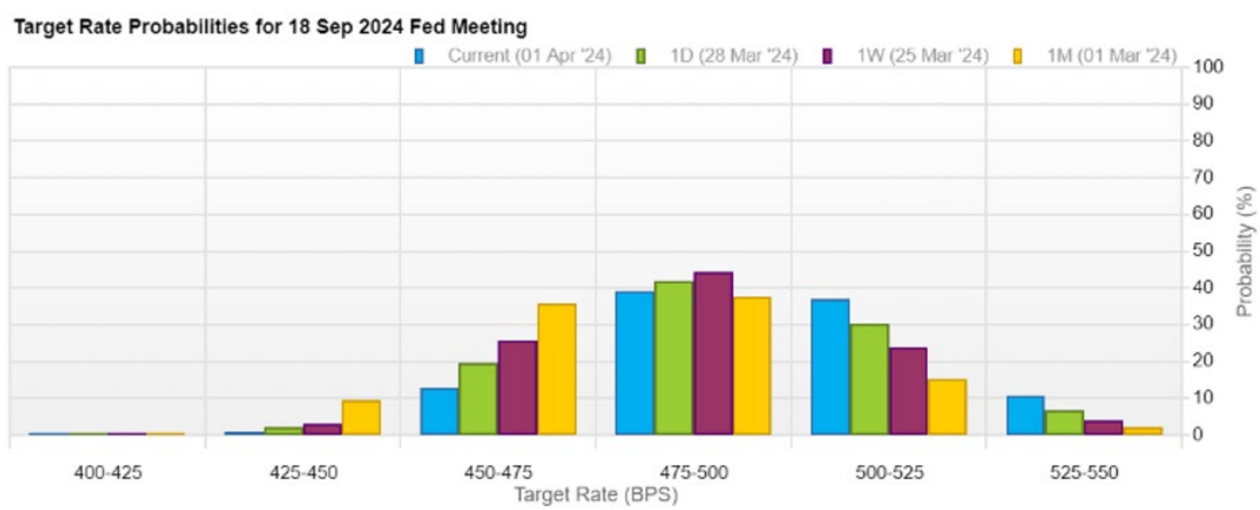


Figure 4 - Source: FactSet

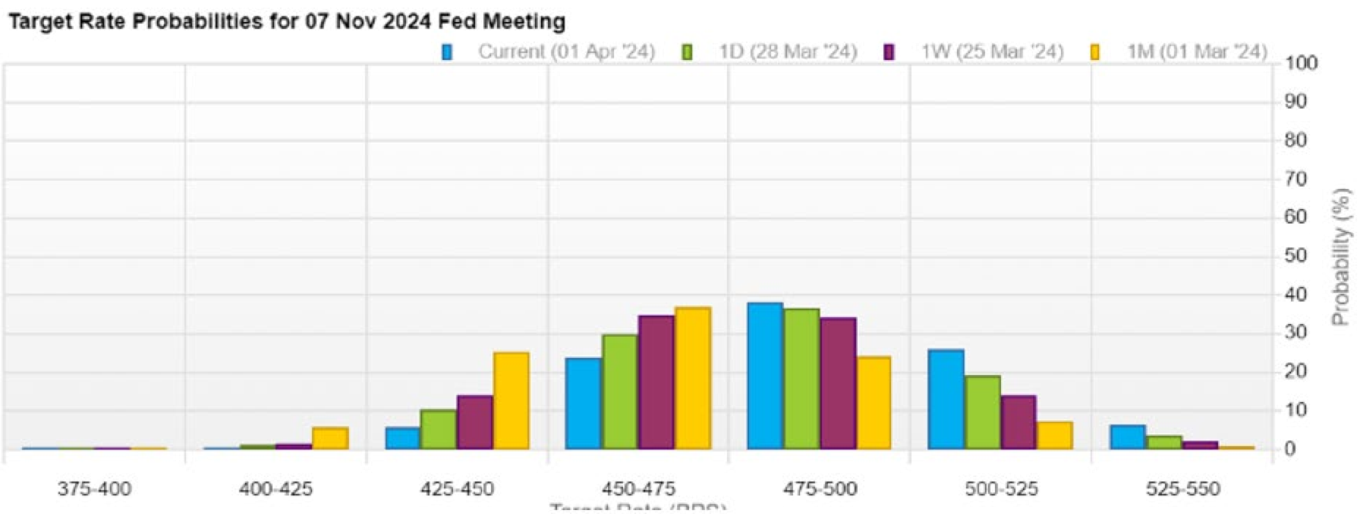


Figure 5 - Source: FactSet

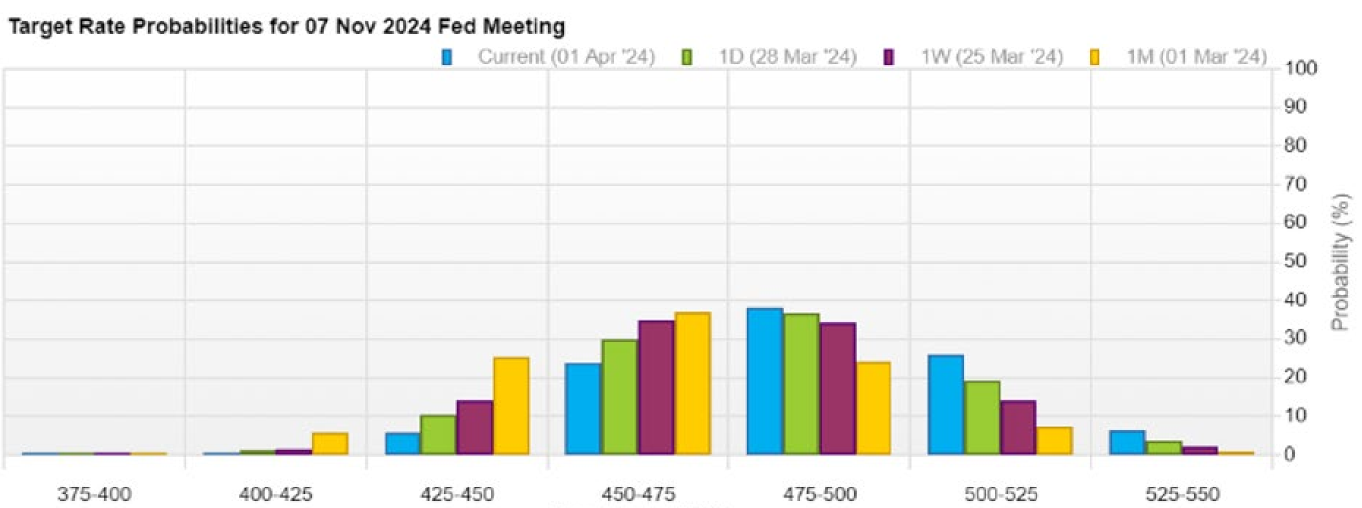


Figure 5 - Source: FactSet

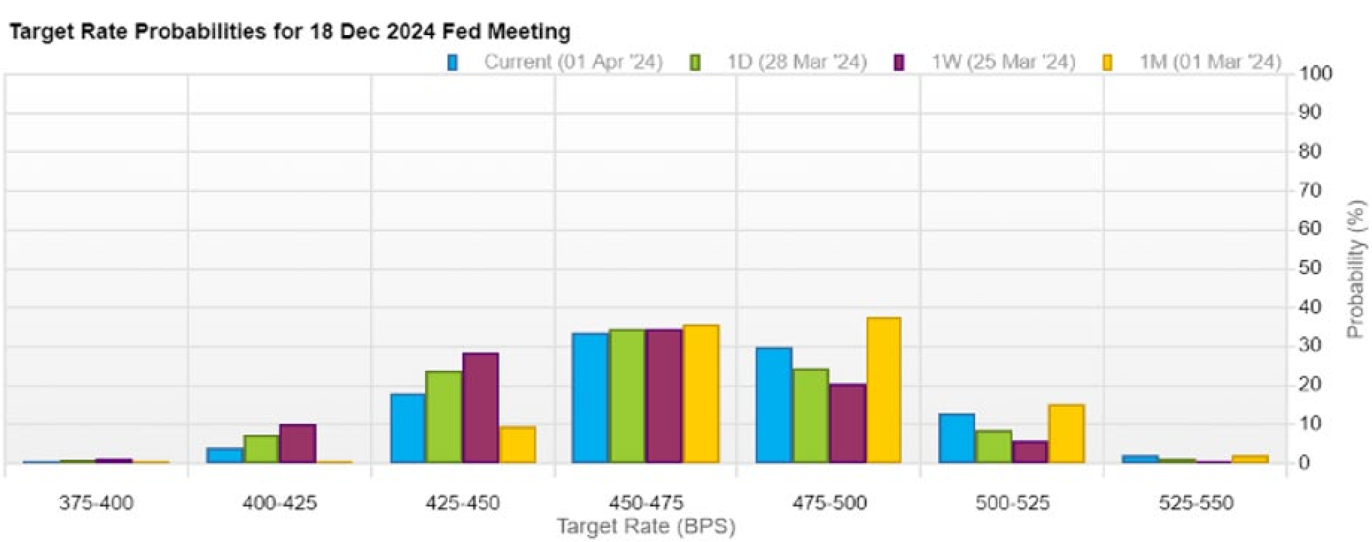


Figure 6 - Source: FactSet

As you can see from the above charts, the probability of a rate cut is fairly small until the June meeting, and then it would appear that the expectation is for a decrease of 0.25% (or 25 basis points). In fact, if we look at the probability of potential rate actions through the end of this year (the next-to-last Fed meeting is the Thursday before election day), we note that as of now, the market is expecting a total of three rate cuts with an expectation that the Fed Funds target rate declines to 4.50% - 4.75% (from 5.25% - 5.50% currently) or 3/4ths of a percent (75 basis points).

Listening to the Fed

