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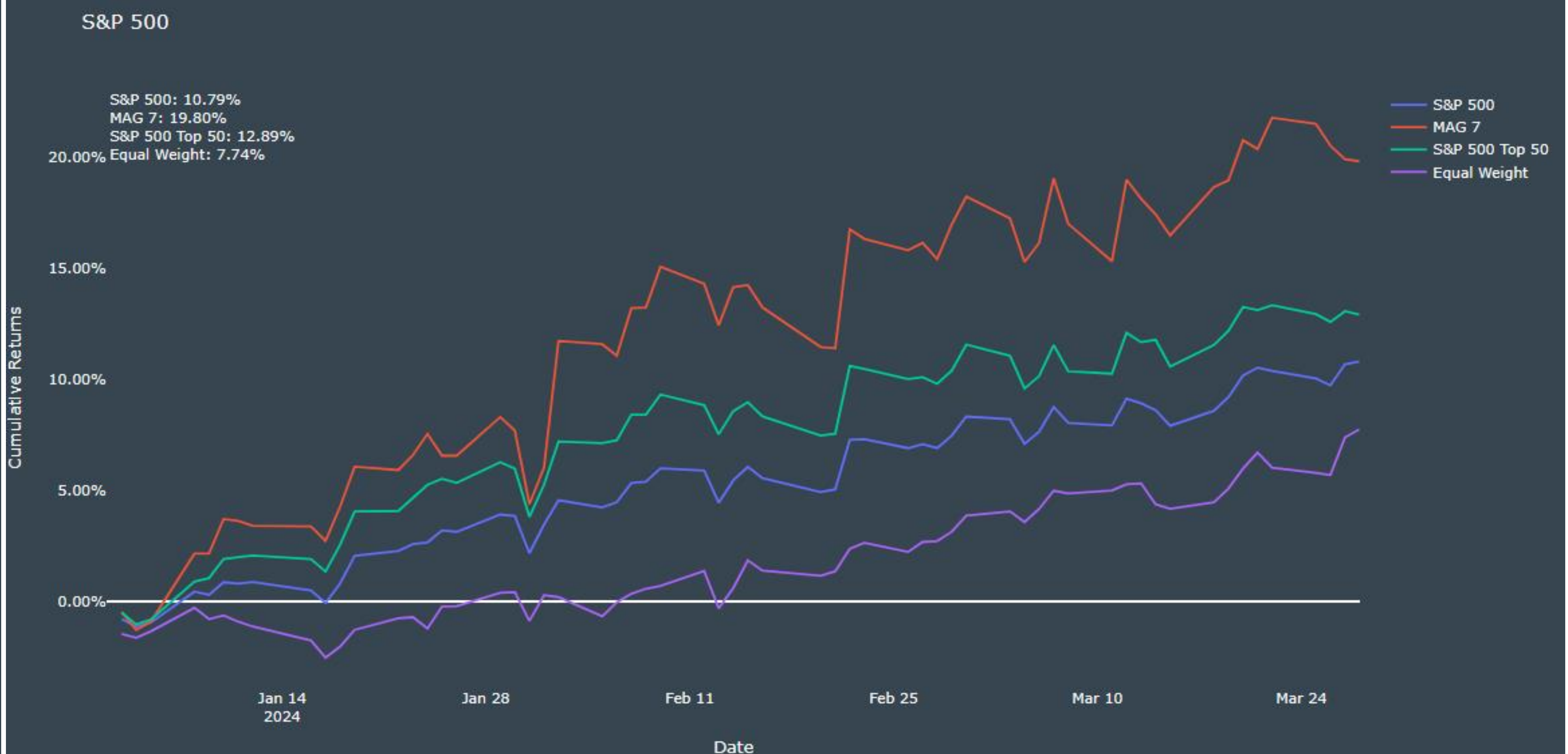
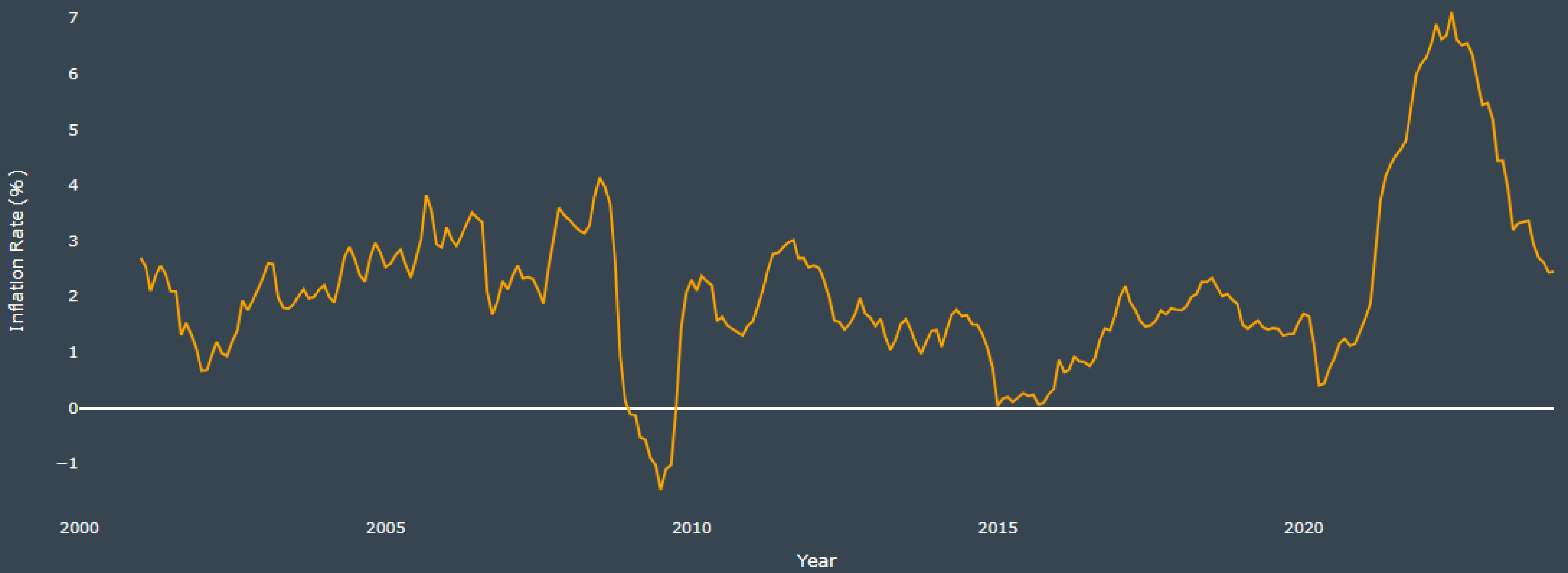
Rate Cuts Are in Jeopardy

