FirstCitizensWealth™ | Making Sense

Basis Points | October 8, 2024

Balancing Act

1. Still Restrictive

Last month the Federal Reserve called curtains on the most significant tightening cycle in decades. The Fed's unexpected 0.50% interest-rate cut (versus the standard 0.25% adjustment) leaves the overnight rate at 4.88%, a level that still greatly exceeds today's inflation rates of about 2.5%. Such a wide differential makes interest rates look restrictive and monetary policy still offsides. Markets expect the Fed will narrow this gap by cutting rates another 1.5% by the end of next year, substantially more easing than in the "mid-cycle adjustments" of 2019 and in the 1990s.[i]

2. Two Economies

Record-high equity prices, easy financial conditions, and above-trend growth are elephants in the room undermining the case for substantially lower interest rates. Robust corporate issuance and tight spreads suggest large firms are readily obtaining financing despite elevated rates. Large-cap firms are as profitable as ever, but an increasing share of mid- and small-cap firms are failing to turn a profit at all, underscoring gloomier anecdotes from the Fed's "Beige Book" and the NFIB's small business survey. A similar inconsistency exists in the household sector: personal spending has been strong, likely reflecting sustained spending power from households benefiting from elevated home-equity and stock-market wealth. But at the same time, delinquency rates are at their highest since 2011, and aggregate consumer confidence is sagging. Financing conditions may still be accommodative for some parts of the economy, but they do appear increasingly restrictive for others.

3. Spinning Plates

In recent months, employment and inflation trends have stabilized at closer-to-acceptable trends, marking a welcome return to normality after years of distortion. Last week's employment figures showed the labor market may be cooling more slowly than previously feared. Inflation is running at about 2.5%,[ii] seemingly close enough to the Fed's 2% target to support initial rate cuts, but work remains to be done before several more cuts are fully justified. While market and economic conditions appear more balanced compared to recent years, several economic variables remain up in the air, and maintaining this stability is far from guaranteed. A stark reminder is the market volatility from two months ago after just a few days of unfavorable macro data.

4. Cutting at the Front

Treasury yields rose after last week's hotter employment data but are still well below recent averages. The aggregate bond yield is down 0.9% from its Q2 peak, but at 4.4% fixed income remains attractive. Markets expect the Federal Reserve will lower rates by another 1.0% over

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the next six months and 1.5% by the end of 2025.[iii] These cuts would have more of an impact on the front end of the yield curve; the Fed does not control rates like the 30-year mortgage, for example, which is more closely correlated with the 10-year Treasury yield.

5. Managing Expectations

Markets are positioned aggressively for interest-rate cuts over the next several months. The Federal Reserve may lower rates significantly so long as inflation remains headed toward the 2% target. But if inflation remains sticky above 2% and the recent spate of stronger economic data proves more enduring, the Fed may deliver fewer rate cuts than expected, judging that such a resilient economy is one with likely higher neutral interest rates.

6. New Heights

The S&P 500 closed out Q3 at yet another record high. Reflected in the price are solid expected earnings growth and continued margin expansion. With Q3 earnings season officially underway, analysts expect 4.2% year-over-year S&P 500 earnings growth for the quarter.[iv] Breadth has improved since July, with stocks outside of the mega-caps outperforming, a welcome sign for the broader market. Historically, equities perform well during rate-cutting cycles that do not end in recessions. We remain constructive on US equities with a 12-month ahead S&P 500 price target of 5,900.

7. Uncertain Landscape

Heading into Election Day, Vice President Harris and President Trump are close in the polls and basically tied in the prediction markets. Most economic policies decided in 2025 will depend on the entire composition of government, and prediction markets assign a roughly 50% probability to split-party control of the Presidency and Congress, something not seen in a first-term administration since the 1980s. The recent escalation of war in the Middle East and the brief dockworkers' strike are reminders that supply shocks remain a risk, even as many adverse supply-side factors have faded since 2022.

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[i] Bloomberg
[ii] Labor Department, Commerce Department, Bloomberg, First Citizens Wealth
[iii] Bloomberg
[iv] FactSet

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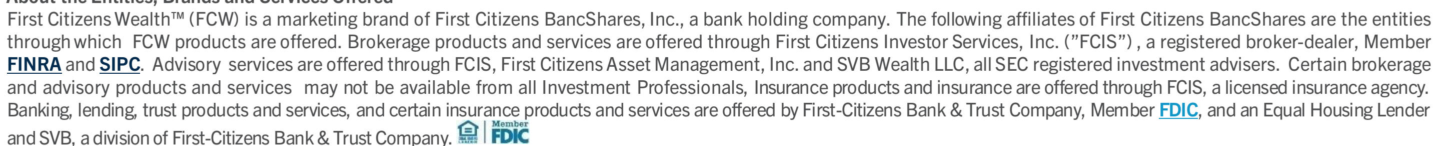

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