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Peak Capital Management

The Fed: Panic or Prudent?

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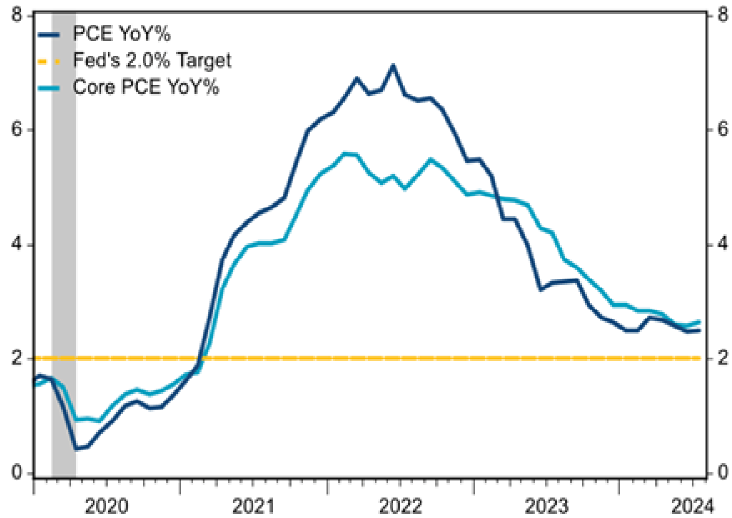
The Fed was the star of the show in September when they, as expected, cut the Fed Funds rate for the first time since March 2020 when they lowered the rate to a range between 0% and .25% in response to the global pandemic. A rate cut was universally expected but many were surprised by the Fed's decision to cut by one-half point rather than one-quarter point. Some have speculated the Fed already feels behind the curve on a slowing economic picture even if the data does not suggest that today. Determining whether the Fed's move was panic or prudent may provide essential clues to how investors should be positioning their portfolios.

Following the Fed's announcement, several voting members made speeches commenting on the rationale for the ½ point cut. Governor Bostic told an audience the large rate cut was a meaningful move to neutral as he sees the risks of inflation and the labor market as balanced today. Chicago Fed Governor Goolsbee, a nonvoting Alternate Member of the Fed Open Market Committee, was even more dovish in his comments stating the rate cut is the first of many necessary to protect growth and labor and was confident in the path to 2% for inflation. Chair Powell was clearly trying to thread a needle in comments stating the cut was strong start while highlighting the "healthy" nature of the economy.



Source: Bureau of Economic Analysis/Haver Analytics

Governor Bowman was the sole dissenter in the Fed's decision to cut by a half point, believing a quarter point was more appropriate. In a speech she noted the half point suggests the Fed may see economic weakness ahead and that the larger cut could lead to an unleashing of pent-up demand that reignites inflationary pressure. Bowman contrasted her colleagues believing risks to price stability remains the bigger threat versus full employment.

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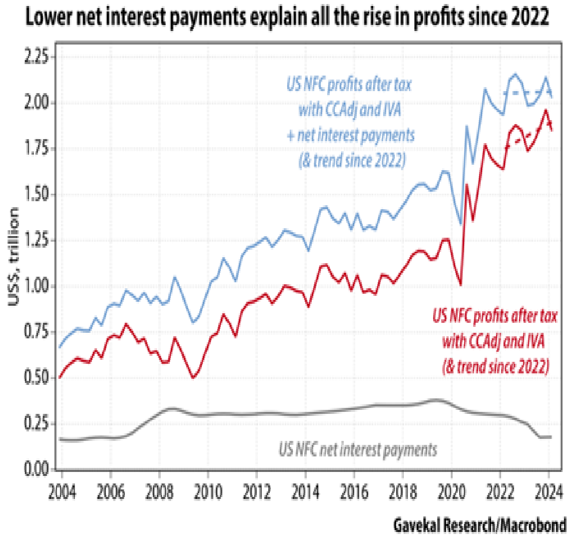
What was not largely discussed on the policy move, but may well play a much bigger role than people are willing to admit, is the perceived reduction in the independence of the Fed. The Fed supposedly operates on the dual mandate of stable prices (inflation) and full employment. The reality is that the Fed has to take into account the magnitude of US government debt in its interest rate calculations. Data shows that $9 trillion in government debt matures in 2024 that has to be refinanced. That means debt that was issued at almost 0% during the pandemic has to be reissued between 4% and 5%.