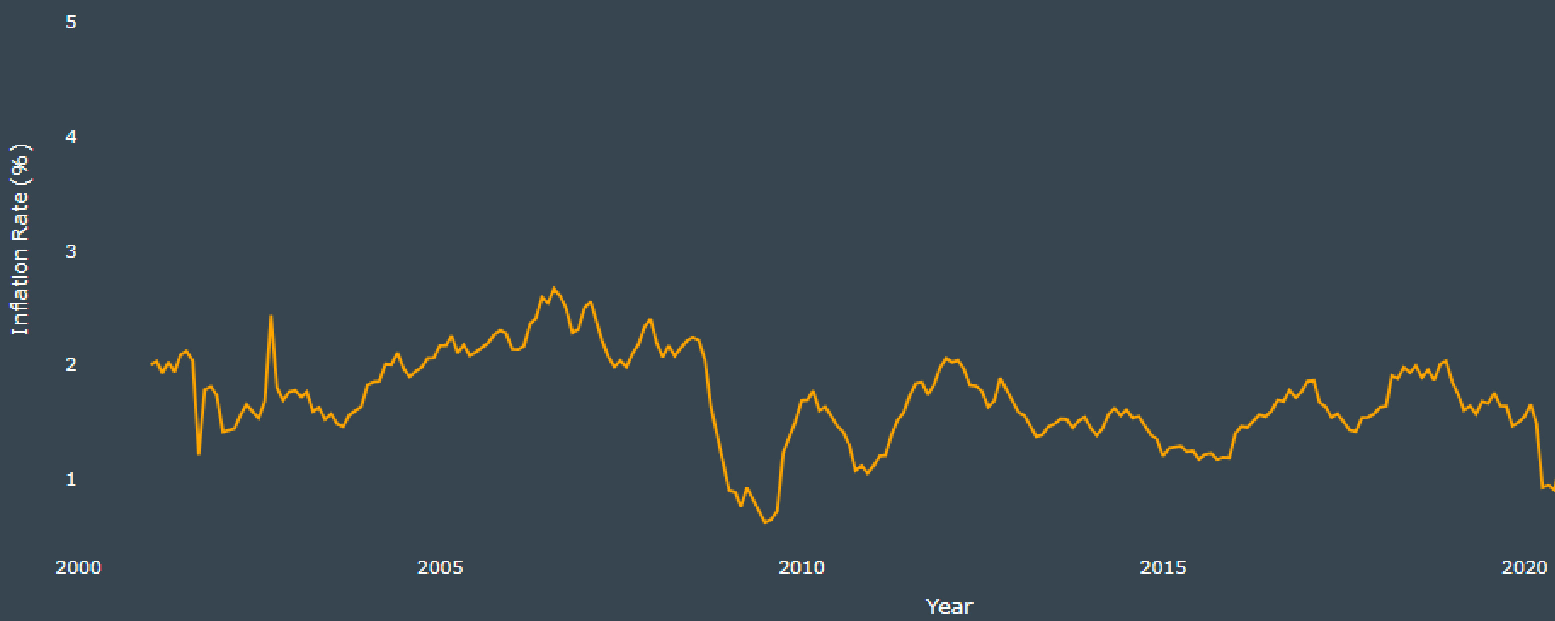
March 30, 2024

The first quarter of 2024 has concluded with financial markets showing strong performance, continuing the momentum from 2023. The S&P 500 and Nasdaq have seen notable increases, with the former up over 10% and the latter up 8.50%. Other asset classes have also performed well, with gold increasing by 7.61% and Bitcoin surging by an impressive 80%. This growth has been driven by factors similar to those influencing the markets last year. A significant development has been the shift within the "Magnificent 7," a group of leading stocks that have previously propelled market gains. This group has narrowed down to what could now be considered the "Magnificent 2 or 3," yet these few have outperformed the broader S&P 500. The top 50 stocks as a collective (Tracked by XLG) have also seen gains surpassing the overall index. Conversely, the Equal Weight index has lagged slightly with a 7% increase. Towards the end of March, a noticeable rotation in market dynamics occurred. Momentum in the technology sector began to decelerate, while sectors like energy, materials, and financials reached new highs. This shift is seen as a positive indicator for the broader market. The rationale is that it's beneficial for the market leaders to take a breather while other sectors attract investment inflows. Assuming no fundamental changes