April 12, 2024

The Waiting Game

Dear Investor:

Market expectations for rate cuts have been the dominant theme in the first quarter of this year. At the beginning of the year, the market was looking for six possible cuts, maybe even seven. As often happens, you see too much emotion driving things. I never bought into the six-cuts camp; I thought it was very unlikely. There were two possible scenarios that could have brought that about. One would have been a very sharp slowdown in the economy. The second would have been inflation continuing very clearly on that downward path to 2%. Neither of those things have happened. As I mentioned last time, there are some people whose work I have great respect for, who have been predicting a recession. In this cycle, the recession predictions have been going on for well over 18 months and have come to nothing so far. Just another example of how hard it is to predict the future.

So, what is going on? For starters, the economy has definitely slowed from the torrid pace of the second half of last year. However, it is still moving along at a good pace for a mature economy. The Atlanta Fed is currently predicting a 2.4% growth rate for the first quarter of 2024. There has been much written about the soft landing. This has always been the most desirable, but elusive goal. Over the last year, many have begun to think that the Fed may have achieved it. The economy is doing well, inflation has been coming down, but there has been no recession or significant damage to the job market. This is a very good result. However, Wall Street can be perverse sometimes. As you occasionally hear on business programs, “good news becomes bad news”. As the job numbers have come in above expectations for several months, the hoped-for signs of a significant slowdown kind of disappeared. Thus, one of the two main reasons for interest rate cuts is fading out.

In my opinion, the high inflation that took off in 2021 came from two sources: the virtual tsunami of money that was put into the system to fight the pandemic, and the severe supply chain problems that occurred at the same time. The money put into people’s hands produced instant buying power, and we know large amounts of that money was spent. Some people were smart enough to use the money to pay down debts and other obligations, which allows for spending again in the future. That is likely one of the reasons things are now going better than expected. The supply chain problems were indeed severe, and I’m sure you remember the pictures on the news of all the ships lined up trying to deliver goods at our ports. This supply shortage drove up prices for the goods that were available, also contributing to inflation. You may remember auto dealers with almost no new cars on their lot to sell, as one example. Prices for new and used cars went way up. The supply chain is moving very well again, and you don’t hear it being mentioned as an issue very often.

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While inflation was on a good downward trend from the high in 2021, the decline does seem to have stalled at the moment. Inflation has now come in above expectations for several months in a row. This has absolutely changed the picture. The big runup in stock prices in the first quarter has been fueled by expectations for many rate cuts as I mentioned earlier. Reality is settling into the market as investors now realize that is very unlikely. This could lead to a pause in the rally or a pullback in stock prices for a while. Chair Powell has stated publicly on several occasions recently that they are looking and hoping to cut rates this year. This is not a guarantee. They will always be looking at the data coming in and making their judgements. The outlook for when cuts will begin keeps getting pushed out into the future. The probability right now is for no chance at all at the coming May meeting and only a 20% chance for the first cut at the June meeting. As you move out to July, the probabilities for a cut rise to 40%. I could go on, but you see the trend.

Housing is a very significant issue worth mentioning. I can't go deep into it here, but it's widely believed in the industry that housing inflation is massively undercounted. The rental price index that is used to calculate housing inflation, has been falling, and does not begin to show the huge runup in housing prices. Right here in Onondaga County where I live, prices for "typical" suburban homes have gone way up. They are easily 30% to 50% more per square foot than they were before the pandemic. The price of many starter homes has literally doubled. New construction is even much higher than that. This has caused monthly payments for housing to skyrocket, and they can easily be double what they were before. Where can people find the money to deal with these kind of prices, particularly younger people getting started in life? This is just one example of why inflation has been "sticky". Although the rate of inflation has been slowing, the actual prices of most goods and services are still well above where they were before the pandemic. The clear path back to 2% inflation has become hard to see at the moment. As long as that's the case, the Fed may have to leave rates where they are.

I believe Fed Chair Powell is very serious about the 2% inflation goal. While inflation hurts us all, it falls harder on those with lower incomes and net worth. Thus, getting inflation back down is the best path for our society as a whole. Hopefully, we will push through these barriers soon and inflation will resume its downward path. There are reasons to be optimistic in that regard. If that happens, they will be in a position to begin to trim the rates. As the rates move down, it will stimulate economic activity of every kind. This will keep the economy and the market moving forward. The expansion that we are in right now could possibly go on for several more years.

Please contact us anytime to discuss your portfolio.

Best Regards,

David

David E. Keim

5788 Widewaters Pkwy | Suite 203 | DeWitt, NY 13214
315-701-5750 | Fax 315-701-5751 | dkeim@keimassetmanagement.com
www.keimassetmanagement.com
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