

## **They Finally Moved**

Most economists have been predicting six interest rate cuts for 2024. Well, they're finally here. I thought rate cuts would come in 2025. Given our economy's strength, I still don't think we needed rate cuts this year, but I suppose it's better to be early than late. The Fed raised rates to the highest level in 23 years by increasing rates 11 times since March 2022 to battle runaway inflation. Higher interest rates increase the cost of borrowing, making employers reluctant to borrow, and business expansion slows. High rates also lower consumer spending.

Last month's Fed interest rate cut was the most widely anticipated in recent memory. They cut interest rates by 50 basis points, bringing the benchmark overnight borrowing rate down to 4.75%–5%. However, the benchmark rate is still very high and far from average. The Fed hasn't cut this aggressively since the early days of the pandemic. Before that, we'd have to return to the 2008 financial crisis to see a rate cut of this magnitude. This cut prompted Goldman Sachs CFO Denis Coleman to predict a soft landing for our economy. According to economists, a soft landing is when the economy slows without causing a recession. A soft landing is said to lower consumer spending, but not by much, increase unemployment, but mildly, and moderate or potentially flatten economic growth. It almost sounds too good to be true.

It's hard to argue with Denis Coleman that we're heading toward a soft landing. Gross domestic product (GDP) growth rose a healthy 3% in the second quarter. Consumer spending, the lifeblood of our economy, keeps surprising on the upside. As interest rates continue falling, consumers can take on more debt, boosting their spending ability. Also, business investment and inventory investment showed signs of strengthening. At the end of 2023, the average corporate borrowing rate was 7%, causing businesses to delay hiring and investing. As rates fall, however, pent-up demand for business expansion and hiring could bolster the economy. Though prices are still high, inflation is expected to be around 2.5% by the end of the year. Inflation has dropped significantly, and it did so without causing a recession. Economists worldwide have been calling for a recession for several years. As it happens, the Fed reduced inflation without causing a recession. This has never happened in the U.S. before, so I can understand economists ringing the recession alarm bell (albeit wrongly). Average hourly earnings are up 4% year-over-year, and unemployment numbers look good. Unemployment spiked in April 2020 at 14.8% due to the pandemic, but it now sits at only 4.2%. Hiring rates and quit rates all point to a mildly cooling job market. It feels like a Goldilocks economy – not too hot, not too cold. However, housing remains a weak spot for our economy as it continues to become increasingly less affordable.

In July, the median sales price for a home was \$422,600, up 4.2% year-over-year. Anyone with young adult children, like me and many of my colleagues at Roffman Miller, knows the strain high home prices put on our young adults. New home construction has been stifled due to higher interest rates. As rates come down, I expect building to increase and more inventory to come online as Americans with low-interest mortgages feel less trapped to stay in their homes.

Recently, Austan Goolsbee, the president and CEO of the Federal Reserve Bank of Chicago, said the U.S. economy is on a "golden path," citing improved inflation and unemployment being in a good

place. Goolsbee continued, "If conditions continue like these, there are a lot of cuts to come over the next twelve months." The Fed will look to normalize the overnight lending rate. What's normal? It depends on who you ask, but most economists think the Fed funds rate should be between 2% and 3.5%. We'll see how long it takes to bring the Fed funds rate down from its 23-year high to a normal level.

The Fed's dual mandate of promoting maximum employment and stable prices is challenging given our massive economy of over \$28 trillion. It's hard to imagine a trillion dollars. If you stacked one-dollar bills on top of each other, a trillion dollars would measure 67,866 miles high. This is a quarter of the way to the moon! The U.S. is the world's largest economy, with China coming in second at about \$18.5 trillion. While the Fed failed miserably on the inflation side of their dual mandate over the last several years, they overachieved on the jobs front. Over the last several years, we've had low unemployment and an overheated job market leading to wage growth that has outpaced inflation for over a year now.

So, if our economy is doing so well, why do so many people feel gloomy? The consumer sentiment index is an economic indicator that measures how optimistic consumers feel about the economy. A reading below 75 indicates a moderately pessimistic view, while a reading above 125 is considered moderately optimistic. The September U.S. Index of Consumer Sentiment (ICS) was 69- hardly optimistic. Prices are a big reason why. Before 2020, food inflation was about 3.9% annually. Since then, food prices have risen 25%! Although price increases are smaller today, food inflation is considered sticky, meaning prices are unlikely to come down. If a family bought a basket of groceries in 2020 for \$150, that same cart today would cost \$187. Also, housing prices and mortgage rates are too high. Although our GDP rose 3% and economists like Goolsbee cheered, people can't eat or live in a GDP number. Prices matter, and sticky inflation isn't hurting the wealthy, but it's undoubtedly hurting the masses.

