Caron's Corner Transcript – 12.11.2023

Fed's Making a List, Checking it Twice for a Policy Rate That's Naughty or Nice?

- In this audiocast I will refer to **real rates**, more specifically the real neutral policy, **r* aka r-star**.
- A ***naughty*** policy rate is either too high or too low, one that then creates a recession or inflation.
- The ***nice*** policy rate is the one that perfectly balances the two and we achieve trend growth. This is **r*.**
- Recently, bond yields have dropped aggressively such that the market is pricing in five 25 basis point rate cuts in 2024.
- Why is this happening and what does it mean? Is it inconsistent with a soft landing? And what about asset prices? We explore in this audiocast.

Jim Caron: Hello, this is Jim Caron, CIO of the Portfolio Solutions Group. The Fed's making a list, checking it twice, for a policy rate that's naughty or nice. Of course I'm referring to real policy rates and to be more specific, the real neutral policy rate also known as r* (r-star). The naughty policy rate is the rate that is too high or too low and creates either a recession or inflation. The nice policy rate is the one that perfectly balances the two and we achieve trend growth - and this is r-star. Recently bond yields have dropped aggressively and the market is pricing in 525 basis point of rate cuts in 2024. Why is this happening and what does it mean? Is it consistent with a soft landing? Most importantly, what does it mean for asset prices? Let's get into it, by answering each question one by one.

So why are rates falling, and why are so many cuts priced into 2024 as compared with the Fed, who keeps saying "higher for longer." To answer this we have to revisit the concept of r-star. This is that magical number that economists, including the Fed, try to estimate as a neutral policy rate, a rate that is neither too tight nor too easy, but just right. A rate that balances full employment and price stability, with inflation at target while achieving potential growth. But we need to do some math. The real policy rate is the nominal policy rate, which is 5.5%, minus inflation which is let's say 3%. Today that would equal a 2.5% real rate (i.e., 5.5% minus 3.0% equals a 2.5% real rate). However, if we look at the consensus estimate for r-star, it's actually about 1.5%. This implies that in a world of declining inflation, if the Fed does nothing and keeps nominal policy rates at 5.5%, then it would be the functional equivalent of tightening policy. This is because real policy would actually be the equivalent of 2.5%, which is 100 basis points higher than where it ideally ought to be - at 1.5%. Monetary policy principles would suggest that the Fed should therefore mechanically lower their policy rate as inflation falls, even if we are not experiencing economic stress or a recession just to keep all else equal. This is where it gets weird. "Higher for longer" could still apply even if the Fed reduces policy rates, as long as the real policy rate is sufficiently high enough to keep inflation low and stable. The trick is to think of policy in relative terms, and this is the explanation as to why falling policy rates are consistent with the higher-for-longer narrative.

The second question is whether policy rates are inconsistent with a soft landing. The short answer is "no" because of what I just said. But let me go deeper. Many people associate rate cuts with a weakening economy and recession - and historically, that is true. But in this case it might not be true,

because the pandemic supply shocks and stimulus-related distortions are being worked through the market today. As stated, policy may fall but still achieve the same degree of tightness because inflation is falling by more than policy rates. In other words, in order for the Fed to actually ease, they need to drop rates by more than 100 basis points, because the first 100 basis points of cuts just gets them to neutral based on the basis of r-star.

What does this mean for asset prices? Well, the short answer is that it's a positive. Why? Because even in a slowing economy or soft-landing scenario, the cash flows generated by financial assets, namely earnings from equities or coupons from bonds, will be valued with a lower discount rate factor, thus increasing their present value. Et voila! Fixed income and equities rally, which is what we've been seeing since November. But markets are quick to value and this is what we meant by markets pulling forward 2024 valuations into 2023. It also implies that in order for the markets to move higher beyond the increased discounted cash flow valuation, where we are now, it would require a positive catalyst. This would be something like stronger-than-expected growth in earnings, but without triggering the Fed to keep rates too high or prevent them from cutting. Similarly, it means that things can go wrong too. If the Fed believes that inflation does not fall far enough or is showing signs of becoming unanchored and rising, then they may keep rates higher than what the market is pricing, or not cut at all. This would revalue markets lower.

Anyway, what will we be listening for at the December FOMC meeting on Wednesday? Well with this context in mind, we will listen carefully for. First, are there any hints on where the Fed sees the neutral rate, that r-star rate that I was discussing? Second, does “higher for longer” mean that they will not cut rates? Third, what are the inflation projections in their Summary of Economic Projections? Remember, they will give us a forecast at the December meeting, and this will tell us how tight they would likely remain. Fourth and finally, how confident is the Fed in the decline in inflation getting toward target levels and remaining anchored?

Look, all of this is complicated, but also really as simple as my naughty and nice analogy. It may be easier for Fed policy to be naughty than nice in 2024 and this brings with it risks and opportunities. In the end, we hope to receive more clarity from the Fed on Wednesday.

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CRC 6147767 Exp. 12/31/2024