The 2024/2025 fiscal year budget anticipates just over 18% of government revenues will be spent on interest on the debt compared to just 9% of revenues in 2021 according to CBO figures. The challenge for the Fed is that the debt problem only appears to be growing worse, not better. The deficit over the last 12 months was a staggering $1.9 trillion equating to 6.7% of GDP. Historically speaking, deficits of that size have only occurred during times of crisis (recession) or war. Several economic think tanks have issued reports suggesting the US has already entered a debt death spiral that it cannot recover from.

It is not just Fed members struggling to agree on what interest rate policy should be or how rosy the economic outlook is. The stock and bond markets are sending radically divergent messages on the short-term future of the economy. The bond market, based on the dramatic fall in long-term interest rates, implies a 70% chance of recession in the next 12 months. The equity markets, by contrast, are pricing only a 9% implied risk of recession in the coming year. This has massive implications for any investor or portfolio manager who desires to maintain hedges against portfolio losses. Treasuries are historically an effective hedge against equity market risk but with the dramatic fall in rates that have already occurred, some have speculated that bonds already priced in a recession leaving little room for additional hedging. This suggests bonds may be very vulnerable today if the economy remains in expansion mode or if a resurgence of inflation were to occur.

I posed the question whether the Fed's half point rate cut was the result of panic or prudence. The best answer is it was a little bit of both. The Fed famously misjudged the spike in inflation a couple of years ago, referring to it as transitory, and faced heavy and deserved criticism for being late to reduce policy accommodation. The Fed does not want to face criticism for being behind the curve and they believe the neutral rate is around 2.50% and many prefer getting to that rate sooner rather than later. The rally in bonds over the last six months does make fixed income investors vulnerable if rates move higher suggesting investors concerned with managing risk need to be cautious.

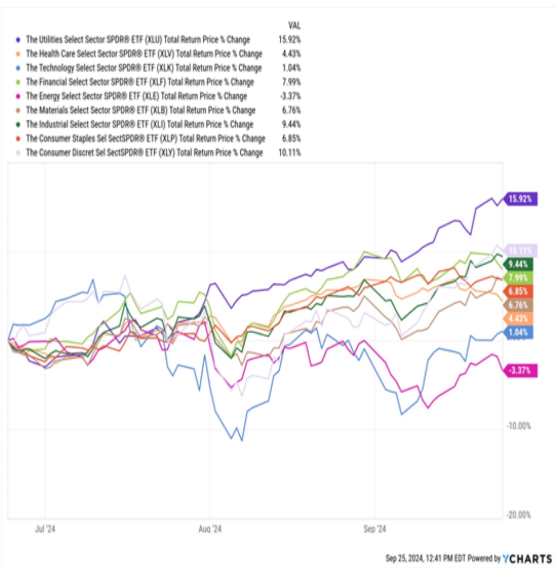
Downside of Rate Cuts



The stock market rallied 1% following the announcement by the Fed they were cutting Fed Funds rate by .50%. Rate cuts are always good for stocks, right? The answer might surprise a number of investors as traditional cause and effect relationships appear to have broken down over the last several years. Equity markets seem priced for perfection and continued earnings growth but a deep dive of earnings data shows a disproportionate contribution to earnings has been financial, not operational. Stimulus payments during the pandemic, both to companies as well as consumers, have led to massive stockpiles of cash and cash equivalents on corporate balance sheets. The interest these balances have been generating move straight to the profit bottom line and will be reduced as a result of the lower rates.

- Cash represented 4.6% of assets on corporate balance sheets in 4Q 2019 but represented 5.9% of assets as of 1Q 2024 generating billions in excess profits for S&P 500 companies.
- Warren Buffet's Berkshire Hathaway will be the most impacted company from the lower rates on cash due to their balance sheet reflecting $277 billion in cash with Goldman Sachs next most vulnerable.
- Lower revenue from interest earned may have another unexpected impact on the economy causing companies to reduce their capital expenditure spending that may cause a drag on growth.

