ClearBridge Investments

AOR Update: The Fed is Done, What's Next?

4 December 2023

Key Takeaways

- With the market pricing and the Fed strongly hinting at the rate hike cycle being complete, attention is turning to when rate cuts will begin. Futures are pricing the first cut in May 2024, a pause of 10 months that would be consistent with the Fed's "higher for longer" messaging.
- Beyond modestly cutting rates to prevent de facto tightening as inflation cools, we believe the catalyst for more substantial cuts to bring monetary policy into accommodative territory would be job losses, usually associated with a recession taking hold.
- Regardless of when the first cut occurs, the Fed pause is typically a favourable period for equities with the S&P 500 Index gaining 5.1% on average, suggesting the Santa Claus rally could continue.

Disinflationary Trends Once Again Taking Hold

Following two months that hinted at a potential re-acceleration, the most recent batch of inflation data shows a clear resumption of a downward drift. As a result, the Federal Reserve is all but assured to remain on hold at next week's FOMC meeting, a notion confirmed by recent comments from an array of voting members including Chair Powell himself. The potential for additional rate hikes had previously come into question after a blowout third-quarter GDP print (revised up to 5.2% last week) along with the risk that inflation was not declining as rapidly as earlier believed.

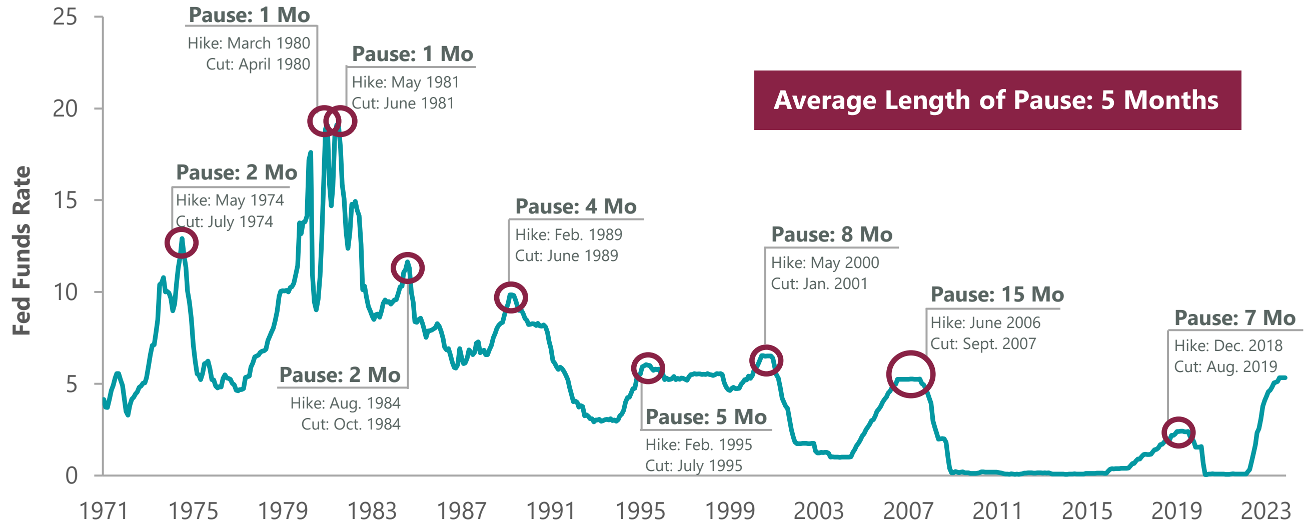
Six months ago, the core Personal Consumption Expenditures Price Index (PCE) — the Fed's preferred inflation gauge — was clearly waning, the question being to what degree. One way to evaluate this is analysing and annualising inflation trends over the prior few months to get a sense of where inflation would settle if the recent pace were sustained. In April, the annualised three-month rate of change stood at 4.1%, while the annualised six-month rate of change was an even stronger 4.5%, both well above the Fed's 2% target but down considerably from peaks in the ~6% range. These figures drifted even lower over the summer before picking back up earlier in the fall.

However, the last month of inflation data was cooler, with the annualied three- and six-month rates of core PCE at 2.5% and 2.6%, respectively. While it is still too early for the Fed to declare victory, inflation is on pace to settle well within target next year, likely taking further hikes off the table.

With the hiking cycle in the rearview mirror, investors have turned their attention to when rate cuts will begin. History provides a reasonable starting point for this discussion, with the first cut coming just five months after the final rate hike on average. The duration of this period — known as the pause — has ranged from just one month in the 1980s to as long as 15 months in the mid/late 2000s leading up to the Global Financial Crisis (Exhibit 1).

