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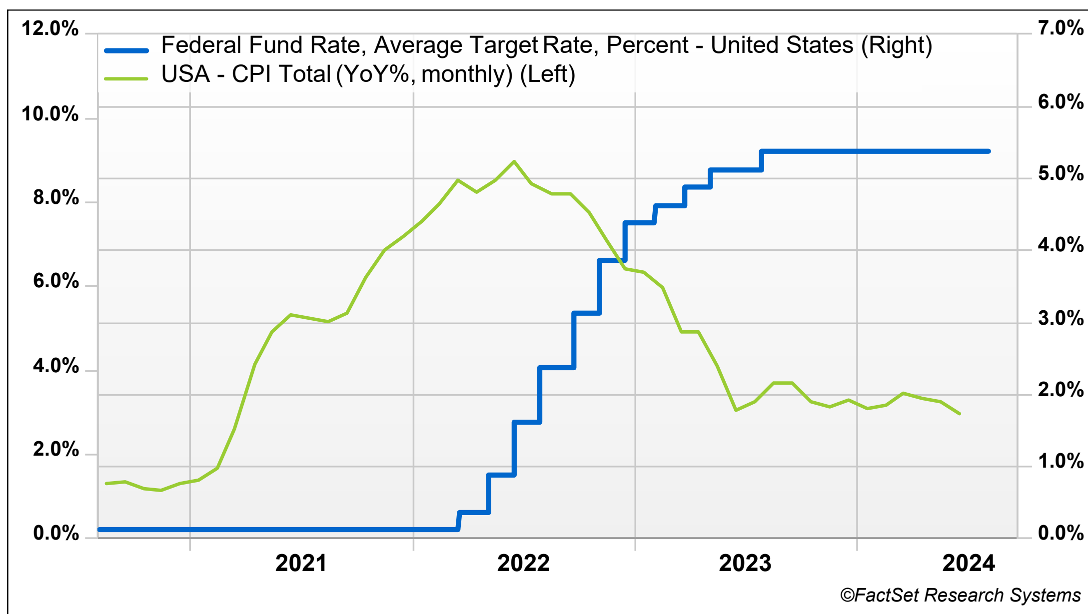
Interest Rates: The Waiting is the Hardest Part

By: Joe Stevens, CFA

Not long ago, consumers enjoyed the luxury of financing purchases at historically low interest rates. There were occasions to finance the purchase of a new vehicle with a 0% APR loan, and for a time homeowners were able to secure a 30-year fixed rate mortgage at a rate under 3%. Then inflation began to spike: Constrained supply chains combined with rejuvenated consumer demand and accommodative monetary/fiscal policy pushed the Consumer Price Index (CPI) from an annual rate of under 2% in the early months of 2021 to a high of 9.0% in mid-2022. The U.S. central bank, the Federal Reserve (Fed), initially thought inflation would be transitory, so it kept its key policy benchmark rate, the federal funds rate, near zero. Inflation continued to rise though, prompting the Fed to enact a more restrictive interest rate policy. Those 0% APR auto loans – gone; meanwhile, mortgage rates spiked northward of 6%.

Fast forward to the present day, and the CPI has fallen from its mid-2022 highs to 3.0% in June 2024 (Figure 1). This represents significant progress on an absolute level, but it's still higher than the Fed's target of 2.0%. This leads to the question that this paper seeks to address: When will the Fed shift to a more accommodative interest rate policy and how might that impact investment portfolios?

Figure 1: Federal Funds Rate and Inflation



Source: FactSet as of 7/31/2024

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Fed Funds Rate: The Basics

The Fed has a dual mandate of supporting price stability (i.e., keeping the long-term inflation rate stable) and reaching maximum employment in the U.S. economy. A key tactic the Fed employs to achieve these objectives is managing the level of the federal funds rate. The federal funds rate is the interest rate at which commercial banks borrow and lend excess reserves to each other overnight to meet regulatory reserve requirements, and it is a baseline rate on which many other interest rates are based.

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The Fed sets a target range for the federal funds rate and employs various tools to maintain the rate within this range. The federal funds rate, in turn, influences the rates that banks charge consumers and businesses to borrow money. In this manner, the Fed can impact the degree of economic activity and prices of goods and services. When the Fed increases the federal funds rate, this increases the cost of borrowing and restrains spending, economic growth, and employment, which can diminish inflationary pressures; as a result, this is generally unsupportive of financial assets. Alternatively, when the Fed lowers the federal funds rate, it decreases the cost of borrowing and promotes spending, economic growth, and employment, which can encourage inflationary pressures; this, in turn, is generally supportive of financial assets.

Federal Reserve Considerations

Over the past year, the Fed has consistently reiterated its commitment to maintaining a “data dependent” approach to setting the federal funds rate, meaning the Fed’s rate decision will be heavily influenced by economic indicators that measure the direction of inflation and employment. The Fed will be more willing to reduce the federal funds rate as inflation falls and labor markets soften, and more willing to keep rates high or even raise the federal funds rate if inflation stays high and labor markets are strong.