Back when we first got into the investment business, most market pundits spent endless hours parsing anything said or written by members of the FOMC, as the Fed was fairly opaque (didn't provide much insight into their deliberations). Additionally, market participants pored over the weekly money supply data (M2 in particular) for insights as to whether the money supply was growing at a rate that was above the FOMC's target growth range. (Runaway money supply growth was provided as the culprit for the high inflation of the 1970s and early 1980s.) Since higher than desired money supply growth was the reason for unacceptably high inflation, it stood to reason that growing money supply at a lower rate would also bring down inflation, hence the focus on money supply growth.

Now the Fed is (trying to be) much more open about its deliberations, going so far as to publish projections of its FOMC participants for economic conditions each quarter (what has come to be known as the "dot plot"). In a change from what was viewed as deliberately vague language (used to keep statements from creating unnecessary alarm or excitement), former Fed Chair Yellen and current Chair Powell have tried to be much clearer in their language. This has created the unusual circumstance that the market can "hear" what the Federal Reserve is saying but believes that something else will happen. As an example, let's look at the market's expectations regarding interest rates.

It wasn't all that long ago that market expectations were built around the idea that interest rates would have to remain "higher for longer" to stamp out the inflation that took off post Covid Recession. Focusing on the extreme spike in money supply (see below), market pundits believed (including yours truly) that the Fed would need to push rates up higher than initially expected and leave rates at those higher levels for longer than would "typically" be needed. This "higher for longer" mantra was reiterated as recently as as recently as September of last year when Federal Reserve Board of Governors and

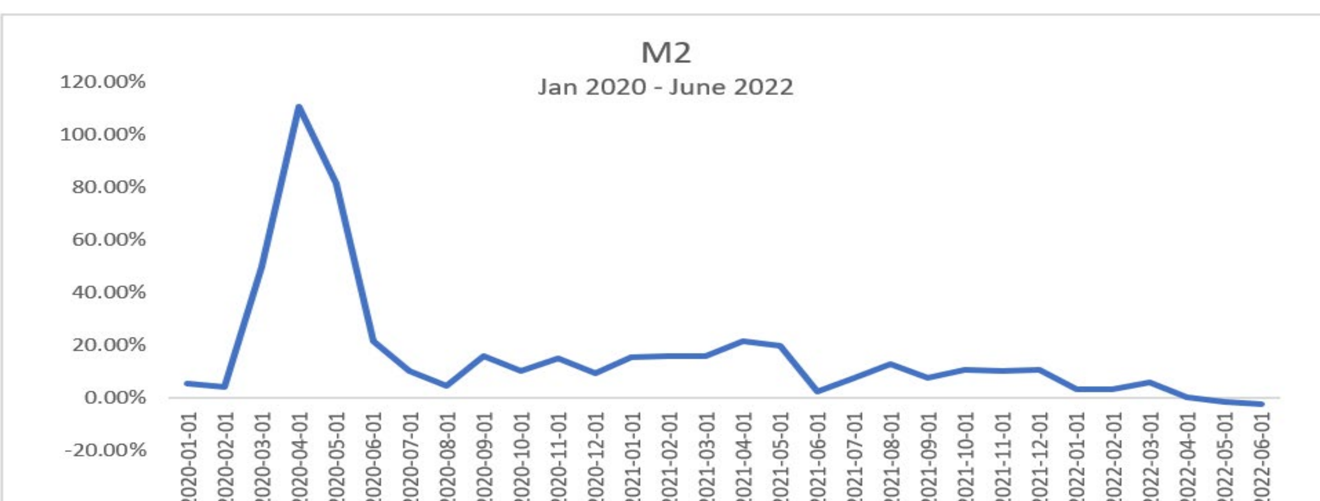


Figure 7 - Source: Federal Reserve Bank of St Louis, FRED database.