If July was the final rate hike of this cycle and the Fed remains on hold next week, the pause will already be five months. Fed fund futures are not pricing the first cut until the April/May 2024 meeting, representing a pause of 10 months, which would be on the longer end of the historical range and consistent with the Fed's "higher for longer" messaging.

Exhibit 1: Higher For (How Much) Longer



Data as of 30 November 2023. Source: Federal Reserve, Census Bureau, Bloomberg.

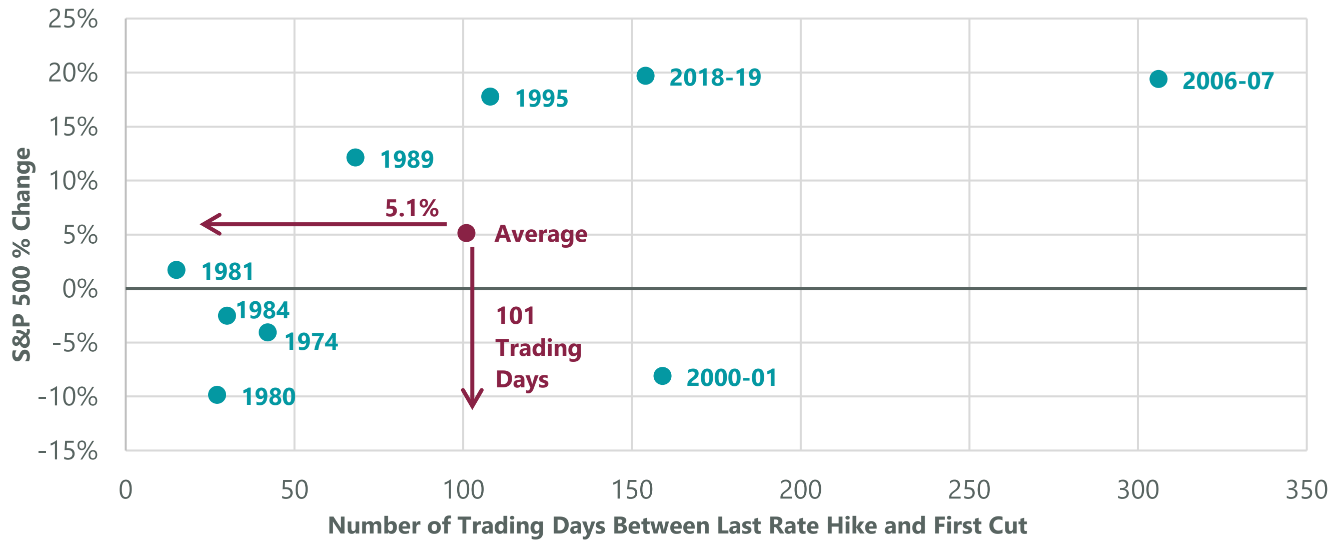
However, each cycle is unique and the length of the pause is driven by conditions at the time. Once the most recent hiking cycle was underway, the bar for a pause was moderating inflation on a credible path toward 2%. We believe the criteria for rate cuts is entirely different.

There are two types of cuts: those that help drive the stance of monetary policy closer to neutral (fine tuning) and those that bring it into accommodative territory (recessionary rate cuts). Monetary policy is evaluated in real terms: the fed funds rate less inflation. This means that as inflation cools, the Fed may need to cut rates in order to not inadvertently tighten monetary policy. Just how far they need to cut is unknowable, but in theory there is a balance point where the real fed funds rate is neither supporting nor constraining economic growth, known as the neutral rate. For a more detailed discussion of these topics and the mechanics at play, see our August 2023 blog.

Beyond modestly cutting rates in order to prevent *de facto* tightening, we believe the catalyst for more substantial rate cuts would be job losses. While the labor market is showing cracks, job creation remains robust, suggesting rate cuts are not yet on the horizon. While the first cut occurring in the second quarter of 2024 does not seem unreasonable, the nearly four and a half additional cuts priced into fed funds futures over the following ~10 months appear aggressive. However, if a recession were to materialise, the FOMC would likely cut rates more forcefully than is priced in at present.

Regardless of when the first cut occurs, the pause is typically a favourable period for equities. Historically, the S&P 500 Index has rallied 5.1% on average during the Fed's pause, suggesting there could be upside given that the index is essentially flat since the Fed's last rate hike in July. However, the S&P 500 fell 10.3% from its July peak to October lows – a period that coincided with increased fears of additional rate hikes and higher 10-year Treasury yields as inflation and economic data came in hotter than expected. Equities nearly fully rebounded in November as stronger disinflationary trends came into view more clearly, bringing to mind last month's blog, as economic and market data rarely moves in a straight line. With no obvious risks on the horizon and third-quarter earnings season coming in solid, the Santa Claus rally could continue.