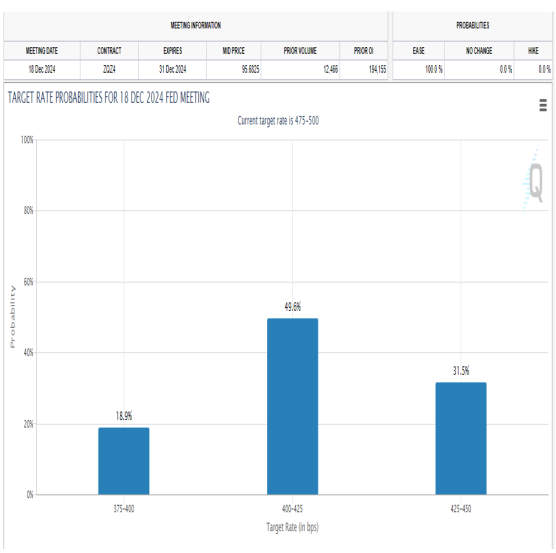
Sector Performance



Sector performance has been somewhat of a mixed bag over the past three months. While generally higher overall, recent returns have been driven primarily by the utilities and consumer discretionary stocks. Utilities have surged roughly 15% over the past three months as measured by SPDR Utility Sector ETF, while consumer discretionary have advanced roughly 10% over the same period, as measured by the SPDR Consumer Discretionary Sector ETF. In contrast, energy stocks have been led lower by the recent decline in the price of oil (WTI is lower by roughly 15% over the past three months). Energy stocks are lower by roughly -3% over the period as measured by the SPDR Energy Sector ETF. The chart illustrates the three-month returns for the S&P GIC sectors over the past three months.

- The advent of AI and the energy demands required to run the technology have been a tailwind for the utility sector, as power grids and water networks are forced to expand and renovate to keep pace. This forecasted increase in energy consumption could provide support for the sector in the years ahead.
- The returns from the discretionary sector were buoyed by the Federal Reserve's decision to cut interest rates by 50 basis points. The move helped assuage concerns over a possible recession.

Recalibration



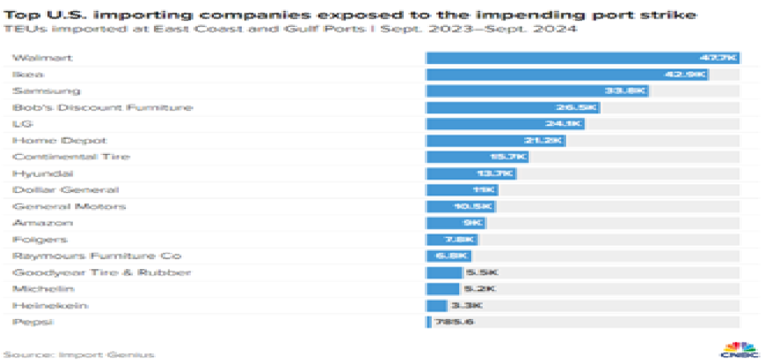
Federal Reserve Chair Jerome Powell introduced the term "recalibration" to describe the Fed's approach to adjusting monetary policy, following an unexpected half-percentage point rate cut. This was the first such move since the early pandemic without a clear economic downturn, signaling a shift in focus. Powell explained that the recalibration is meant to sustain economic strength and labor market growth while continuing to manage inflation. Markets were initially skeptical but rallied as they interpreted Powell's message as an effort to fine-tune policy, not as a response to recession risks. Powell emphasized that the rate cut aimed to prevent labor market weakness rather than counteract inflation, which is nearing the Fed's target.

- Despite Powell's assurances, market expectations suggest further significant rate cuts as there currently is a 77.7% probability that there will be at least 75 basis points of additional interest rate cuts before year end according to the CME Group's FedWatchTool.
- Last Friday, the personal consumption expenditures price index, a gauge the Fed focuses on to measure the cost of goods and services in the U.S. economy, rose 0.1% for the month, putting the 12-month inflation rate at 2.2%, down from 2.5% in July and the lowest since February 2021.