While any single product or service that is a component of the CPI could cause the overall inflation rate to move higher or lower, the cost of housing is a meaningful factor: The shelter component represents nearly a third of the CPI and increased at an annual rate of 5.2% as of June 2024, accounting for two thirds of the index’s growth rate. Historically, the shelter component of CPI has closely tracked the Zillow rent index, which has decelerated over the last year (Figure 2). Should that relationship continue, and rents remain soft, we should expect to see the overall inflation rate slow, all else being equal.

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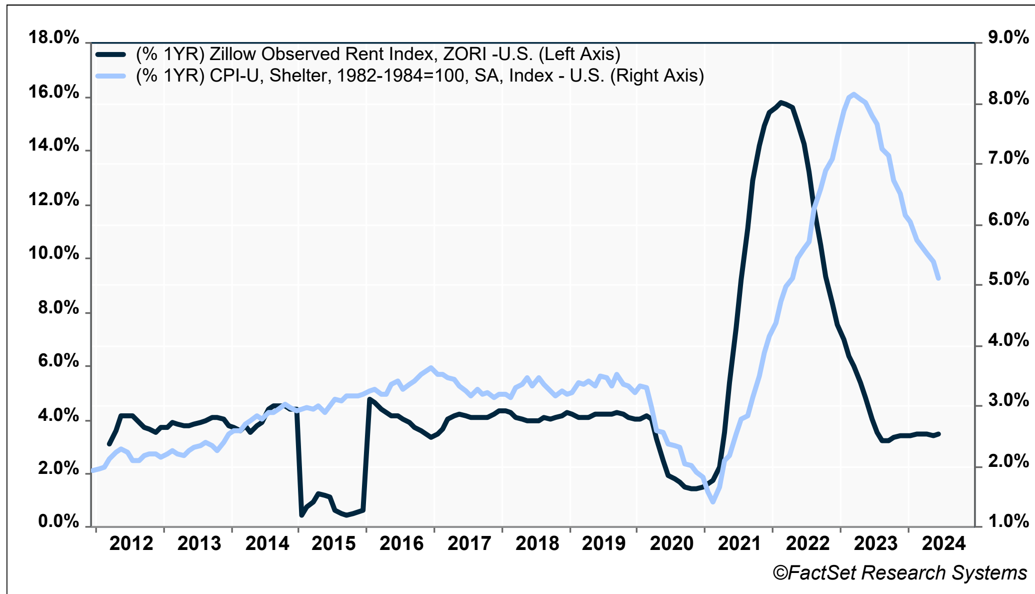
Figure 2: Zillow Observed Rent and Shelter CPI Component



Source: FactSet as of 6/30/2024

The Fed is also closely watching domestic labor markets. By most measures, the employment picture has been solid in recent years. Through July 2024, the U.S. economy has gained on average 213k jobs a month this year, and the unemployment rate at 4.3% is low by historical standards. Still, there are reasons for the Fed to be concerned: Job gains have slowed over the past four months to an average of just 154k, and the unemployment rate has risen by 0.80 percentage points since July of 2023. Furthermore, there are questions about the dependability of the estimated monthly job gains given the tendency of the data to be revised lower in subsequent months. Jerome Powell, Chairman of the Federal Reserve, both accentuated the strength of the labor market and raised concern about the veracity of jobs data, “You’ve got strong job creation, you have payroll jobs still coming strong, even though there’s an argument that they may be a bit overstated.”

Federal Funds Rate Projections

Rather than simply relying only on our prediction and interpretation of these economic variables, we can also look to specific estimates of the future federal funds rate. Four times per year the members of the Fed’s policy committee, the Federal Open Market Committee, issue federal funds rate projections – aka the “dot plot.” In Figure 3 below, which depicts the most recent dot plot issued by the Fed, each dot represents a different Fed governor’s projection for the federal funds rate at the end of a given year. As of mid-June, the median year-end 2024 projection was 4.75% - 5.00%, while the median year-end 2025 projection was 4.00% - 4.25%, implying the Fed will lower the Federal funds rate twice in 2024 and three more times in 2025 (assuming each cut is 0.25 percentage points).

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Figure 3: FOMC Federal Funds Rate Projections[1]

Percent
7.0
6.5
6.0
5.5
5.0
4.5
4.0
3.5
3.0
2.5
2.0
1.5
1.0
0.5
0.0

2024 2025 2026 Longer run

Financial markets can also provide some perspective. We can use the prices of federal funds futures contracts traded on the Chicago Mercantile Exchange to derive market participants' implied estimates of future federal funds rates. At the time the dot plot above was released, these market-based estimates indicated the Fed would reduce the federal funds rate by approximately one percentage point by mid-2025. Nearly a month later on August 6, 2024, that estimate increased to almost two percentage points following the release of a weaker-than-expected July jobs report and commentary by Mr. Powell that a rate cut "may be on the table" at the Fed's next meeting in September should inflation continue to moderate.

