Market Perspectives - FOMC Update

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Today the Federal Reserve lowered the target Fed Funds rate by 0.50% to a new level of 4.75% - 5.00%. In the statement released following the decision, the Fed noted that the FOMC has gained greater confidence that inflation is moving sustainably toward 2% and judges the risk to achieving its employment and inflation goals are roughly balanced. It is clear that inflation and economic growth has cooled and the Fed Funds rate was too restrictive at this point in the economic cycle. Chairman Powell emphasized that the rate cut should be thought of as insurance steps aimed to keep the economy where it is, not a catch-up step in response to dramatic weakening. The market was positioned for this cut as noted by U.S. Treasury yields that have been falling for several months in recognition of the fact that the Fed Funds rate was due to be lowered. Note that the Fed Funds rate is the key tool that the Federal Reserve uses to stimulate economic growth, in the event of a slowdown/recession, or restrict it, in the case of excessive inflation.

The financial markets initially responded favorably to the cut, with 10-year bond yields rising slightly to 3.72% and the 10 yr vs. 2 yr yield curve now hovering at +9bp. Fed officials now expect the Fed Funds rate to fall to 4.40% by year-end 2024 and 3.40% by year-end 2025. We view such a decline as a normalization of the Fed Funds rate, and not an indication by the Fed that they are panicking or had fallen “behind the curve”. Note that once the Fed begins moving rates in a particular direction, i.e. cutting or raising, they tend to continue along that path for a period of time. Whether or not the Fed Funds rate reaches what is assumed to be its neutral rate of 2.5 to 3.0% over the next two years will be determined by the pace of economic growth and inflation.

The bottom line is that the Fed has entered a new monetary policy era with today’s reduction in rates which is intended to prevent a recession and ensure the health of employment in the U.S. The real evidence of whether their actions are successful will not be known for at least 12 months. As a result, prudent diversification of investment portfolios, and avoiding the temptation to overreact to short term market “noise”, remains the best course of action