affect the leaders, they are poised to resume their upward trajectory following this consolidation phase. Such a rotation, especially without a major pullback, is viewed as a constructive sign for future market direction and pricing.

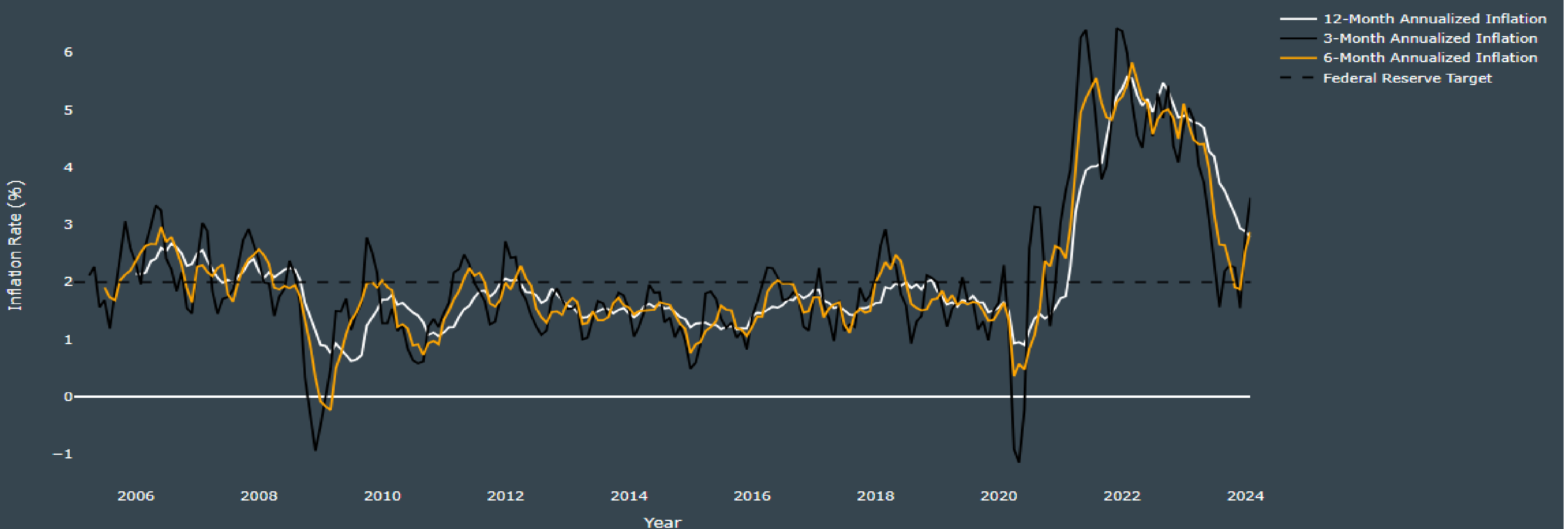


In observance of Good Friday, the stock market was closed, creating a unique situation where the Federal Reserve's preferred inflation gauge was released without the immediate feedback mechanism of real-time market reactions. The Personal Consumption Expenditures (PCE) Price Index, a critical measure of inflation, indicated a year-over-year increase to 2.5%, slightly up from the previously annualized rate of 2.4%. Meanwhile, the Core PCE, which excludes the volatile food and energy prices to provide a clearer measure of inflationary trends, was reported at 2.8%. This incremental rise in inflation metrics underscores a persistent economic pressure point. It complicates the narrative and expectations around the Federal Reserve's monetary policy path, particularly the anticipation surrounding potential interest rate cuts. With inflation indicators steadily inching upwards, the argument for reducing interest rates in June, or even enacting multiple rate cuts within the year, becomes increasingly challenging to justify. Currently the CME Fed Watch Tool places a 61% chance of a cut in June.



