Weekly Market Insights

December 18, 2023

"And visions of sugar plums…"

No doubt the story of the week, and, perhaps the year, is the present Jay Powell and his colleagues at the Federal Reserve gave to investors this past week. As all of us interested in the economy are well aware, Chairman Powell not only held interest rates steady, but gave mild indications of rate cuts in 2024. Markets reacted just as expected, rallying for the sixth straight week. A happy New Year to all! The Dow increased by 2.92%, the S&P 500 by 2.49%, and the NASDAQ by 2.85%.

As readers will see in both the Economics and Yield Curve sections, a small change in expectations for interest rates influences more than just financial markets, but also the real economy, the dollar, and global trade balances. It is not just the Fed that has changed its tone. The European Central Bank, led by President Christine Lagarde, who has been no slouch in the fight against inflation, and the Bank of England, with slightly less conviction, have signaled that they are leaning toward easing or holding rates steady. A weaker dollar follows falling U.S. interest rates and can be a financial godsend to emerging markets in easing the burden of paying off their debt.

Economics

As we wrote earlier, lower interest rates and the weakening of the U.S. dollar against other currencies can have a positive effect on both the domestic economy and international trade balances. Obviously, the easing of monetary policy would lower the cost of borrowing for consumers. Much has been written about the level of mortgage rates when purchasing a house in the U.S. Cost of credit is a major part of the housing market, and lower mortgage rates should make purchasing a home more affordable for many Americans.

Internationally, a weaker dollar makes products made in the United States more attractive to foreign buyers. As insignificant as it may seem, this helps cut the trade deficit. Along with these benefits, if global bankers are correct, a lower inflation rate would ease the anxiety of U.S. consumers.

Of course, there is a danger. What if we see a reacceleration in inflation and the Fed is forced to tighten again? One would think that the world would go back to the state it had been in for much of this year, but that is not likely. Just as market participants reacted so strongly to the good news, an equal and opposite reaction would likely occur.

Yield Curve Update

The Treasury yield curve declined substantially this past week, with yields across all maturities falling in similar magnitudes. 2-year yields fell 30 basis points, 10-year yields fell 32 basis points, and 30-year yields fell 30 basis points. While we received several notable economic releases throughout the week, Wednesday's Federal Reserve FOMC meeting was undoubtedly the primary catalyst for the week's drastic moves.

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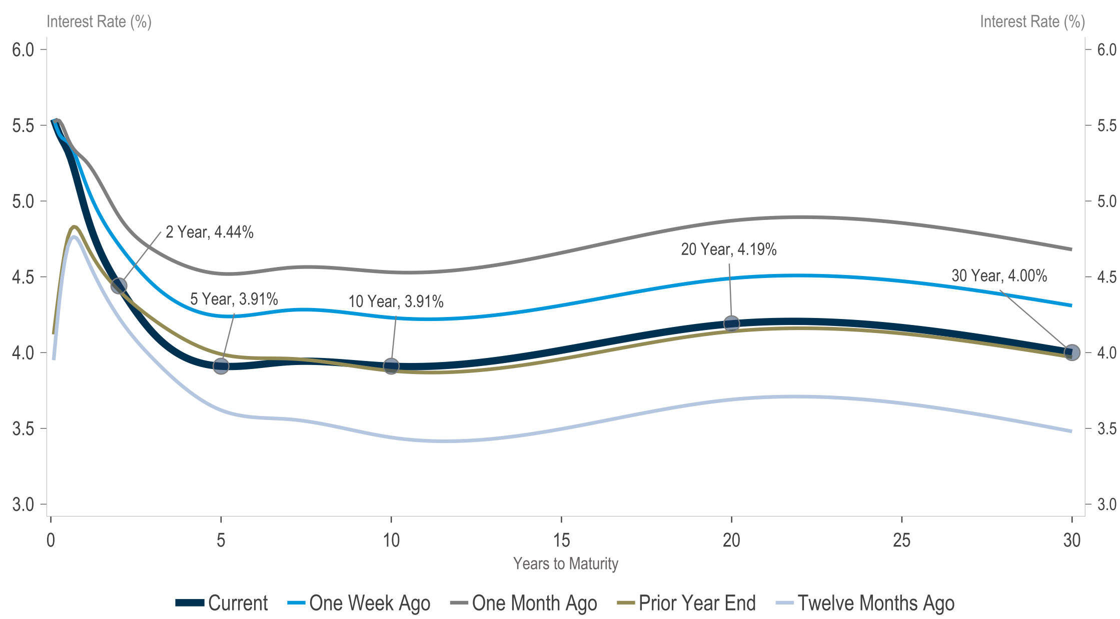
The Federal Reserve concluded their final FOMC meeting of the year on Wednesday, voting to hold the upper target for the Federal Funds Rate steady at 5.5%. The rate decision was widely anticipated, so far more attention was paid to the Committee's updated Summary of Economic Projections (SEP)[1] and Chairman Powell's post-meeting press conference. While Fed members' projections for unemployment and GDP remained largely consistent with September's SEP, they revised down their forecasts for inflation and increased the number rate cuts forecasted for 2024. Specifically, the median policymaker projection called for three rate cuts, or 75 basis points of easing, in 2024 compared with their September forecast, which called for a policy rate just 25 basis points below the current level. The Committee is still calling for fewer cuts than the market has priced in, but investors interpreted the update as a dovish signal that the Fed is closer to easing than they were in September. Chairman Powell largely echoed these sentiments in his post-meeting press conference, acknowledging that the Fed likes how the economy is trending, but also warned that it's still too early to declare victory over inflation or completely discount a recession. Importantly, Powell stated that the Committee believes they are at or near peak rates, but he did not want to completely rule out the possibility of additional hikes should economic data progress in surprising ways.

On this front, last week's indicators were supportive of the Fed's goals. The Consumer Price Index (CPI) signaled continued disinflation, Retail Sales surprised to the upside, Continuing Unemployment Claims inched higher, and Industrial Production indicated moderate growth. Taken together, these data points reinforced the Fed's messaging coming out of Wednesday's meeting and helped to pressure yields lower.

Yield Curve

Interest Rates for U.S. Treasury Securities by Maturity Date



U.S. Department of Treasury, Daily Treasury Bill Rates Data
Data as of 12/15/2023

[1]The Summary of Economic Projections (SEP) offers insights on each participant's assessment of the appropriate path for monetary policy given their respective economic outlooks.

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Conclusion

After reading some recent comments by market pundits, we believe they may be over aggressive when it comes to their forecasts for 2024 rate cuts. We do believe the Fed will lower interest rates at some point next year, but to argue five cuts in 2024 is excessive. The Fed, in its wisdom, will carefully watch what occurs as the year progresses. The last thing they want is to retrace their steps, no matter how small. Although the equity markets have done very well, we caution readers not to get overaggressive.

We will not be publishing next week, so we wish all of our readers a joyous holiday season and a happy New Year! Our first issue in the New Year we will explore some exciting, but perhaps not so apparent, developments for 2024. Thank you all for comments and questions.

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