To Cut Rates or Not to Cut Rates, That is This Week's Question

On behalf of everyone at Cabana, I hope all our clients and advisor partners had a wonderful holiday weekend with family and friends. The 4th of July is my personal favorite holiday. Not only is it a great excuse to get outside, but it is a stress-free day spent celebrating our country and having some fun with the people we love.

Now, on to the markets. The second half of the year is off to a rocky start. Much of the first half's gains were due to the expectation that the Federal Reserve is coming to the rescue with interest rate cuts this month. As recently as two weeks ago, the bond market was pricing in the possibility of a 50-basis-point cut at the July meeting. Well, that expectation was hit squarely in the face with a very strong jobs report on Friday. As I mentioned in a commentary several weeks ago, record-low unemployment goes a long way in staving off a recession. If people have jobs, they can continue to live and plan, which translates to buying things. Buying things results in demand-side growth in everything from houses to tennis shoes. In fact, the relationship between employment and the underlying economy is so strong that it is a fundamental tenet of the Federal Reserve policy. In the present circumstance, it is hard to argue that we need much stimulus from our Central Bank in the form of rate cuts. This is a classic case of good news is really bad news. Markets are crazy like that. On Friday, we saw steep drops across the board. Stocks fell and interest rates rose, taking bonds and fixed income assets down as well. The selling in stocks continues today, although we are still right around all-time highs in the S&P 500.

In my view, the Federal Reserve has gotten itself caught on the horns of a dilemma. If it doesn't cut rates, the markets are likely to take a quick 5-10% drop as investors reprice assets. If it does cut rates, that could represent that things are worse than we really know and, just as importantly, the Fed has lost the ability to remain independent and is catering to the market's desires (and President Trump's). Over the short-term, not cutting rates will probably create the most volatility. Over the long-term, good news is good news, and the Federal Reserve should stick to its job. My best guess is that rates are cut 25 basis points and the Federal Reserve provides a statement that a small cut is all that is currently needed.

Chairman Powell will give testimony to Congress beginning on Wednesday, and you can bet he is finding a way to communicate his way through this issue in advance of the July Fed meeting. Stay tuned.

Last week's commentary is available here.

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