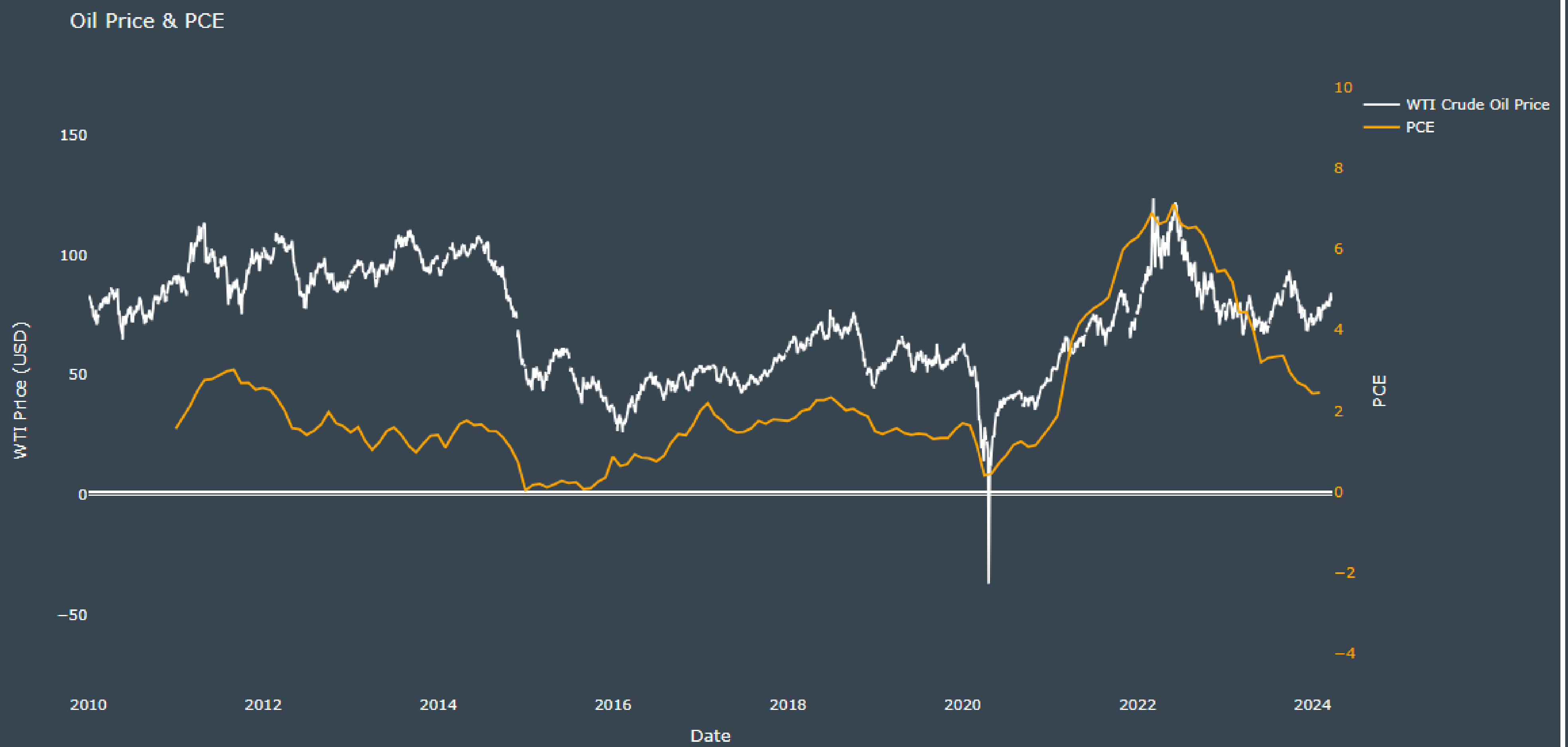


The above shows the year-over-year changes for both PCE and Core PCE. While still elevated, the Fed has pointed out that inflation is coming down and they can justify cuts prior to it reaching their 2% target if the path inflation is taking continues to trend lower. This will allow them to avoid overshooting their target. They also claim they act in accordance with the data and the problem is if you look at 3- and 6-month annualized PCE, inflation is re-accelerating. 3-month annualized PCE is up to 3.5%- and 6-month annualized PCE is at 2.9%.