[1] Source: FOMC Summary of Economic Projections as of June 12, 2024

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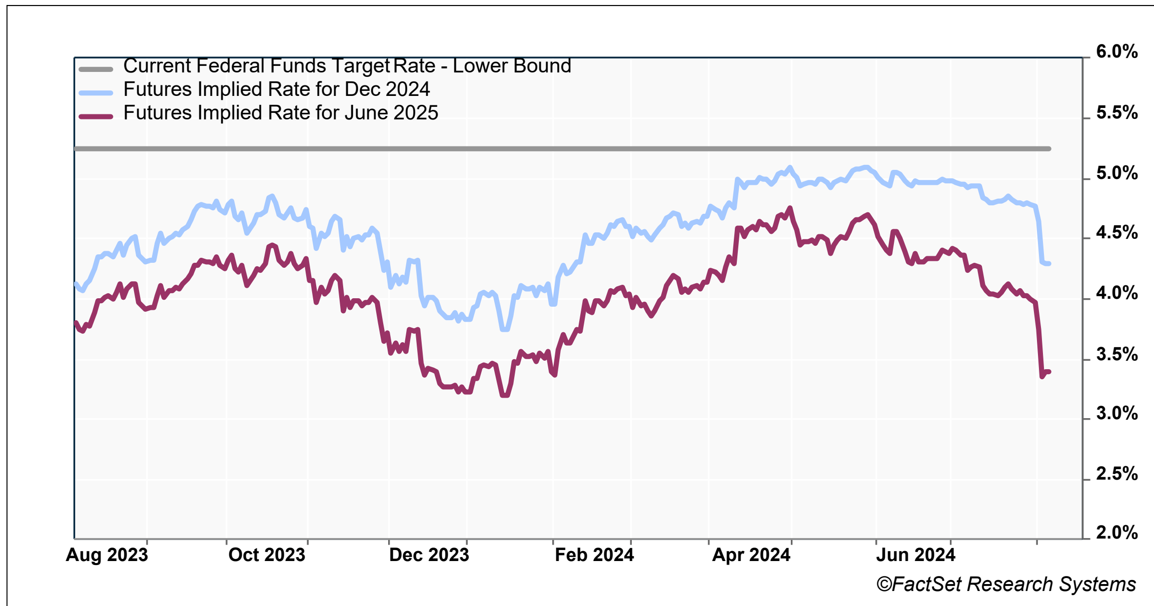
Figure 4: Market Implied Federal Funds Rate



Source: FactSet as of 8/6/2024

Investment Portfolio Impacts

With both the Fed and financial markets predicting a drop in the federal funds rate over the next 18 months, it is instructive to examine how stocks and bonds have performed in past periods in which the Fed lowered the federal funds rate. We found six instances over the last 40 years in which the Fed has materially lowered the federal funds rate, and we measured the cumulative returns over each cycle of stocks (Russell 1000 index) and bonds (Bloomberg U.S. Aggregate Index) from the last day of the peak Federal funds rate to the last day that rates were cut.

A few interesting patterns emerged from the data: Bonds, which increase in price as market yields fall, generated positive returns in every past period, with the lowest returns occurring during the “Great Financial Recession” and the COVID pandemic. The performance of stocks was more mixed, rising in only half the periods, and, not surprisingly, exhibiting a greater degree of volatility. While lower interest rates are generally beneficial for stocks as well, the data show they may fall in value despite declining rates if the Fed cuts occur in response to economic weakness. In aggregate over the measured periods, bonds had an average cumulative return of 28% with a standard deviation of 18%, while stocks had an average cumulative return of 7% with a 41% standard deviation.

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Figure 5: Cumulative Returns for Periods of Falling Federal Funds Rates[2]

Peak Federal Funds Rate		Low Federal Funds Rate		Russell 1000 Index	Bloomberg U.S. Aggregate Index
6/12/1981	19.50%	12/13/1982	8.50%	12.36%	37.61%
8/31/1984	11.63%	8/21/1986	5.88%	64.21%	50.54%
6/30/1989	9.56%	9/4/1992	3.00%	44.31%	40.34%
1/2/2001	6.50%	6/25/2003	1.00%	-22.97%	24.80%
9/17/2007	5.25%	12/16/2008	0.25%	-37.46%	7.37%
7/31/2019	2.50%	3/16/2020	1.75%	-20.78%	5.71%

Conclusion

Several indicators suggest the Fed is on the verge of cutting the federal funds rate. The Fed's own dot plot projections point to one-and-a-quarter percentage point of cuts by the end of 2025, while more recent federal funds futures imply the Fed will lower the federal funds rate by almost two percentage points by mid-2025. Market participants will closely watch key economic variables, particularly those related to inflation and labor markets, to anticipate changes to this predicted schedule. Should the Fed cut the federal funds rate, past data would indicate that this, on the margin, produces a favorable return environment for bonds, but could also be beneficial for stock returns. Gallagher consultants will consider these patterns when rebalancing accounts or raising cash to cover plan obligations. More broadly we believe in maintaining diversified portfolios given the difficulty with making predictions.

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[2] Source: FactSet

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