Good News is Bad News is Good News...?

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Picture this: Economic data, particularly employment data, comes in hot; payrolls went up more than expected. That may sound like a positive surprise, and in most cases that's true. These days however, good news is bad news. The Federal Reserve (the Fed) see's those numbers and thinks "hmm payrolls are going up, that means more people have more money to spend, that equals inflation... let's hike rates." Your typical investor see's those numbers, hears about the Fed's plan and thinks "what the heck Jerome Powell, the economy is going strong, why are you trying to run it into the ground!?!?" Lastly your economists see those numbers and think "that means another interest rate hike... I hope this isn't the one that breaks something." So what looked like good news on the surface turned into an almost certain interest rate hike, which isn't news that the market typically sees as positive. Now these are generalizations of course, not every investor thinks that way, nor does every economist, but they are definitely viewpoints that are common in the industry right now.

Things get a little more interesting when you get more into the weeds. The Fed is looking at high inflation numbers and high employment numbers knowing that it has a dual mandate to keep inflation around 2% and to keep employment high. Employment is already high, but inflation isn't at 2%, so the rate hikes keep coming. Everyone else pretty much understands that positive economic data equals interest rate hikes, unless of course that inflation number comes down considerably. The divergence comes in the expectations. Your average investor is screaming from the rooftops saying "cut interest rates – you're killing the average worker," and you're even seeing this type of message coming from politicians lately. The hope being that the Fed cuts rates and the market rebounds brilliantly and quickly. The economist isn't shouting a whole lot, they see the need for interest rate hikes, but they know that with each one, the window for a "soft landing" gets a little bit smaller. They're hanging in the background waiting to see how things play out, hoping that higher interest rates bring inflation down without putting too many people out of jobs, but maybe secretly thinking that a recession is in the near future. When they think about a rate cut, they see 6% unemployment, mortgage defaults, credit card delinquencies, etc.; because for that to happen, those are the types of things the Fed will have to see. Unfortunately, when you take a look at historical data, that brilliant rebound your average investor wants seems a lot less likely than what the economists are picturing. Looking at the last 3 rate cutting campaigns by the Fed, you'll see market bottoms happening several months after the first cut, sometimes longer (1). The reality is that the Fed doesn't raise interest rates for no reason, and it certainly doesn't cut them without one. To get it off the current path of increasing rates, we're going to need a significant reversal in inflation, or we're going to need something to break.

Nevertheless, a rate cut isn't the saving grace that many people are making it out to be. The way I see it, there are two paths to a rate cut. The first one beginning with an extended period of relatively high rates that result in inflation coming down consistently and significantly, at which point the Fed might decide that there's no need for rates to be so high. The second path looks a little less nice, the Fed keeps hiking rates until the economy can't take it anymore, unemployment skyrockets, and the Fed decides that maybe they've gone too far. In both cases inflation is taken care of, the first in a systematic and orderly way, and the second in a quick in destructive way. That first scenario would be called a soft landing, slowly decreasing demand would dampen inflation over the course of many months – a process that has already begun to happen. The second scenario is a hard landing, demand collapses as unemployment ticks up and thus inflation comes down rapidly. The takeaway here being that the Fed isn't going to cut rates without taking care of inflation – the real question is whether they'll be able to do that without destroying demand and sending us into a recession.

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1: https://www.fool.com/investing/2022/10/30/do-fed-rate-cuts-signal-bear-market-bottoms/

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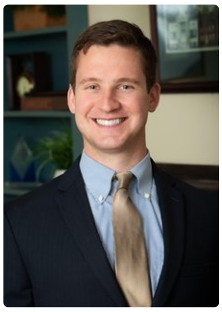

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