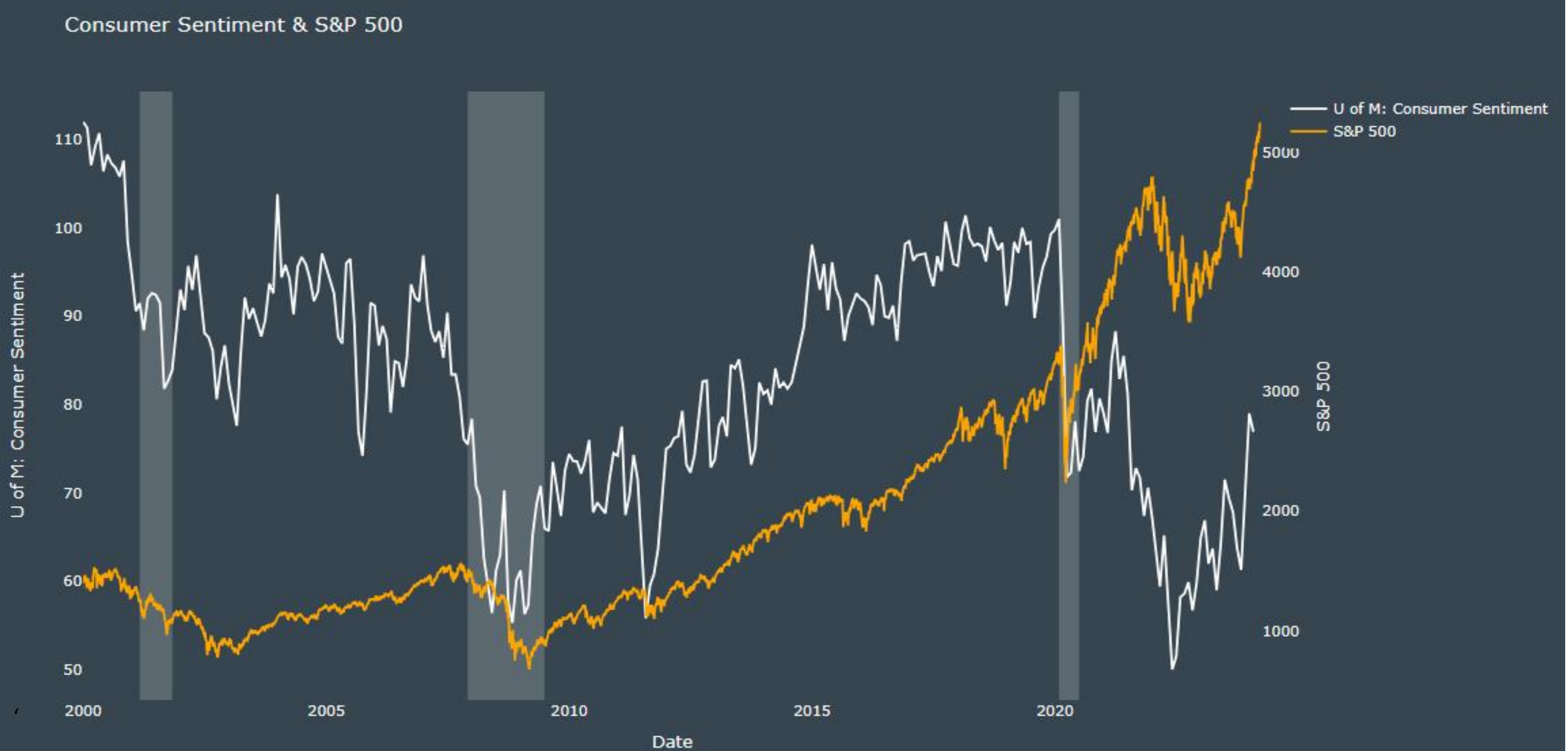
Some drivers behind why the Personal Consumption Expenditures (PCE) data remains elevated are rising wages, an uptick in services, buoyant consumer sentiment, and climbing energy prices. Conversely, the goods sector has provided some relief to overall inflation trends, with non-durable goods experiencing deflation. However, this silver lining is not without its clouds. One area of concern is the potential rebound in the prices of goods. Energy prices, a significant input in transportation costs, could precipitate such a turnaround. Should goods prices begin to rise, particularly if fueled by escalating energy costs, this could serve as a potent catalyst for broader inflationary pressures. This backdrop poses a significant challenge for the Federal Reserve. Cutting interest rates in such an environment, especially when asset prices are hovering at peak levels, could be counterproductive. The risk is that easing monetary policy too soon or too aggressively might fan the flames of inflation rather than contain them, especially if the goods sector ceases to act as a moderating force on overall inflation.