We have a presidential election this year, but history has shown that, as far as the stock market is concerned, it doesn't matter which party wins. Historically, the Democratic party has a slight edge in stock market returns. However, if you remove two extreme periods, the 2008 financial crisis under Bush and the dot.com bubble under Clinton, market returns for both parties are virtually identical. Also, the stock market historically has done well in election years. No matter who wins, companies will adjust to the new reality.

In the coming year, we'll be in a Fed-cutting cycle, which is bullish for stocks. Since 1974, twelve months following an initial rate cut, stocks have been positive 80% of the time with an average return of 15%. Barring a significant event, I'm optimistic that markets will continue to make new highs over the next twelve months.

If you would like to review your overall allocation and financial plan or discuss how to put additional cash to work, please contact your local Roffman Miller Investment Advisor. On behalf of our whole team, thank you for your trust and confidence.

Bob Hofmann, CFP®  
President

## Fixed Income Corner: New Policy Direction, Same Mixed Signals

The Federal Reserve delivered the first Fed Funds rate reduction in over four years last month, cutting the most watched interest in the global economy by .50% to a range of 4.75%-5.00%. There was some market uncertainty on whether it was going to be .50% or .25% so on average it was a little more aggressive of a move, but chairman Powell commented that this was not a signal they had fallen behind moderating economic signals and a potential recession but rather a commitment to *not* get behind. The messaging being used is that the initial cut and projections for .25%-.50% by year-end and continued cuts through the end of 2025, to a much debated and elusive “neutral rate” somewhere around 3%, is reflective of just how much the Fed considers current policy as still being restrictive to economic growth and inflation as supposed to being reactive to a pending recession or financial crisis of some sort. Part of the problem for investors, however, is that these two scenarios, a “soft landing” and recession, look a lot alike. Typical rate cycles see the yield curve (treasury rates from overnight to 30 years) invert (short rates higher than long) when a recession is first projected and then reverse course back into a “normal” yield curve posture as the Federal Reserve responds to a slowing economic cycle with rate cuts when recession is closer at hand. The most recent inversion has been the longest on record since the previous record in 1978, and this is reflective of just how long we have been dealing with mixed economic signals. Recent research by Deutsche Bank has shown that the average time between this reversal back to a normal curve, or disinversion, and to an actual recession has been 2-6 months over the last four recessionary periods (2020, '07-'09, '01, '90-'91). However, continuing the long running theme of mixed signals, within just a couple weeks of the Fed’s rate cut that many construed as a possible quicker deterioration of the economy to come, we received what many considered a blow-out employment report for the month of September with jobs being added at 254,000 versus an average expectation of 150,000, and July and August figures being revised upward by another 72,000. In addition, I am writing this shortly after the CPI report which showed headline inflation continuing to slow but at a decreasing rate, and core prices up by a more than expected 3.3%. I don’t want to get bogged down in the details here but it’s important to reflect the type of unpredictable economic and market environment we are in and that the most recent data seems to indicate this will only continue.

The bigger question is, “what do we do with this information as long-term investors?” I believe the general theme we have is that the shorter, policy-driven interest rates (five years and less) will continue to decline, and longer-term rates (greater than five years) may not have much to come down with such a resilient economic backdrop still at hand. This scenario fits with the idea that while the easy money-market trade may not yet be over, the writing is on the wall and income investors should not get caught up in a short-term trade when they can plan now by locking in attractive rates for the longer term. This doesn’t mean you now buy everything longer in maturity, but what does seem sensible is to redeploy excess short term capital (all that excess cash you’ve stashed in money market funds) to plan better for yourself in the long run, and remember, if rates decline further in a broader economic deterioration, lower rates will enhance the total return of your longer dated purchases, and if rates re-accelerate, you’ll still have capital in the short end to take advantage. Don’t get stuck in paralysis-by-analysis and end up having to reinvest more capital at the wrong time.

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