FOMC member Michelle Bowman indicated that "inflation was still too high" and Boston Fed president Susan Collins stated that, "I expect rates may have to stay higher, and for longer, than previous projections had suggested." Yet, the Federal Reserve did a policy turn at year-end 2023 when its outlook for interest rates changed. The FOMC's Summary of Economic Projections (the SEP) included, for the first time in more than four years, an expectation that it would need to begin cutting interest rates.

The market is a funny thing. It is forward looking because it needs to build into its pricing process expectations for what the future might look like. This process, called discounting, takes current information, and makes assumptions about varying scenarios and assigns probabilities for each scenario's likelihood. While it all sounds very formal and regimented, the reality is that no one knows how the market will react to new information. In other words, the market takes in information, reacts to it, and then digests it, adjusting for varying degrees of impreciseness in the initial reaction.

As we indicated in our Year End Commentary, we believed that the market's reaction to Chair Powell's pivot was a bit extreme. Indeed, as indicated at the beginning of this commentary, that outlook has declined from the possibility of six cuts beginning in March to three reductions, beginning in June. While the market has changed its view that the Fed is likely to cut rates far less aggressively than at first discounted, we are concerned that the markets are taking an overly expectant view that rates are headed meaningfully lower.

While the market does often get things exactly right, it can put-on rose-colored glasses – ignoring the potential for disappointment. What we are becoming concerned about is this: What if the Fed does... nothing?

