Evaluating the Change in Fed Policy

September 23, 2024

Last week, the Federal Reserve Board shifted monetary policy by lowering the fed funds rate by one-half percentage point, bringing the range down to 4.75-5.00%, ushering in a major change in the Fed’s fight against inflation. Looking back, as recently as the first two months of 2022, the Fed was holding interest rates near zero and still buying billions of dollars of bonds to stimulate the economy. Then, it began raising rates in March of 2022 and continued to raise them an additional 10 times so that by July 26, 2023, the range was 5.25-5.50%. This shift in Fed policy to lower interest rates represents the decision to move away from fighting inflation to minimizing unemployment. The plan is to shift toward keeping the economy on an even keel and curtailing any slowdown that would cause unemployment to rise to unacceptable levels. Forecasts by economists are calling for further rate reductions this year and next to get interest rates back to levels that are considered “normal” by the economic community. This recent change in monetary policy has pushed both the Dow Jones Industrial Average and the S&P 500 indices to all-time highs.

The 50-basis point cut in the Fed funds rate will not magically affect interest rates or the economy. Such decisions take time to filter through to the broad economy, and usually, a series of rate cuts trigger more economic activity. Historically, rate cuts have impacted the housing market, but this time a measurable impact may be hard to come by as mortgage costs for most people are low. Refinancings are at record lows due to higher rates that keep owners from wanting to sell. Decisions not to sell are paramount, especially since homeowners would have high monthly mortgage payments to make a move to another property.

Falling rates are perceived to impact the economy favorably, but do not ask individuals invested in short-term fixed-income securities to agree. Falling rates lead to lower income levels for those who rely on interest from savings. So, when interest rates fall, conservative investors end up facing another type of “inflation” in the sense that they may not have enough income from their investments to maintain their standard of living.

If history is any guide, easy monetary policy/falling interest rates are good for financial markets. Currently, both individual and corporate wealth are at record levels, and corporate profitability is on the upswing. Even though many investors think that the “market” multiple is high, many stocks are reasonably priced. Investors have also recognized that the prior disparity between the Magnificent Seven and all other stocks is narrowing as the strong rally we have been experiencing is broadening out to other market sectors. This change in monetary policy is likely to benefit the overall economy.

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