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TOGETHER WE'RE INVESTED

Recalibrations

September 30, 2024

The Federal Open Market Committee (FOMC) just wrapped up their sixth official meeting of the year on Wednesday, September 18th and it resulted in what many believe to be the first of a series of rate cuts that may extend all the way into 2026. We think it would be helpful to analyze what this might mean for the capital markets going forward and how one might want to position for the coming months ahead.

In that context, we think it would be beneficial to look back to one of our "Behind the Scenes" updates from January 31st earlier this year when we last commented about the Fed and their interest rate policy. It'll allow us to set the stage for what's ahead by reviewing how we described the environment back then. This is what we wrote:

Quote of the Week:

"Nobody can predict interest rates, the future direction of the economy or stock market. Dismiss all such forecasts and concentrate on what's actually happening to the companies in which you are invested."

- Peter Lynch

"Be Careful What You Wish For"

There seems to be a narrative throughout the capital markets that the next direction for interest rates is down. Many practitioners scrutinize the Federal Reserve Quarterly Dot Plot, which is the central bank's official projection for the federal funds rate. The dots reflect what each U.S. central banker thinks will be the appropriate midpoint of the fed funds rate at the end of the next few calendar years. The median dot plot projection has the fed funds rate declining by 75 basis points by year end 2024, another fall of 100 basis points in 2025, and a further reduction of 75 basis points in 2026. That's a full 2.5% decline in the next 3 years. That's the Fed's official projection.

The market view is quite different, with some projecting five or six interest rate cuts this year alone. Our take on this: be careful what you wish for! The 1 Year Treasury bond yields 4.76% today, which is significantly higher than what it has been over the past ten years or so. Ever since the Great Financial Crisis (GFC) of 2007-2009, interest rates have been close to zero, and only in the past two years have we returned to what we would view as normal. See below, how over the past 60 years, the 1 Year Treasury Note has had an average yield of 4.90%.

Exhibit 1: 1 Year Treasury Yield Curve:

So, if you are hoping for a decline in interest rates, you might then be asking for a recession or a dramatic economic slowdown. Is that what you really desire?

We can think of two primary reasons for interest rates to fall, and the first reason is one with negative consequences. That would be due to a decline in economic output, lower consumption, higher unemployment – all the classic symptoms of a recession, if you will.

The other more potentially positive outcome of lower interest rates would be due to inflation falling to such a level that the Fed could justify lowering the fed funds to bring the natural real rate in line to the inflation rate to not be overly restrictive with its monetary policy. That might be an overall good outcome with one caveat - if the disinflationary forces do not turn into a full-fledged deflationary spiral.

So, that's a long explanation as to why we might champion interest rates remaining sticky around current levels. It would likely mean a healthy economic environment, no recession, and maybe even good corporate margins, earnings, and strong share prices. We'll find out as the year progresses.

