February 15, 2024

SKBA Economic Update

That Dove Won't Fly!

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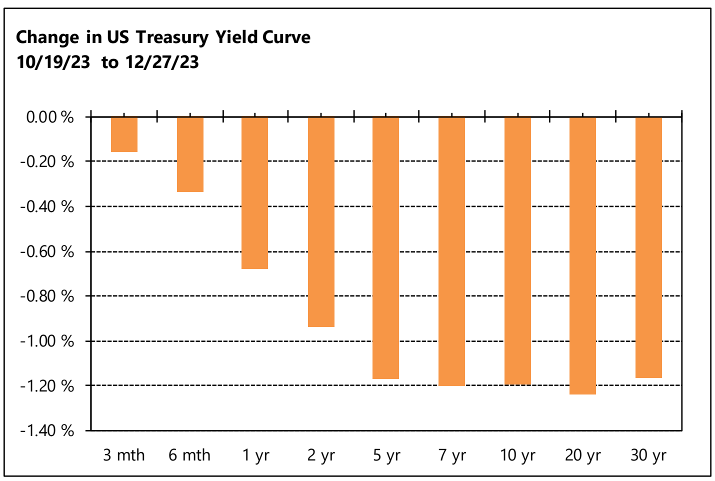
With financial markets itching to declare the "Powell Pivot" had arrived, just the whiff of expectation that the last rate increase was done, and bond yields plunged from their October 19th highs accompanied by a rebound in the stock market. And then at the December 13th announcement, the Fed indeed left rates unchanged, and Powell suggested there would be no more rate increases. This was the "Dovish Pivot" the markets had hoped for.

The adjacent graph illustrates the massive bond rally that ensued from the October peak to the lows on December 27th, and indeed it was big! While short-term T-Bill yields were stuck above 5%, the entire yield curve from 5-year maturities and beyond plunged nearly 120 basis points in the space of just over two months. The shift in the curve also, as reported on CNBC and others, led to the prediction of six rate cuts (of 25 basis points each) in 2024 starting with an implied 65% probability of a cut in March and nearly 100% probability of one occurring in each of May and June.



Source: FactSet

But then in January…Powell splashed cold water in the idea there would be any likelihood of a Fed Funds Rate cut in March. Oops! The market found itself well ahead of the Fed's likely rate cuts.

To our thinking, the notion that the Fed would reach six cuts in 2024 seemed dubious from the start. Perhaps a true hard landing in the economy could produce such an outcome, but there are a number of reasons to believe such a forecast would not "fly."

Our first concern has been that the rate of price inflation would not fall as fast as the market appeared to be predicting. We've stated for months that getting inflation even to a sustained level below 3% would be difficult, much less to the Fed's 2% target. The massive amount of federal government spending that continues to stimulate the domestic economy puts upward pressure on costs and prices, not the reverse. We feel vindicated in the short-term as January's CPI reported this week was worse (meaning higher) than expected, leaving both the headline and core CPI change above 3%. Yet this report pretty much killed the prospect of a March rate cut.

No doubt the federal government would love to have rates cut to reduce the cost of deficit spending. Certain senators have "demanded" that the government order the Fed to lower rates (so to speak). This is not new, nor can it legally happen. The Federal Reserve Board's independence has been threatened periodically since the establishment of Bretton Woods after World War II, yet it remains independent. With the federal government engaging in gung ho deficit spending when rates were low, the only weapon against the 2021-22 surge in price inflation was Fed action to abandon its Zero Interest Rate Policy (ZIRP) and bring interest rates back up to more normal levels. We are there.

However, there is another reason we shouldn't expect anywhere near six rate cuts. In this, a presidential election year, the clock is ticking rapidly toward…***the no change zone***. This discussion isn't new, and the Federal Reserve Board may become increasingly reluctant to alter Fed Funds Rate policy during the summer and fall in a presidential election year. So our view is that if the Fed plans to cut rates in 2024, they need to get it done before July. So maybe two cuts could be in the cards if the inflation chips fall the right way, but even this is not a certainty.

Everyone would probably agree that the Fed *doesn't want to seem* political or to favor one party or the other during an election year. Favoring an incumbent president would presumably imply that the Chair would seek either no upward shift in the Fed Funds Rate or a decline—perhaps helping the economy just before the election. Has this been true over the Post WWII period every four years? Yes and no—the historical record isn't close to perfect.

Fed Chair Paul Volcker was appointed by President Carter in 1979 with the permission to aggressively fight rapidly rising price inflation. The four months of July through October should normally be the quiet period for Fed policy changes in presidential election years. Volcker didn't get that memo and instead raised the Fed Funds Rate by 682 basis points just before the 1980 election. Wow! This amounted to all of the increase that occurred that year. President Carter lost his reelection bid to Ronald Reagan, but not simply due to Volcker's actions. The problems were already too far gone by 1979. With the inflation beast on the run (meaning lower), Volcker then cut rates aggressively in 1984, all in the four months before the presidential election.

Conversely, Chairman Ben Bernanke, slashed the Funds rate repeatedly in during the financial crisis of 2008. This appears to have had nothing to do with the election that year.

Because the Federal Reserve Board chair is appointed by the president, it's not hard to imagine that he/she might be swayed to do the president's bidding, particularly during an election year. William McChesney Martin served as Fed Chairman from 1951 ending in 1970. He cut the Funds Rate twice during the summer and fall of the 1960 and 1968 election seasons by 79 and 21 basis points, respectively. In 1968, he flipped from raising rates in the first half of the year to cutting them in the second half. Furthermore, his rate increases in 1956 and 1964 were modest, only 13 and 10 basis points, respectively. It has been suggested that he was very accommodative to his presidents.

Arthur Burns, Fed Chair from 1970 to 1978 was also noted for being accommodative to presidents Nixon and Carter.

Perhaps Alan Greenspan, the longest serving Fed Chairman (1987-2006), showed the most restraint in changing interest rates in the election years of 1988, 1992, 1996, 2000 and 2004. Less than 25% of the changes in the Funds rate, up or down, occurred in the months of July through October leading up to these elections.

In terms of actions taken by Bernanke, Janet Yellen, and Jerome Powell in the election years of 2012, 2016, and 2020, virtually zero changes in rates was the norm during the four months prior to each election.

While Jerome Powell was appointed by President Trump, if Trump wins the election, he has suggested he probably won't reappoint Powell. He likes low interest rates. Although Powell is very careful in his statements, the Biden Administration has left the entire job of fighting inflation to the Fed, being completely unwilling to stop the excessive federal spending that has created the price inflation problem. Mums the word out of the White House. So it seems to us that Powell has a free hand to do whatever he believes is right, which just as likely means nothing. Nor will the stocks do well that are dependent upon this presumed dovish pivot by Chairman Powell.

Even with its reaction to the falling probabilities of seeing 5 or 6 rate cuts in 2024, the stock and bond markets appear to still be pricing in too many for 2024. If the cuts don't occur as planned, we should see diminishing returns for highly-valued tech and media stocks as well as companies that are sensitive to interest rate changes. That dove just won't fly!