The Economy

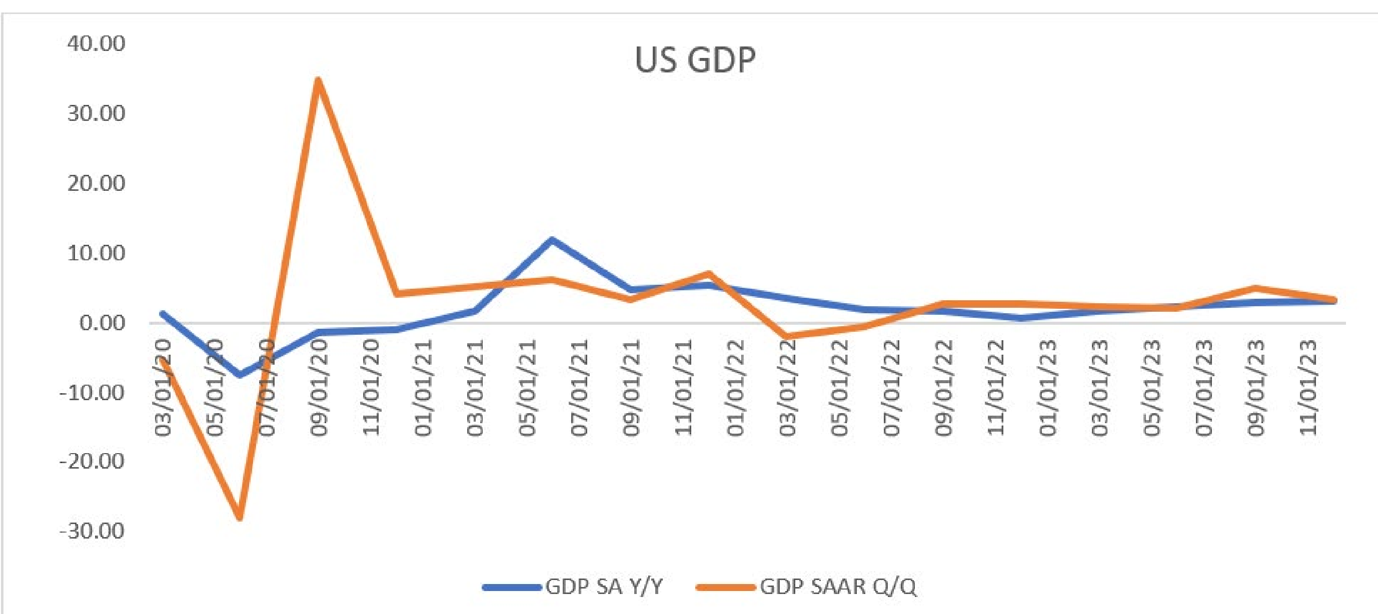


Figure 8 - Source: FactSet

The US economy showed continued vibrance throughout the year, with GDP gaining strength on a seasonally adjusted, year-over-year basis, ending the fourth quarter with better than three percent growth. While the seasonally adjusted, annualized, quarterly (quarter over quarter) data slowed from a torrid rate of 4.9% in Q2, 2023, it still showed robust growth of 3.4%. Consensus expectations for Q1 growth are for significant slowing to a 1.6% annualized quarter over quarter rate, yet the Atlanta Fed's GDPNow (which incorporates economic data on a "real-time" basis) is expecting a much more robust 2.3% growth rate. More importantly, at least in our mind, is that the broad-based economy seems to have avoided a recession, reducing the need for aggressive rate actions by the FOMC.

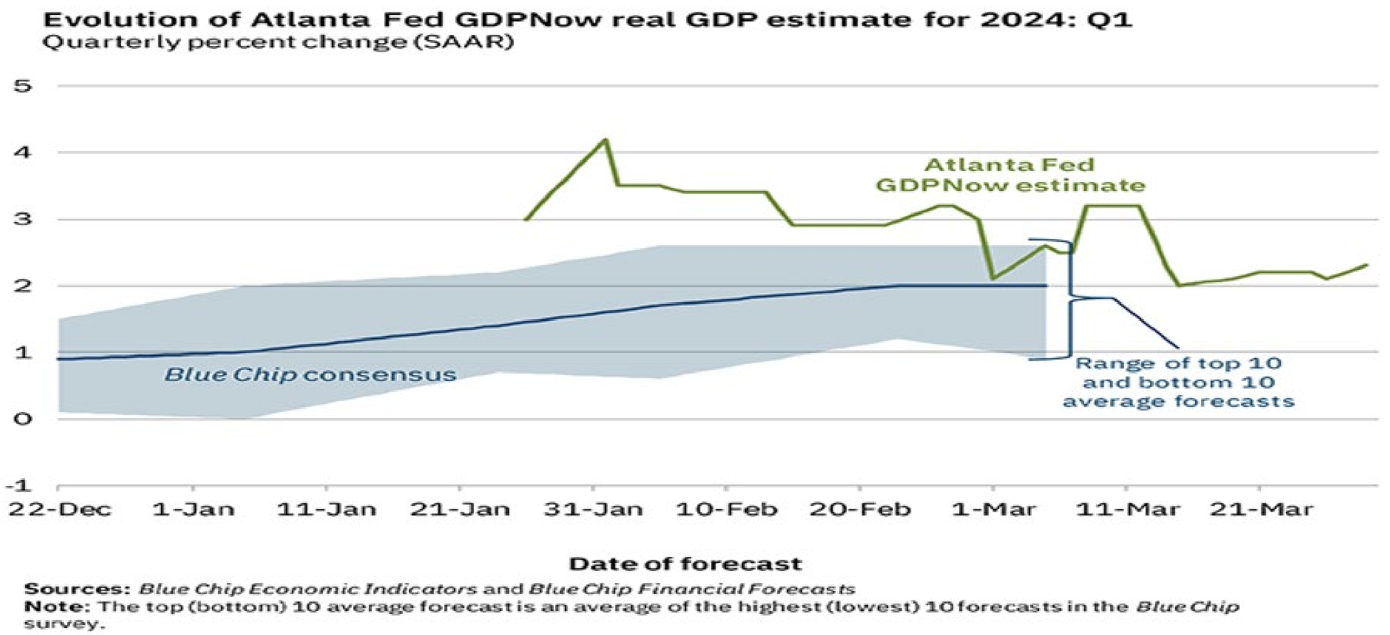


Figure 9 - Source: www.atlantafed.org, GDPNow.

More troubling to us, however, is that the inflation fight doesn't appear to be over. Note the core inflation chart below. What we find disconcerting is this: While the rate of core inflation came down on a month over month basis for both CPI ex-food and energy and Core Personal Consumption Expenditures (Core PCE – the Fed's preferred inflation measure), the trend is higher. In the case of CPI ex-food and energy, it appears to have bottomed in June of 2023 at a seasonally adjusted annualized rate of 1.9% and the Core PCE appears to have bottomed in the third quarter at a seasonally adjusted annualized rate of 1%.