Quinn VandeKoppel

Macro View – Supply Chain Disruptions

A potential strike by the International Longshoremen's Association (ILA) at East Coast and Gulf Coast ports is imminent, threatening U.S. trade and economic stability. The ILA represents 50,000 workers, and their contract with the U.S. Maritime Alliance (USMX) expires at midnight on Monday 9/30. If no agreement is reached, the strike could disrupt the processing of 43-49% of containerized goods entering the U.S., affecting over $13.67 billion worth of freight in just one week. Logistics companies are racing to move goods before the strike, but clearing backlogs from a port shutdown could take weeks. Key goods like refrigerated produce and apparel could see supply chain disruptions, raising concerns about inflation and economic impact. A prolonged strike could lead to a $641 million daily loss for the Port of New York/New Jersey alone. Negotiations have stalled over issues like port automation and wages, and no new talks are planned. While the Biden administration is involved, it has ruled out using federal powers to prevent the strike.

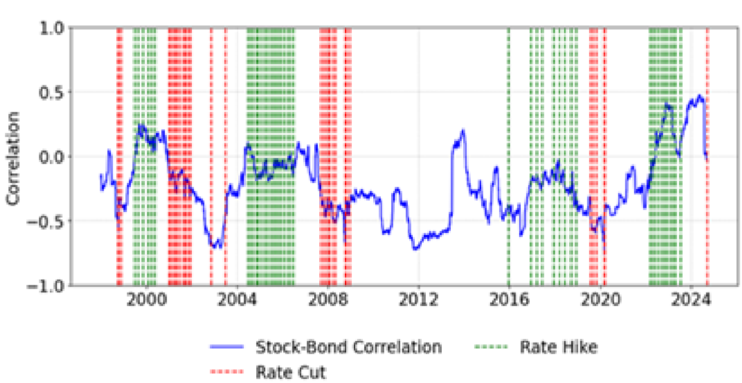


Taking Stock – Potential Semi Acquisition

Qualcomm (QCOM) has in recent days approached Intel (INTC), to explore a potential acquisition of the troubled chipmaker, in what could be a transformational deal in the semiconductor sector but faces many potential regulatory hurdles. While it appears that these conversations between both Qualcomm and Intel are at an early stage, Reuters reported that Qualcomm has explored the possibility of acquiring portions of Intel's design business and that its PC design unit was of particular interest. Reuters could not determine how Qualcomm, which has a market value of $188 billion, would finance a bid for Intel, which is valued at $122 billion, including its debt. Qualcomm has roughly $13 billion in cash, according to recent company filings.

Fixed Income – Stock Bond Correlation

With the Federal Reserve recently cutting interest rates by 50 basis points, a shift in the relationship between stocks and bonds appears to be unfolding. Analysis produced by Verdad Capital of the last 25 years reveals that stock-bond correlations tend to shift notably around Federal Open Market Committee (FOMC) decisions. Rate cuts, marked in red in the chart below, have coincided with economic slowdowns or recessions, during which bond yields decline and Treasurys act as a counterweight to weak equity markets. On the other hand, periods of rate hikes, shown in green, see higher correlations as inflation shocks drive stocks and bonds in tandem. But if recent trends persist, further de-correlation between stocks and bonds could be on the horizon, particularly if the Fed continues cutting rates as widely expected over the next 15 months.



Technical – Uncharted Territory

At the start of the year, many analysts predicted that the S&P 500 Index would finish 2024 with gains of around 8-12%. However, with three months remaining in the year, few could have anticipated that the large-cap index, represented by the SPDR® S&P 500® ETF Trust (SPY) in the chart below, would already be up 21.55% year-to-date as of this writing. After reaching new highs on the 19th, the 564-price level is likely to serve as a key support level if the market experiences a near-term pullback. While investors may feel optimistic about the economy's trajectory, especially after the Federal Reserve's recent 50 basis point interest rate cut and the potential for another 50-75 bps cut by year-end, uncertainty still looms. It's likely that market volatility is not entirely behind us.

Fed Rate Cuts and Equity Returns

Clint Pekrul, CFA

The Federal Reserve just cut its target interest rate for the first time since the onset of COVID in 2020. The 50-basis point move was of greater magnitude than most economists thought and has many investors wondering what the rate cut means for equity returns.

