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Weekly Market Flash

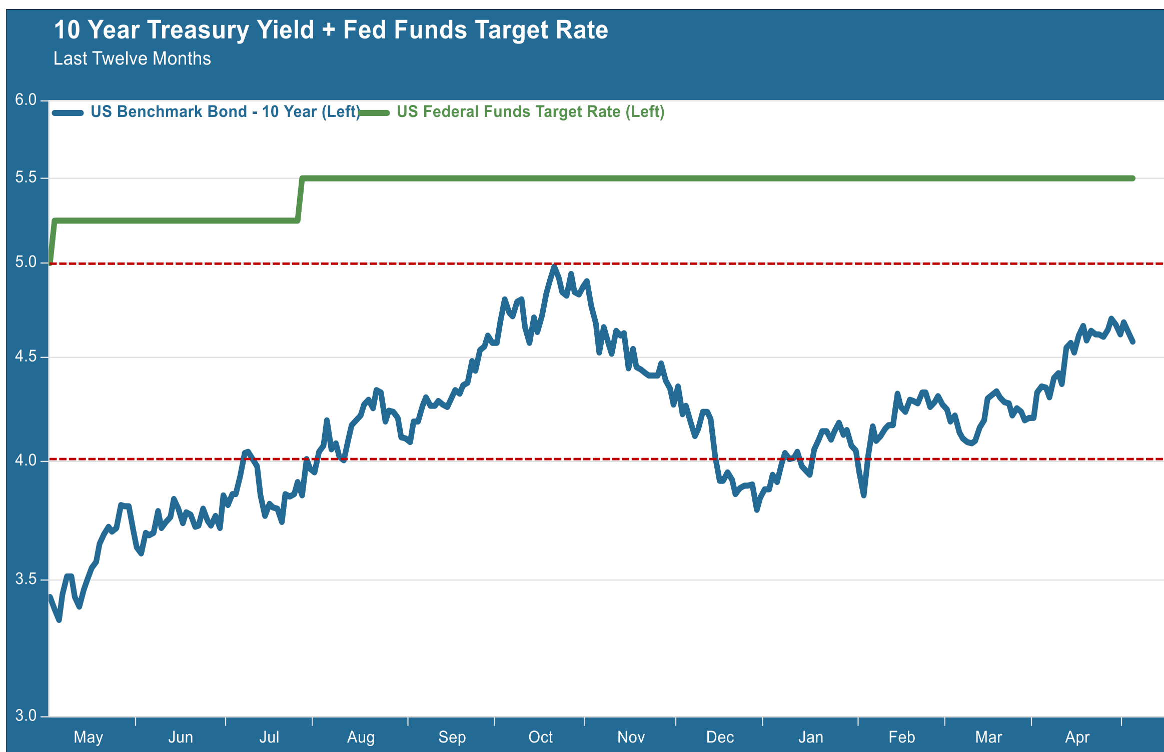
How the Bond Market Learned to Love the Fed

May 3, 2024

Love the Fed? That may be too strong a sentiment. But at the very least, the bond market is channeling its inner Dude (as in "The Big Lebowski") and abiding the Fed. The market had already priced itself out of the multiple rate cut fantasy with which it started the year when the FOMC sat down this week to deliberate for two days on an outcome it had telegraphed well in advance. No change in rates today, no change in rates tomorrow, and we'll just have to see what happens after that. Market pundits observing the event could come up with all manner of contests betting on how many times the phrase "data-driven" would proceed from Jay Powell's lips. In his customarily clear and unambiguous way, Powell said that there is more work to be done on inflation, that growth continues to be strong, that stagflation (as we discussed in our commentary last week) is not something the Fed is unduly worried about today, and that the Committee will make decisions on the Fed funds rate without regard for extraneous political considerations as the November election approaches (points again for "data-driven"). The market abides.

Two, One or None

The chart below shows how the market has adjusted to the realities of the Fed's world from the overly enthusiastic response to last December's FOMC meeting to this week's confab. The dotted crimson lines on the chart show where the upper bound of the Fed funds rate would be with two rate cuts in 2024 and with six rate cuts in 2024.



Source: MVF Research, FactSet

Right now, Fed funds futures markets are pricing in two rate cuts, with the likely timing now pushed back to the second half of the year – July at the earliest, but more likely September for a first cut (note here

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again the importance of Powell's response to a question at the Wednesday press conference about rate cuts and election optics – data-driven trumps political expediency). There are only three more months of inflation data to digest before the July 31 meeting, which may not supply enough data for a rate decision even if they come in less hot than the three reports thus far this year. At the next FOMC meeting, which ends on June 12, we will get to see whether the "dot plot" – the Summary Economic Projections reflecting Committee members' best guesses about rates – has changed from the March numbers that still showed a median expectation for three rate cuts this year. More likely than not, that expectation will have shifted.

What About Growth?

The other side of the equation is growth. On Wednesday Powell strongly downplayed the possibility of a slide into 1970s-style stagflation. He noted that the lower than expected real GDP growth of 1.6 percent in the first quarter did not reflect a meaningful shift in the recent strong trends of household spending and private business investment, with most of the deceleration having to do with changes in business inventory spending. The Fed's base case view continues to be that growth will maintain a steady pace while inflation gradually –but eventually – gets back to the two percent target.

That being said, a couple other macro data points this week merit some attention. The March Consumer Confidence report came out earlier this week showing a decline from 103.1 in February to 97.0 in March. Economists had expected the number to rise to 104.0 in March. This morning, the Bureau of Labor Statistics reported payroll gains of 175,000 for March versus a forecast of 235,000, along with a slight uptick in the unemployment rate from 3.8 to 3.9 percent. This is not a bad jobs report per se, but it could suggest that the recently hot labor market is starting to cool off.

To be clear, our base case is more in line with the Fed's view that stagflation is an outlier scenario; nonetheless, we need to pay attention to any signs of a potentially cooling economy. The message from both the bond market and the stock market this week reflects satisfaction, more or less, with how the Fed is threading the needle between inflation and growth. A few data points in the wrong direction could change things quickly, however.

Masood Vojdani
President & CEO

Katrina Lamb, CFA
Head of Investment Strategy & Research

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