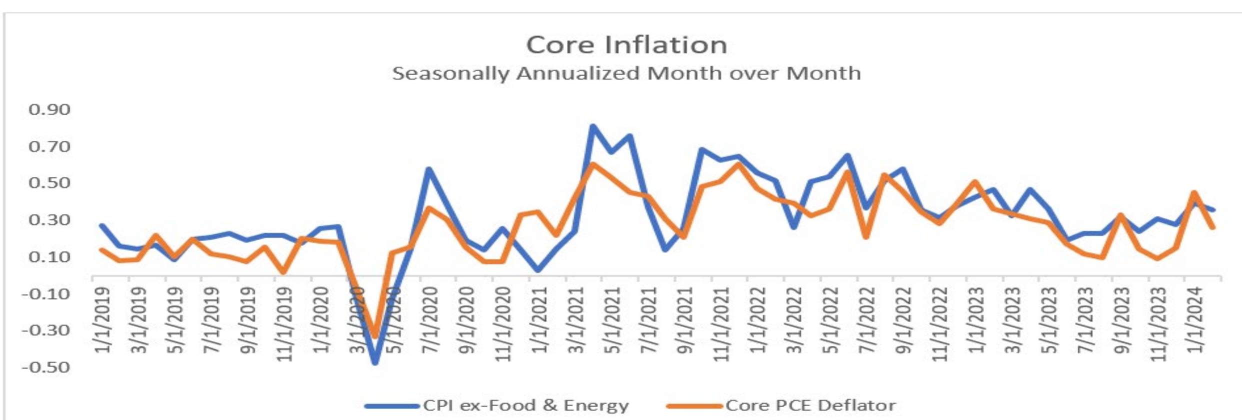


Figure 10 - Source: FactSet

Why is this troubling? Two reasons. First, if the Federal Reserve has learned its lesson from the 1970s, that allowing inflation to bubble upward can create the need for harsh monetary policy in the future, and they have truly meant what they have said regarding the dangers of inflation, then they may need to act counter to expectations. Second, and in our view more importantly, with the market expecting the Fed to cut rates multiple times this year, any risks to that expectation could create uncomfortable turbulence.

While the market remains focused on multiple rate cuts, we feel it important to actually listen to what the Fed says. Indeed, Christopher Waller (member of the Federal Reserve Board of Governors) makes the point for us when he said in his comments to the Economic Club of New York on March 27th of this year, "Back in February, I noted that data on fourth quarter gross domestic product (GDP) as well as January data on job growth and inflation came in hotter than expected. I concluded then that we needed time to verify that the progress on inflation we saw in the second half of 2023 would continue, which meant there was no rush to begin cutting interest rates to normalize the stance of monetary policy. Over the past month, additional economic data has reinforced this view... Core personal consumption expenditures (PCE) inflation jumped to 0.4 percent on a monthly basis in January, after averaging around 0.1 percent in October through December last year. And with February consumer price index (CPI) and producer price index inflation data in hand, some forecasts are predicting core PCE inflation may be revised up for January and is expected to come in at 0.3 percent for February... my view that there is -1- The views expressed here are my own and are not necessarily those of my colleagues on the Federal Open Market Committee. - 2 - no rush to cut the policy rate. Indeed, it tells me that it is prudent to hold this rate at its current restrictive stance perhaps for longer than previously thought to help keep inflation on a sustainable trajectory toward 2 percent."