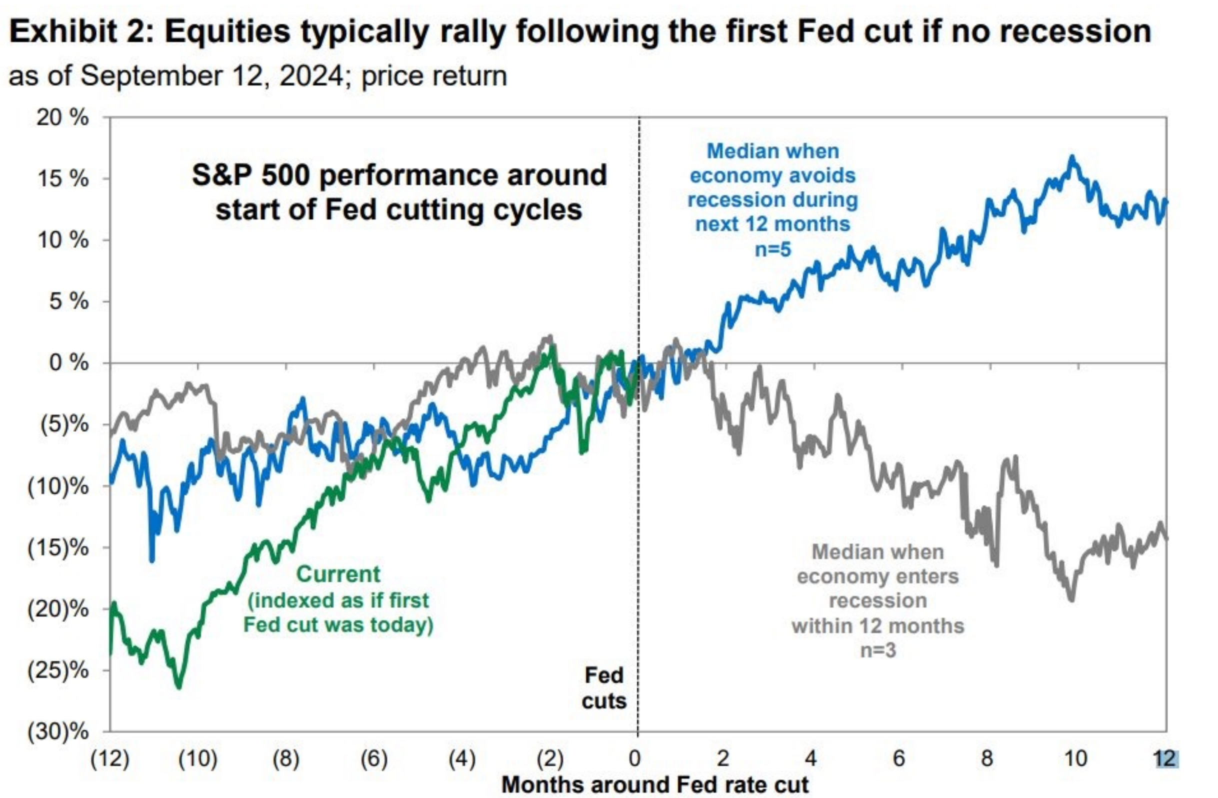
~End

Do you see how that is a terrific starting point for today's discussion?! Fed Chairman Jerome Powell used the phrase "recalibration" at least nine times during his afternoon press conference on the 18th of September when he described the Fed's intent to bring the fed funds rate closer to what the inflation rate appears to be at the present time. As we mentioned above, the "potentially positive outcome" to lowering rates could be justified if restrictive fed funds needed to be brought more in line with the inflation rate. Thus, with inflation running below

3% and possibly forecasted to fall towards 2%, a 5.25-5.5% fed funds rate was seen as highly restrictive and many saw cracks forming in the employment numbers. Thus, the FOMC decided to initiate a first in what many prognosticators and the Fed's own dot plot suggests will be a decline in short term interest rates of 100 or more basis points by mid next year.

Here's where things get tricky. Not all rate cuts are the same. The direction of the market may be more dependent upon whether a recession develops. Back to our comments from January 31st earlier this year when we penned: "Be careful what you wish for." According to Goldman Sachs Global Investment Research, the market will do just fine after the first cut if we do not experience a recession. Note the disparity in the chart below.

Exhibit 2: Equities typically rally following the first Fed cut if no recession



Source: Goldman Sachs Global Investment Research

Furthermore, we spotted a very good analysis of past rate cuts seeking to understand the difference between recalibration cuts relative to recession or panic rate cuts. See this fine piece from Carson Investment Research:

