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The Dance of the Fed

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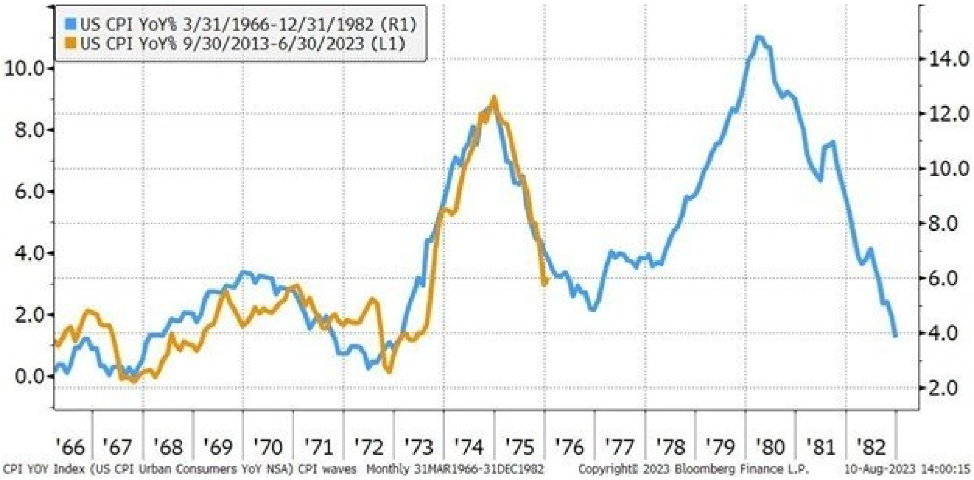
When will the Fed cut rates? At this point, it seems like this question was being asked even when the Fed was still raising rates. It's not a question of if, of course, but when. The Fed can't, and likely doesn't want to keep rates at their current levels for much longer. However, the Fed is also scared out of its mind, and would rather do almost anything else than have inflation come back in a meaningful way. And by almost anything, what I really mean is throw the US into a recession. At every Fed press conference, someone inevitably asks Jerome Powell if the Fed is willing to drive the economy into a recession if that's what it takes to vanquish inflation. Jerome Powell, being the veteran he is, gives us a beautiful cookie cutter answer declaring that the Fed doesn't see a need for a US recession in order to bring inflation back to their target. He emphasizes that a soft landing is the base case among the various Fed members… What?? Fed members think they're doing a good job? Who would've guessed. All joking aside, that's like asking a first term president who they think is going to win the next election… any answer besides themselves would be politically unwise to say the least. The same is true for the Fed. Of course they don't *want* a US recession, and they likely believe that a soft landing is on the horizon, but even if they didn't, would they be declaring that in their press conferences? I think not. Anyways, I digress. The point is that the Fed might say one thing while truly believing another, and it's the job of the market to figure out where the truth actually lies. This, of course, is easier said than done. For example, at the end of January, the market was implying a nearly 50% chance that the Fed would cut rates at their March 20th meeting. Just two weeks later, on February 15th, the market was pricing those odds at just 10%. What brought on the dramatic change you ask? Well, the market was expecting year-over-year inflation to fall to 2.9%, but it instead came in at 3.1%. If you're asking yourself why a 0.2% surprise had such an effect on the market, take a look at the chart below comparing CPI (inflation) in the 70's to the inflation we're experiencing today.



You can see why the Fed isn't so convinced they've done their job. That scared out of their mind feeling I mentioned earlier is because everyone knows what happened in the 70's when the Fed started cutting rates too soon. Right about in 1976 when that blue line starts ticking back up, that's when the Fed decided they'd done enough, that's when they decided they'd start cutting rates… Whoops. Fast forward a few years and the Fed had to raise those rates right back up, in fact, pushing them much higher than they were before.

Let's imagine for a second that the Fed was 80% confident that they'd beaten inflation when they started cutting rates in the mid-70s. Looking back knowing they were dead wrong, how confident should the Fed be today before they start doing the same? Whatever it is, it's not 80%. The Fed won't make *that* mistake again. Couple the fear of cutting too soon with the fact that the US economy is, by all measures, performing strongly, and you've created an environment where the Fed has very little pressure to cut rates. If the economy were in a more precarious position, the Fed might be willing to cut rates at the 80% confidence level we mentioned earlier, but given the reality of the situation, they could be holding out for 90% or even 95% confidence. In the end, barring a drastic change in circumstances, we're going to get rate cuts this year. The experts agree, the market has priced them in, and even the Fed's outlined this as their plan (though they've heavily emphasized that plans can change). The question, of course, is when they'll start and how low they'll go.

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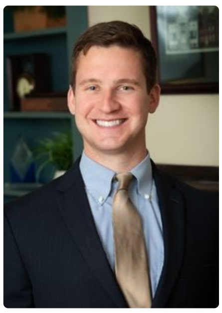

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