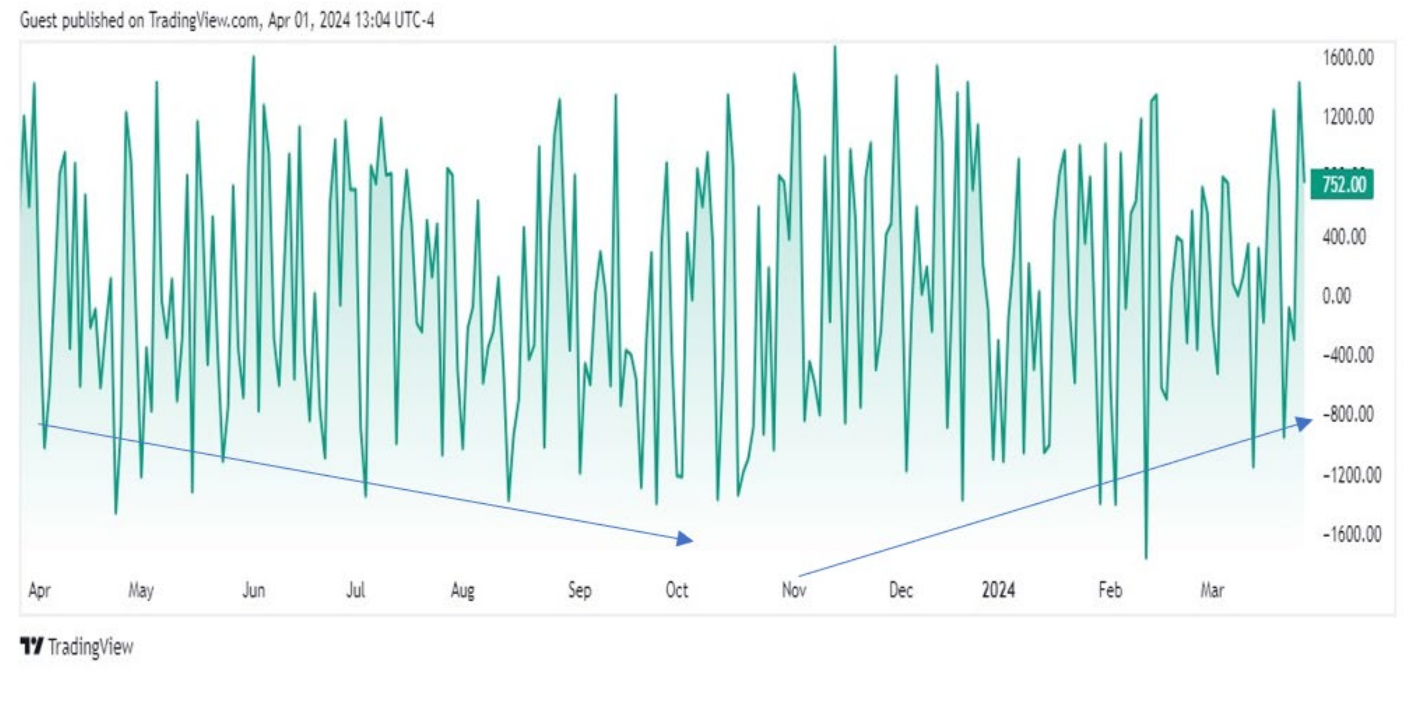
Capital Markets

Equity markets have had a good first quarter, with larger cap stocks being better than smaller-cap stocks. The S&P 500 led the pack among broad equity market indices, rising 10.56%. Mid-Cap stocks, as described by the S&P 400 rose an also robust 9.93% with small-cap stocks, as illustrated by the Russell 2000 gained a respectable 5.18%. International stocks lagged the equity market parade, increasing 4.61%.

While equity markets appear to be waiting on FOMC rate actions, we think that one of the reasons that equity markets have powered higher for the quarter is earnings growth expectations a year from now (up 12.29%) and two years from now (up 9.12%). Though we believe that expectations might prove overly optimistic, if the Fed delays its expected rate cuts, higher earnings might compensate.

Over the course of the first quarter, the Magnificent Seven became the Fantastic Four, with Tesla and Apple showing negative returns (-29.3% and -10.9% respectively) and Google providing positive, but (relatively) underwhelming performance, rising "only" 8%. The newly renamed Fantastic Four gained, on average, 37.6%, led by NVIDIA Corporation's 82.5% return.

Has the market broadened out? It appears, at least, as if it is trying to. The chart below is the Advance/Decline line for the New York Stock Exchange over the last twelve months. (The Advance/Decline line measures the number of stocks rising versus the number falling at a point in time. A generally rising Advance/Decline line indicates that more stocks are participating in the rising market.)



In looking at the Advance/Decline line (AD line) chart above, it appears as if the AD line bottomed in the fourth quarter of last year and has been trending higher. This is a good thing from a market perspective as it means that more companies are participating in the market move.

Using the S&P 500 year-to-date performance through the end of the first quarter as a benchmark and sorting the S&P 500 constituents by price change, there are 192 stocks that saw their prices increase at a larger rate than the average return for the index. (We realize that comparing price change to total return is comparing apples to oranges, but it gives us a point of comparison.) Changing the comparison to the average price change of the average S&P 500 constituent stock gets us 235 stocks whose price changed at least as much as the index average. As a comparison, at year-end 2023, 138 stocks saw their price move more than the average return for the index and 199 stocks rose more than the average price change. It looks as if breadth (the number of stocks participating in the market's performance) has, indeed, improved.