Exhibit 3: Not All First Rate Cuts Are the Same

Not All First Cuts Are The Same

S&P 500 Returns After First Cut The Past 10 Cycles

Date of First Cut	Type of Cut	Size of First Cut	S&P 500 Index Future Returns: 1 Month	3 Months	6 Months	12 Months
9/27/1984	Normalization	0.25%	-1.0%	-0.7%	7.5%	8.6%
10/22/1987	Panic (Crash of '87)	0.25%	-2.5%	-0.7%	4.8%	13.9%
6/5/1989	Normalization	0.50%	-0.4%	9.8%	8.9%	14.1%
7/13/1990	Recession	0.50%	-8.1%	-19.8%	-14.2%	3.5%
7/6/1995	Normalization	0.25%	0.9%	5.0%	11.5%	21.4%
9/29/1998	Panic (Russian Ruble and LTCM crisis)	0.25%	1.8%	18.4%	22.6%	20.9%
1/3/2001	Recession	0.50%	0.1%	-18.1%	-9.5%	-14.3%
9/18/2007	Recession	0.50%	1.4%	-4.9%	-14.6%	-23.9%
7/31/2019	Normalization	0.25%	-1.9%	1.9%	10.2%	8.9%
3/3/2020	Panic (COVID)	0.50%	-17.7%	2.6%	16.5%	27.2%
	Average		-2.7%	-0.7%	4.4%	8.0%
	Median		-0.7%	0.6%	8.2%	11.4%
	% Higher		40.0%	50.0%	70.0%	80.0%
Normalization Cut						
Average			-0.6%	4.0%	9.5%	13.2%
Median			-0.7%	3.4%	9.5%	11.5%
% Higher			25.0%	75.0%	100.0%	100.0%
Panic Cut						
Average			-0.3%	8.8%	13.7%	17.4%
Median			-0.3%	8.8%	13.7%	17.4%
% Higher			50.0%	50.0%	100.0%	100.0%
Recession Cut						
Average			-2.2%	-14.3%	-12.8%	-11.6%
Median			0.1%	-18.1%	-14.2%	-14.3%
% Higher			66.7%	0.0%	0.0%	33.3%

Source: Carson Investment Research, FactSet, Bloomberg 01/25/2024 (1984 - Current)
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According to Carson, what they call normalization is the same as how we'd interpret Powell's "recalibration" stance. If history can be a guide to what might happen in the future, the market was higher in all instances 6 and 12 months later when normalization cuts were in progress. It's the recession outcome where the market suffered.

Of course, we are mere weeks from a U.S. presidential election, and some investors think October brings the Halloween frights out in force (although September has historically been the worst month in stock market history). However, that is a far too simplistic view to drastically change your investment strategy and would be an exercise in market timing, where most investors are unsuccessful.

Frankly, the good news is that the participation rate for the overall market is broadening out and we are seeing nice performance from stocks that have been treading water for some time. Recall, it does not mean the businesses have been under-performing, but in the past few years some share prices have been a little stagnant while so much money has rushed into a handful of stocks leaving well performing companies with somewhat stale stock prices. As we have said many times in the past, if the business is there, the share price will follow! And we are starting to see signs of more broadly improving share prices!

In closing, the key as we move into the last part of 2024 and into 2025 with a new Administration and a Federal Reserve undergoing an easing campaign, is to expect the unknown and to keep your laser-like focus on the rewards possible when you own high quality companies at the right price. The dividend and interest income from your securities will sustain you in the near term and the growth of your principal over time will likely help you achieve your long-term goals. The path ahead never appears straight forward, but as our grandmothers taught us, things worth doing are never easy.

Stay Invested!

One last thought: There are roughly 250 trading days a year, making it ~2,500 days for a decade. Statistically speaking, major portions of a company's equity return over ten years happen in approximately 50 to 60 trading days. This means that what happens in 2% of the days decides your decadal returns. Stay invested with good companies and patience is crucial. What happens next month or next year pales in comparison to what is possible in the next decade.

We thank you for your commitment to the value, contrarian, growth, and income strategy that we have put in place for you. We will continue to monitor things closely and make the necessary adjustments as dictated by the fundamentals of the businesses we own. We have high conviction about how, where, and why we are invested, and we are extremely optimistic about the next few years.

All the best from the CORDA team.