

BULL & BEAR *Bulletin*



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The Federal Reserve Delivers First Policy Rate Cut

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At September's Federal Open Market Committee (FOMC) meeting, monetary authorities delivered a 50 basis point reduction to the current short-term policy rate of 5.5%. The market was largely expecting this outcome with odds leaning in the direction of a 50 basis point cut as opposed to a 25 basis point reduction, though there was a tad more uncertainty around this to make it a runoff. Initially, market reaction implied a dovish bias to the policy action and cyclical stocks rallied fairly strongly, but this move tempered somewhat by the conclusion of the press conference and the question and answer session. After the dust settled, the market reaction the following day was clearly in favor of risk assets. Cyclical sectors were seen to outperform more defensive ones and short rates trended down, while longer duration interest rates moved higher in a steepening of the curve.

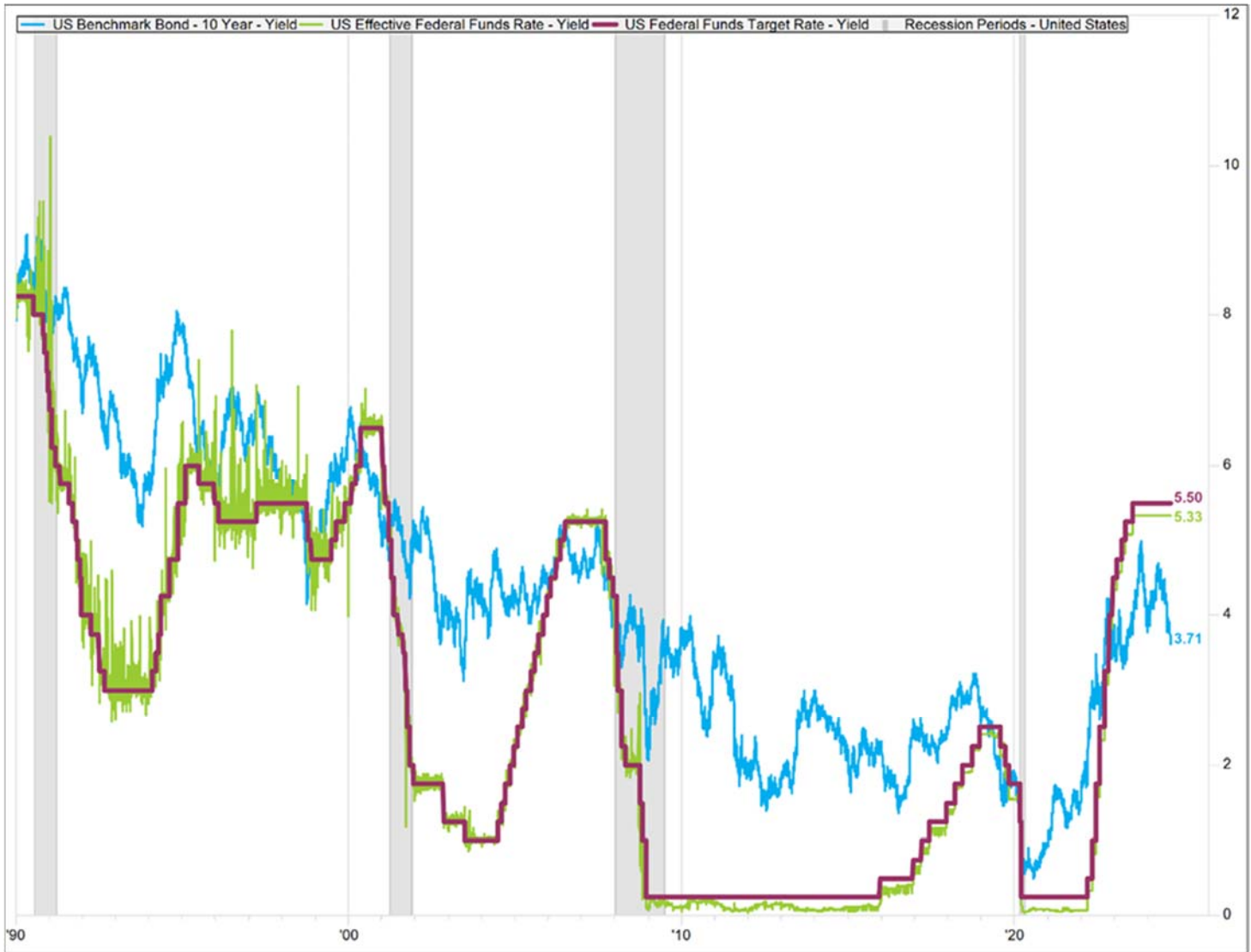
In the press conference, Federal Reserve Chair, Jerome Powell, seemed to push back against an overly dovish interpretation, communicating strongly that this upfront larger rate cut does not signal the start of a rapid rate cut sequence and that the committee will continue to watch the evolving data as it unfolds in order to determine future policy steps. There was even a rare committee member dissent around this policy outcome, underscoring the varying views of the current labor and inflation backdrop.

The Fed Chair's message seems to have been one of policy interest rate recalibration, normalization of the Fed balance sheet by continuing the roll-off and size reduction, and communication that a soft landing in the economy is possible. In response to his first question, Powell articulated that the nonfarm payroll numbers that we have been getting are artificially high. This combined with the recent observed increase in the unemployment rate may have convinced the committee that it was indeed appropriate to begin moving monetary restriction. Additionally, since progress has been made on the inflation front, the message is that risks are now more balanced between inflation and further undesired weakness in the labor market.

Looking at the policy rate alongside the longer term 10YR US Treasury yield (see graph), it is clear that the bond market has already seen rates declining at the long end of the curve, driven most probably by the disinflation and slower growth trend. One key unknown is how hard or soft the economy ultimately lands. Bulls are likely to feel that the income and investment levels will remain resilient and elevated enough to avert a recession. Additionally, housing affordability and pricing may actually improve as more supply is brought onto the market via a structurally lower mortgage rate. The policy rate as seen in the 1990's has been recalibrated lower without the economy immediately entering recession and this time could be more of an analogue of that.

Bears, on the other hand, are still cautiously pointing out that the stock market is at an all-time high at the beginning of this rate-cycle lower. If continued asset inflation spurs a wealth effect and increases demand, then higher inflation rates may reappear, stifling the Fed's maneuver. There is also a view that the restrictive policy is actually already beginning to present headwinds into the economy and the weakening labor condition will build in momentum over the next year as revenues and corporate margins begin to be pressured to the point that profit expectations are threatened. In other words, an old fashioned recession will ensue.

Near-term market action has been supportive of the Bull case, however, the need to monitor conditions as they evolve into the remainder of this year and into the next is as important as ever given the policy inflection. Market participants will keep a keen eye on the labor dynamic and credit market conditions in order to gain an understanding of market and economic circumstances as this further unfolds.



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