The Fed signals “a new phase”

Thursday, December 19, 2024

An interest rate cut followed by a sobering message

The Federal Reserve reduced the short-term interest rate by one-quarter percent on December 18th, but its accompanying economic projections combined with Chairman Powell’s sobering narrative during the press conference led to a sharp selloff in the stock market. The updated economic projections showed inflation remaining sticky around 2.5% a full year from now, and the Fed’s expected level of short-term interest rates still hovering close to 4% next year. Even more consequential, however, was Chairman Powell’s press conference message that discussed “a new phase” in the interest rate cycle. He indicated that the Fed needs to see further progress on inflation before moving ahead with future rate cuts despite emerging signs of labor market softness.

The Fed’s “new phase” may seem a lot like being stuck

The risks to the Fed’s dual mandate of price stability and maximum employment may be “in balance” as Chair Powell described in his 12/18 press conference, but the subtext pointed toward the balance being struck by both risks looking equally unfavorable. For now, Fed interest rate policy is on hold – at a high and restrictive level – for the foreseeable future. Throughout 2024, even though the Fed’s rate-cutting campaign was slow to get started, the tailwind of eventual Fed easing supported the markets. After today’s Fed messaging, that tailwind has become still.

Rising long-term interest rates are a recurring concern

The post-Fed announcement market selloff was also exacerbated by rising longer-term interest rates, which have drifted higher over the past week and rose sharply in response to the Fed’s updated messaging. A considerable amount of lending, including home mortgages, are linked more closely with longer-term rates, which are controlled by the market, not by the Fed. Since mid-September, the yield on the 10-year Treasury Note has risen more than three-quarters of a percent to over 4.5%, which roughly offsets the positive economic impact of the Fed’s rate cutting since that same time. The stock market also has scars from the October 2023 selloff that was sparked by the 10-year Treasury yield reaching 5% and resulting concerns that economic activity and stock market valuations could come under sustained pressure.

Outlook and portfolio considerations

Fortunately, a timely reminder arrived in the morning on December 19th, a day after the Fed announcement, in the form of third quarter GDP being revised upwards from an annualized 2.8% to 3.1%. Healthy growth and profits driven by a productivity burst remains our base case for 2025. The yield on the 10-year Treasury Note has continued to drift higher, however, dampening the market’s enthusiasm for stronger growth. We do, however, expect the rising long-term yields to level off in the coming weeks and not result in the same degree of market pressure seen in 2023. Potential tariff announcements in the coming months add risk to that view as detailed in our 2025 annual outlook, and we expect the coming year will be prone to bouts of volatility. The Fed may no longer have the market’s back, so to speak, but the economy is able to stand on its own and weather the coming uncertainties. Even with the Fed’s updated messaging, we see the coming opportunities as outweighing the risks.

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