Exhibit 2: The Final Hurrah



Source: FactSet, Federal Reserve, S&P.

We continue to believe the market and the economy are facing the crux – the toughest part of this cycle's journey – over the next two to three quarters as the lagged effects of Fed tightening take hold and the so-far healthy consumer and labor markets may downshift from strain to outright retrenchment. As such, we're not confident that the risk of a recession has passed just yet. This is consistent with the ClearBridge Recession Risk Dashboard, which experienced no signal changes last month. Although several indicators marginally improved, the progress was not sufficient enough to drive any changes or shift our base case away from a 2024 economic downturn.

Exhibit 3: ClearBridge Recession Risk Dashboard

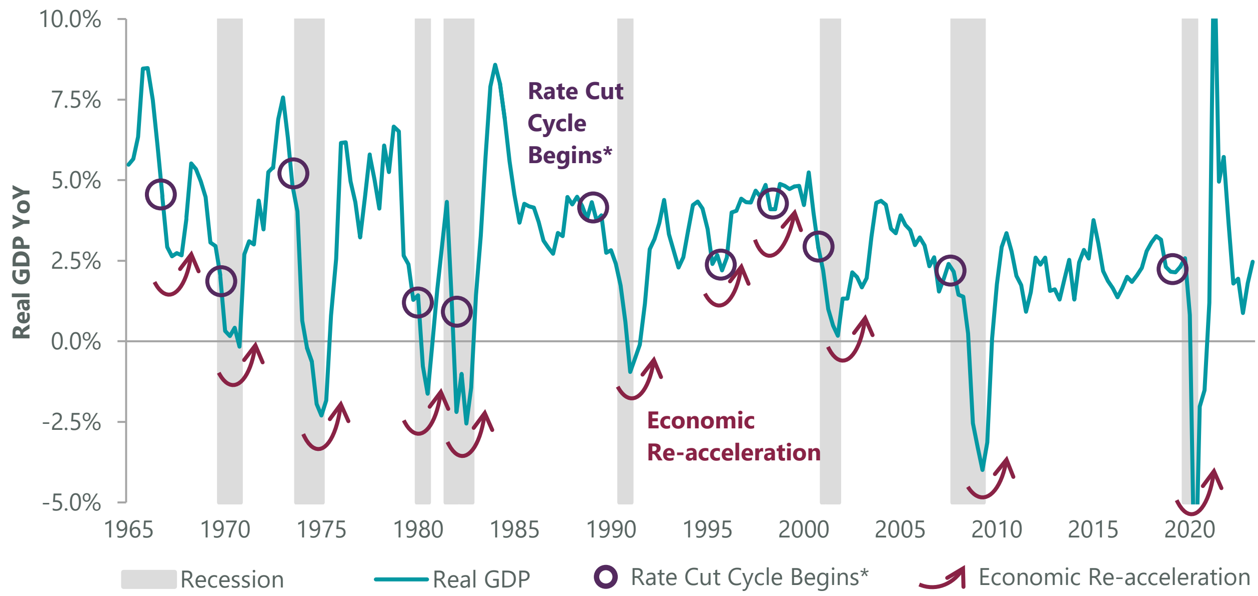
		November 30, 2023	October 31, 2023	September 30, 2023
Consumer	Housing Permits	✖	✖	✖
	Job Sentiment	✖	✖	✖
	Jobless Claims	●	●	●
	Retail Sales	●	●	✖
	Wage Growth	✖	✖	✖
Business Activity	Commodities	✖	✖	✖
	ISM New Orders	✖	✖	✖
	Profit Margins	✖	✖	✖
	Truck Shipments	●	●	●
Financial	Credit Spreads	✖	✖	✖
	Money Supply	✖	✖	✖
	Yield Curve	✖	✖	✖
	Overall Signal	✖	✖	✖

⬆ Expansion ● Caution ✖ Recession

Source: ClearBridge Investments

While we are more receptive to the idea of a soft landing given the recent string of data, we remain cognisant that a material cutting cycle (75 bps or more) has historically been instrumental in changing the trajectory of economic momentum. With the Fed hamstrung by generationally high inflation and a tight labor market, we expect reluctance by policymakers to cut substantially (cutting could create a durable move higher in economic activity) unless it becomes obvious a recession is taking root. We believe clarity on the Fed's next policy move to arrive in the first half of 2024. Until then, we continue to believe a tilt toward higher-quality and more defensive equities is prudent.

Exhibit 4: Economy Needs Fed Resuscitation



*Rate Cut Cycles of at least 75 bps that did not occur within broader hiking cycles. Data as of 30 September 2023, latest available as of 30 November 2023. Source: BEA, Federal Reserve, FactSet, NBER.

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