On the one hand the rate cut lowers financing costs for companies to invest and expand, and for individuals to access credit to start new businesses or apply for a mortgage. We might assume that a stimulative rate cut would support above-average stock returns. The overhanging question, however, is the inflation side of the equation.

If the rate cut is followed by stubbornly high, persistent inflation, then its effect on the economy and stocks in general might not translate into above-average equity returns. We must consider equity valuations when the rate cut occurs, the economy's gross domestic product (GDP) and current levels of inflation, as well as exogenous events.

For perspective, we look historically at past rate cuts and subsequent 1- and 3-year equity performance, as measured by the S&P 500 Index.

1960s

The U.S. officially entered a recession in April 1960 that lasted until February of the following year. The Fed cut its effective rate from roughly 4% in early 1960 down to approximately 2% by December. GDP fell from 5% to roughly 3%, but the 1960 recession proved to be relatively mild in part due to stimulus spending and tax cuts.

At the beginning of 1960, when the rate cuts began, the S&P traded at a 17x P/E ratio. Over the following twelve months, the index gained approximately 11%, not including dividends, while finishing higher by 19% over the subsequent three years (6% annualized).

1970s

After a prolonged economic expansion in the 1960s, the Fed had tightened interest rates to stem inflation. However, in early 1970, the central bank began cutting its target rate from roughly 9% at a time when GDP was running at 6% and the S&P 500 was trading at roughly 15x earnings. Over the ensuing year, the S&P 500 gained 8% and finished higher by roughly 25% over the following three years (8% annualized).

The rally in equities was cut short by the OPEC oil embargo in late 1973, which send shockwaves through the global economy. Leding up to the embargo, the Fed had taken its target rate as high as 12% as inflation was rampant. By mid-1974, the Fed began cutting rates from roughly 13% down to roughly 5% by 1977, but the global economy remained mired in a recession with persistently high inflation and unemployment. The S&P 500 fell -26% over the twelve months following the first rate cut but finished higher by roughly 24% over the subsequent three years.

1980s

Stagflation dominated the 1970s and by the early 1980s, the Fed was determined to tame inflation with strict monetary policy. We experienced two recessions that saw unemployment jump to roughly 11%. The Fed cut its target rate down to roughly 8% by early 1983 from 19% in mid-1981. During this period, the S&P 500 traded below historical valuations based on a P/E multiple below 10x.

The stage was set, however, for a prolonged equity rally. Having brought inflation under control, the Fed began cutting interest rates in the summer of 1984. Over the next twelve months, the S&P 500 gained roughly 13% and was higher by approximately 97% over the ensuing three years (26% annualized). This rally coincided with a rate cut that did not accompany a recession.

1990s

The decade was a period of economic expansion with moderate inflation, relatively low unemployment and robust GDP growth. We experienced only a mild recession in 1990. The Fed cut its target rate from roughly 8% in late 1990 down to roughly 3% in 1992. The S&P began the 1990s trading at roughly 15x earnings. Twelve months after the initial rate cut, the S&P 500 gained roughly 30% and was higher by approximately 54% over the ensuing three years.

2000s

The decade was bookended by two recessions – one relatively mild and the other near catastrophic. After holding rates relatively steady in the later half of the 1990s, the Fed initiated a rate cut in late 2000, which brought its target down from roughly 6% to approximately 1%. While the recession was mild in terms of GDP contraction, the S&P 500 suffered tremendous losses due to extreme valuations that, by and large, were disconnected from the real economy.

With interest rates near 1%, leverage grew within the economy, and by 2007, the housing market cracked, which impacted every segment of the economy. By 2008, liquidity froze, and financial institutions failed. The Fed took interest rates from roughly 5% in mid-2007 to the zero bound in early 2009. The rate cut helped stem the meltdown, but the S&P 500 fell roughly -13% from the initial rate cut and was lower by approximately -25% three years later.

Q: What sectors are going to be most impacted by AI?

The world is definitely still trying to figure what the long-term impact of AI will be but few doubt it will be significant. Many will recall the 2017 McKinsey Global Institute report that forecasted between 400 and 800 million jobs globally would be replaced by machine learning by the year 2030. The impact of increased utilization of AI will result in job gains in some industries and job losses in others. The net effect should be an increase in productivity that helps corporate productivity.

