The Federal Reserve Open Market Committee kept the Fed funds rate unchanged today at 5.25-5.50%. The vote was unanimous. The formal statement wording was minimally changed, but with more important underlying meaning. Economic activity was upgraded from 'solid' to 'strong,' while the comment about job gains changed from 'slowed' to 'moderated.' On the other hand, a reference to 'tighter credit conditions' was updated to 'tighter financial and credit conditions.'

Based on CME Fed funds futures[1] just before the meeting, there was about a 99% chance of no change, reinforced by hints from several Fed members in recent weeks. (Interestingly, a 3% chance for a quarter-point rate cut appeared earlier in the week—the first time in a while.) Commentary from other members has been a bit more hawkish, pointing to continued concern over high inflation and surprise at the strength of economy and labor markets—leading to futures pricing a ~25% chance of a hike in December. After estimates earlier in the year calling for a dramatic decline in the Fed funds rate in 2024, expectations have become more restrained. Consensus guesses point to highest odds of a -0.25% cut by June, with the likeliest odds at about 4.50-4.75% by December. This points to today's levels being very near peak rates.

<u>Economy</u>. U.S. economic growth for Q3 came in at 4.9%[2], far stronger than expected versus Q2, driven by still-robust consumer spending. Albeit not precise, some measures show consumer savings draining, leading to lower expectations for future quarters. Based on the Atlanta Fed's GDPNow measure[3], an early estimate for Q4 growth has dropped from an initial 2.3% to 1.2%, with the Blue Chip economist median estimate just under 1.0%. Among private sector economists, expectations for 2024 have settled in a fairly wide range of 1.0-2.0% range, which isn't far from the level of longer-term trend growth, based on demographics/labor force change and assumed productivity. All else equal, slowing growth would pressure interest rates eventually downward.

<u>Inflation</u>. This focus of Fed concerns remains elevated, with September trailing 12-month CPI[4] having come in at 3.7% and 4.1% for headline and core (ex-food and energy), respectively. While inflation remains 'unacceptably high,' in the Fed's words, compared to the 2% core PCE target, more recent data has shown improvement, particularly when sticky housing costs are removed from core. Easing inflation still points to higher rates coming back down ultimately. But, in the near-term, inflation is still too high, with the Fed's credibility at stake somewhat in its efforts to bring it down.

<u>Employment</u>. In short, labor markets remain strong with not much slack. While a tiny amount of weakening has been noted at the edges, particularly in softer data like job openings (although these saw a move back up today), most overall measures remain robust. Coincident indicators, such as the unemployment rate, remain minimally changed in recent months and markets have been free from major layoffs, elevated jobless claims, or other areas indicating stress. In fact, still-tight job markets have kept wage growth high, which is related to inflation in a chicken-and-egg type of way. Strong current labor does not point to recessionary tendencies (as a reason to cut rates), but is no doubt an input the Fed is monitoring carefully.

Rising long-term Treasury yields—particularly in the maturities of 5y, 10y, and beyond, to as high as 5%—serve to tighten economic conditions in the same way an elevated Fed funds rate does, and then some. This work accomplishes some of the central bank's job for it, as the Fed itself has admitted recently, likely contributing to today's continued pause. This has also flattened the yield curve, which, if sustained, would be another step toward further financial normalization. Typical (i.e., non-recession) environments feature a positive-sloping yield curve, which can be accomplished through a lowering of the Fed funds rate, a rising long-term treasury rate, or a combination of both. Why are long-term interest rates rising? A mix of reasons include the Fed hinting at 'higher for longer,' economic growth far surpassing expectations, higher oil prices and re-regionalization leading to fears of persistent inflation, higher Treasury supply, weaker foreign demand, quantitative tightening removing demand, return of a stronger long minus short term premium in the curve, and perhaps more uncertainty about the environment for U.S. political consensus. There could of course be some seasonal tax loss harvesting at play as well, which drives prices down.

One difficulty is that many investors (and economists) still see the 1970's as a baseline for the unusual environment of high inflation, adding the fact that today's interest rate levels haven't been seen in nearly two decades. Recent rapid moves may have required an adjustment in thinking for those not having experienced an environment of 'normal' rates; however, these can't be considered 'high' from a very long-term historical context (where 'average' has fallen roughly around the 5% level). The cumulative tightening effect this time from a rising Fed funds rate is not necessarily the impact of going from 0% to 1%, but 0% to over 5% at a compressed pace of 18 months.

Higher interest rates are punishing to risk assets, such as stocks and real estate, as well as the economy overall depending on the pace of re-financing debt upward to the new market rate. However, as rates reach a peak, financial sentiment has historically tended to improve, as 'the worst is over' in the minds of markets. Then, depending on other elements in the environment, a Fed pause could persist for a period of time, before rates likely fall back as policy ultimately eases. Interest rates are subject to this self-correcting mechanism, as they're always chasing equilibrium, but never seem to find it, undershooting and overshooting along the way.

Ryan M. Long, CFA
Director of Investments
FocusPoint Solutions, Inc.

Sources:
[1]CME Group (https://www.cmegroup.com/trading/interest-rates/countdown-to-fomc.html)
[2]U.S. Bureau of Economic Analysis (https://www.bea.gov/data/gdp/gross-domestic-product)
[3]Federal Reserve Bank of Atlanta (https://www.atlantafed.org/cqer/research/gdpnow.aspx)
[4]U.S. Bureau of Labor Statistics (https://www.bls.gov/cpi/)