Bonds had a difficult quarter as the Bloomberg Barclays Aggregate Bond Index declined three-quarters of one percent. The reason for the losses can be found below. While we started the year with higher interest rates than have been experienced for more than a decade, the reality has been that, at least at the longer end of the yield curve, rates are still below average. Additionally, if we are to assume that we

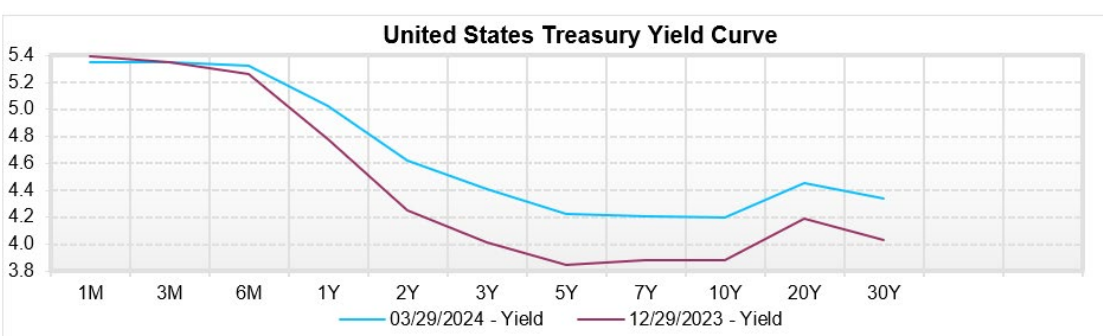


Figure 12 - Source: FactSet

will avoid a recession, then the yield curve should resume a more normal shape: that is, upward sloping. This upward slope can happen either through the short end of the yield curve (less than one-year) falling or the longer end of the yield curve rising. We would point out that even if the Fed cuts rates three times for a total of 0.75%, the only way to resume a more normally sloped yield curve would be for longer rates to rise – even if only marginally.

Something else that might be acting to keep longer rates higher than many would like is the growing need to finance the deficits and the growing national debt. With interest costs on the National Debt crossing the $1 trillion mark as of the end of fiscal 2023 (the Federal Government's fiscal year runs from October 1 – September 30), there is a growing danger that the federal government's need to fund the debt will begin to "crowd out" other suppliers of debt funding, resulting in higher interest costs than otherwise might be the case. (Crowding out is a theory that suggests that increased government spending/borrowing ultimately decreases private sector spending/borrowing.)

Outlook

We believe that returns could be more difficult to come by through year end. While we are heartened by the appearance that the economy may be on more stable footing, higher than expected interest rates would, necessarily, translate into higher discount rates (for valuation purposes) and lower valuations. (Interest rates and values move in opposite directions.) Equity market returns have already surpassed what we had expected through the end of the year, and we believe that the remainder of the year may hold disappointment in terms of where interest rates end.

We continue to refer to our position as "worried" or "cautious" bulls, believing that we can still see positive returns through year-end. However, those positive returns are dependent on lower interest rates and better earnings. If interest rates don't decline as much as the market expects and/or earnings don't come through as expected, then equity returns could be at risk.

On a broad asset allocation basis, we continue to believe that potential bond returns hold the least attraction, though broad-based equities could challenge on the downside – short-term. It is our view that more risk averse and short(er) term-oriented investors may want to hold a bit more cash given nearly five percent yields.

Figure 13 - Source: Yardeni.com

Our base case for equities for the balance of this year is low single digit returns. Longer-term investors may want to hold a bit more cash than normal in order to have some dry powder for potential corrections (when they come). Given the comparative underperformance of small(er) cap stocks relative to large-cap stocks we would not be surprised if smaller-cap stocks see modest outperformance for the balance of the year. As you can see below, the Forward PE ratios (the ratio of the stock's price to its expected earnings one year from now) for the S&P 400 (MidCap) Stock Index and the S&P 600 (Small Cap) Stock Index are well below that of the S&P 500 and the Mega-Cap 8. Given this PE differential, we are inclined to believe that smaller cap stocks will be preferable and the smaller companies within the S&P 500 may well outperform the broader index. (Capitalization or Market Capitalization (market cap) refers to the price of the stock multiplied by the company's outstanding shares.)

There is an ancient Chinese curse that says, "may you live in interesting times." Given uncertainty regarding the direction of interest rates, the year-to-date upward move of the equity market, particularly large-cap stocks, and the addition of the presidential election cycle, interesting times are here.

Sources: FactSet, Federal Reserve Bank of Atlanta GDPNow, tradingview.com, Yardeni.com

Disclosure: Investment advice offered through Stratos Investment Management, a registered investment advisor.

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