Healthcare has been the most impacted sector and the one to benefit the most to date. Predictive analytics, personalized medicine and enhanced diagnostics are making positive impacts on patient care and results. I expect to see heavy additional investment and many new employment opportunities. Finance is also significantly impacted by AI and machine learning and has enhanced fraud detection, trading automation, and equity analysis. There is likely to be a significant loss in employment as a result of AI in finance, many of those being formerly highly compensated analyst roles. Retail is probably the next most impacted sector as AI is routinely being deployed to replace low skilled labor. The shift to online retail will only increase as more last mile transportation options become available. AI is the new frontier, so I expect investment to continue to flow.

We have previously highlighted recent sector performance and the dispersion of returns over the past several months. In particular, the utility sector should be a direct beneficiary of the growing demand for AI technology and innovation. In a 2024 report from Goldman Sachs, it is estimated that data center power demand from AI usage will increase by 160% by 2030 and that data centers would consume roughly 3 – 4% of overall worldwide power. Consider that it takes roughly 10 times the electricity to run a ChatGPT query than it does a Google search. There will be significant infrastructure needs in the years ahead to improve power grid capacity.

Based on the report, Europe needs $1 trillion to prepare its power grid for AI, and U.S. utilities will need to invest $50 billion in new generation capacity just to support data centers alone. So, there is a significant investment opportunity within the utilities sector. Obviously, the technology sector will continue to reap the rewards of AI development. But the rollout of AI will likely result in a spike in overall energy demand unlike anything we've seen in over one hundred years. This isn't a scenario of improving efficiencies with current infrastructure but making substantial investments to build out new capacity.

Q: How will rate cuts impact Developed and Emerging markets?

While there has been a rise of nationalism from a geopolitical perspective with recent elections in Europe and Latin America, the global economy is as interconnected today as it has ever been. The old saying, "when the US sneezes, the world catches a cold" remains true as developed and developing countries take their lead from US monetary policy. Lower rates in the US have a direct impact on emerging market economies as borrowing costs typically move lower since they most often borrow in US dollars. Currency valuations are heavily influenced by monetary policy so there is some speculation the dollar could weaken as rates fall, helping strengthen developed and developing currencies appreciate. I am doubtful we will see a significant dollar decline for a couple of reasons. First, in three of the last four cycles, the greenback actually appreciated following the Fed's first rate cut. Second, rates in the US would have to fall much further before being considered a "low yield" currency.

Nine of eighteen tracked emerging market Central Banks had front-runned the Fed's rate cut and a dovish Fed provides cover for these countries to move to a more accommodative monetary policy. While lower rates do mean lower borrowing costs for emerging markets, they are also more at risk of economic contraction, particularly if consumption in the US slows. Concerns over recession, following weak US jobs data, led to a 6% decline in global stock markets in August. Similarly, Japanese stocks are down 10% from July highs as the Yen has risen against other currencies and rates moved higher in Japan.

Lower interest rates in the U.S. should be a tailwind for emerging markets. Typically, emerging markets will issue sovereign debt to finance their economies that is issued in U.S. dollars. Higher interest rates imply higher financing costs for these emerging countries. Higher interest rates in the U.S. also make it more difficult for emerging economies to attract capital. The competition from Treasuries requires a higher hurdle rate from much riskier investments in emerging economies. When the Federal Reserve cut the target rate earlier this month by 50 basis points, emerging market equities experienced a rally based on the MSCI Emerging Markets Index.

Interest rates, along with inflation expectations, are also closely tied to exchange rates. With higher rates in the U.S., domestic investors can earn a higher risk-free return than in foreign countries, which attracts foreign capital, particularly with low rates of inflation. From an investor's standpoint, a strong domestic currency will lower the return expectation on assets invested overseas (currency hedged vs. unhedged). Conversely, a relatively weak domestic currency will make foreign investment more compelling. While earnings growth expectations overseas might lag the U.S., the Federal Reserve's most recent rate cut removes some of the headwind that investors to overseas markets must consider.

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