Looking back at 2020 and 2021, Energy prices were a catalyst that started off the first round of higher prices



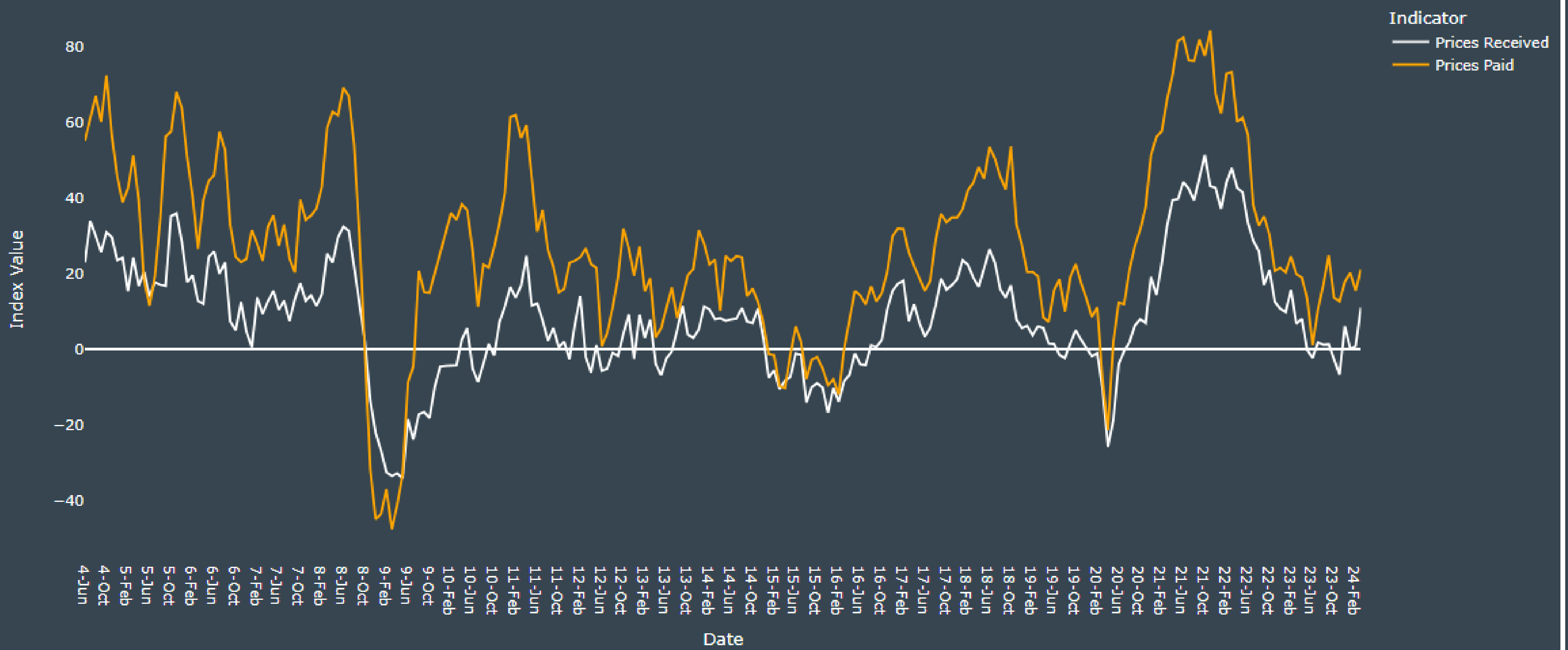
There is also a direct correlation between the price of Oil and the price consumers see at the pump. Peak oil consumption occurs in the summer months. An influx of demand is not something that will push prices lower

As far as Consumer sentiment, it is a crucial barometer of economic confidence and significantly influences broader economic trends as well as individual spending behaviors. A notable driver of consumer sentiment is the performance of asset prices. There's a documented correlation between high or rising asset prices and increased consumer optimism regarding spending power and economic prospects. This phenomenon, often referred to as the "wealth effect," suggests that the perception of wealth, irrespective of an individual's actual investment in these assets, can spur consumer spending. This relationship between asset prices and consumer sentiment underscores a psychological dimension of economic activity. As asset values appreciate, even consumers who hold a minimal portion of their wealth in these assets feel wealthier and more secure financially. This perceived increase in wealth boosts consumer confidence, encouraging higher spending and, by extension, stimulating economic growth. Furthermore, robust asset prices contribute to greater credit availability. Financial institutions are more inclined to extend credit when the value of collateral (often tied to asset prices) is high and the overall economic outlook is positive. This easier access to credit further empowers consumers, enabling both increased consumption and investment activities. This psychological phenomenon is a contributor to the sticky inflation we see.

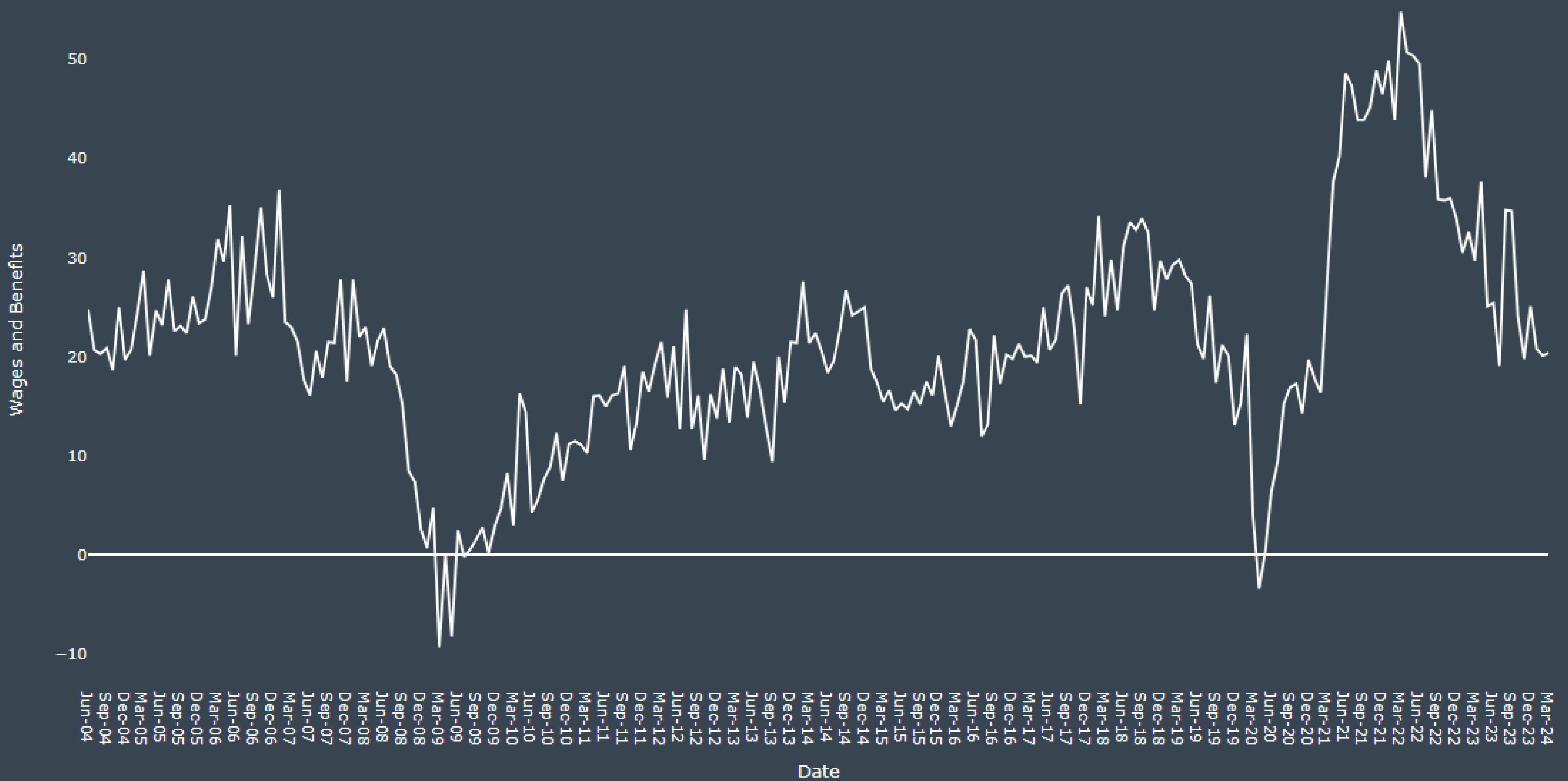


The Dallas Fed Manufacturing Survey, released this past week by the Federal Reserve Bank of Dallas, provides monthly data on Texas's manufacturing sector, offering insights into its vitality and wider economic trends. A diverse array of manufacturing entities across Texas contributes to this survey by reporting on various operational metrics, such as production levels, order volumes, employment figures, pricing trends, and general business outlook. The cumulative data forms an index, with figures above zero denoting sectoral growth and figures below zero indicating a downturn (Diffusion Index). Specifically, the latest responses concerning inflationary trends—highlighted by the metrics for prices paid, and wages and benefits—corroborate the ongoing narrative of persistent inflation. This suggests that inflationary pressures remain pronounced, with the trajectory of these pressures appearing to level off rather than head toward the Feds target of 2%.

Prices Paid by Manufacturing companies bottomed back in June 2023 and have since trended higher. Along with this, prices received also bottomed out and they follow the prices these companies pay with a lag. To maintain margins the higher costs will be pushed along to the consumer.

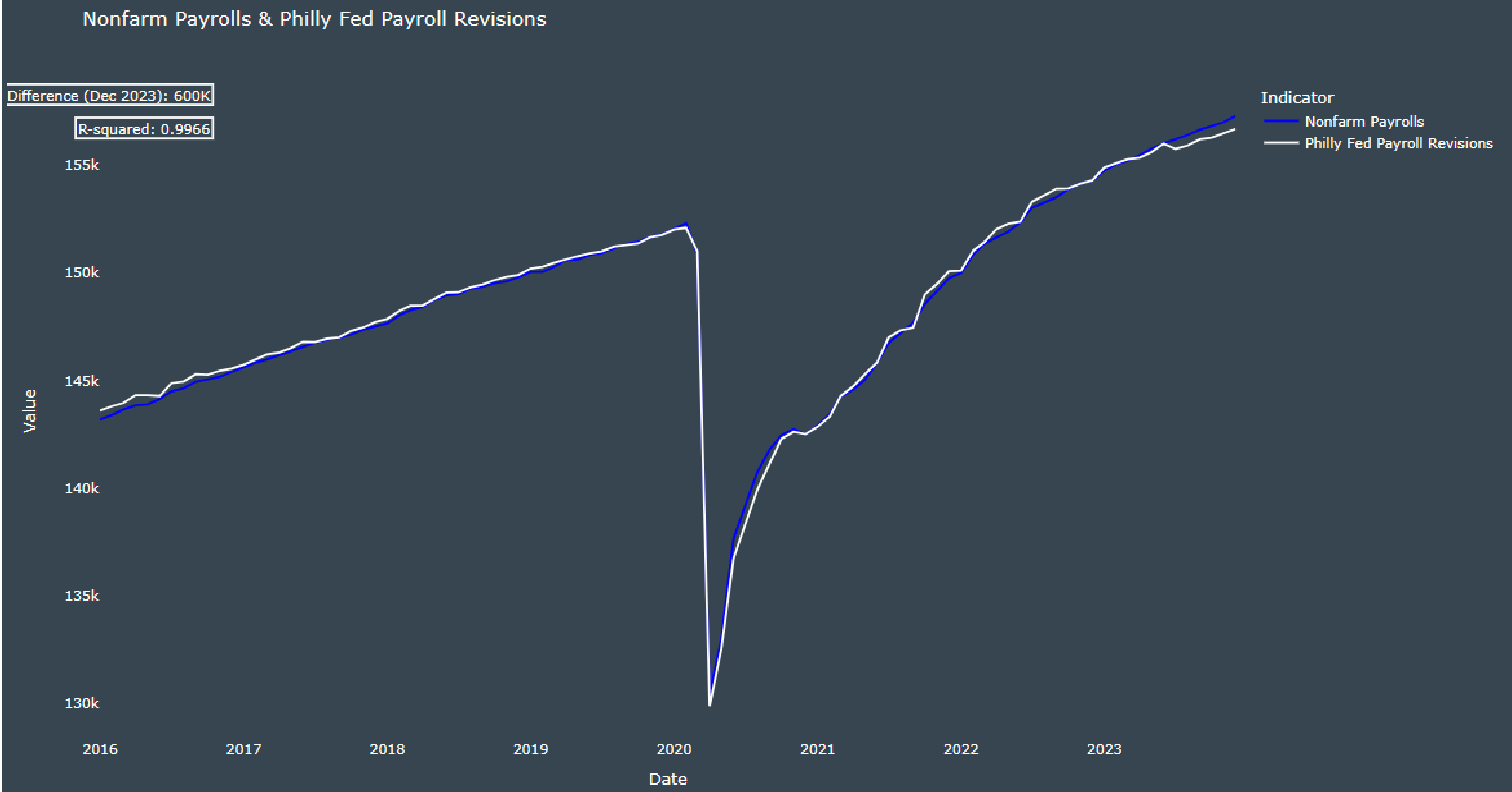


One of the most problematic portions of inflation has been wage growth. Atlanta Fed's Wage Growth Tracker is still up at 5%. Wages and Benefits reported by the Dallas Fed corroborate this as the Manufacturing sector is still reporting elevated Wages.



An array of economic indicators, from commodity prices to rent, services, and wages, have trended unfavorably, challenging the Federal Reserve's inflation targets. Asset prices add another layer to the complexity of the current economic climate, making it a precarious time for the Fed to entertain the notion of rate cuts without significant shifts in fundamentals. Despite the Fed's verbal commitment to a dovish stance, suggesting that rate reductions are on the horizon, it's plausible that they will manage market expectations by hinting at cuts without immediate action, potentially deferring any real changes to later in the year. This strategy could be sufficient to maintain market stability without triggering a correction. However, should there be a notable rise in headline inflation or unemployment rates, the situation could become more tangled. This is reinforced by the Philadelphia Fed's monthly payroll revisions for all 50 states, which show a strong correlation (R2 of 99%) with the Bureau of Labor Statistics' figures. Their

recent report indicates that the 2023 Nonfarm payroll numbers were overstated by ~600,000, hinting that the labor market is not as robust as advertised.



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