

The Fed dual mandate

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To assist financial systems to operate smoothly and to reduce the likelihood of financial crises, most modern nations have central banks, which among other things influence economies by setting interest rates and participating in open market operations to control the cost of borrowing and lending. Their main goal is to maintain stable prices, which means low inflation. In the United States, the central bank is called the Federal Reserve, often abbreviated as “the Fed”. The Fed, unlike most central banks, has a dual mandate which includes maximizing employment over and above the responsibility to maintain stable prices. The dual mandate is aimed at avoiding a condition known as stagflation, where an economy has high inflation and unemployment simultaneously.

Last year, the resilience of the U.S. consumer shocked economists who had widely expected an economic downturn to ensue as the Fed aggressively raised interest rates to curb inflation. Fast forward and there has been much talk that the Fed is closer to bringing down inflation back to target without a recession, the so called “soft landing” - a feat which has only been achieved once during the 1990s. The U.S. economy has continued to expand in the second quarter, while inflation resumed a downward trend and seems to be on track to slow further toward the Fed’s target. Gross Domestic Product (GDP) has been much stronger than economists had predicted. With the risk of stagflation fading, with not much stagnation and not much inflation, the market is overwhelmingly betting that the Fed will decide to cut rates in its September 17-18 meeting. With this optimistic view, interest rate cuts would suggest that the Fed officials feel confident that inflation is under control and returning to the 2% target. Lower rates are generally perceived as good news since they translate to lower borrowing costs on everything from mortgages, car loans and credit cards.

However, recently there has been a shift in the U.S. macro narrative from a Fed that would be able to cut policy rates due to the easing of inflation to one that is behind the economic curve and must cut imminently to prevent a recession. If rates are cut on this basis investors would have to navigate the terrain differently. It is not crystal clear if this duo of slower inflation and stronger growth will persist. There are now concerns over risks surrounding the labour market, which has long been a pillar of strength for the U.S. economy. It is highly unclear how the economy will unfold going forward as the lagging effects of monetary policy may be starting to show up in the labour market. The biggest question here would be if the job market is loosening or weakening. There seems to be more upside risk to unemployment especially if we experience a continued drop in job vacancies.

The recent increase in unemployment has triggered a famous and historically reliable recession indicator known as the “Sahm rule”. The rule states that a recession is likely underway when the three-month moving average of the national unemployment rate rises by 0.50% or more relative to its low during the previous 12 months. The rule has been a robust tool and very accurate in identifying downturns in business cycles. During a downturn in the business cycle, joblessness, delinquencies and bankruptcies could suddenly spike, quickly unwinding a market priced for a soft-landing into a hard landing. At 4.3% the unemployment rate is currently at its highest point in more than two years, having been as low as 3.4% less than a year ago. Critics of the Sahm rule have argued that the recent uptick in the labour participation due to a large exogenous increase in immigration flocking into the country may have altered the use case of the rule. To the critics’ credit, distortions to economic activity and policy interventions during and after the pandemic have been so large that most stylized economic patterns underpinning cyclical gauges have broken down. The obvious examples being the inverted yield curve



and the Conference Board's Leading Economic Index, both of which erroneously flashed recession warnings last year.

Taking a further look at the business cycle, there has been a reality check on the U.S. mega-cap technology related growth companies as recent earnings underwhelmed and investors started to question whether the aggressive spending to build out Artificial Intelligence infrastructure would generate adequate returns on investment. Most recently, Intel, once the world's most dominant chipmaker with a stronghold on PCs and Macs, slashed 15% of its staff (over 15,000 jobs) as part of plans to reduce costs. Management cited that revenue had not grown as expected and that they have yet to fully benefit from powerful trends, like Artificial Intelligence. Perhaps this could be the genesis of more layoffs from major companies or rather that Intel is an isolated case not representative of the broader U.S. companies and the economy at large. If this is indeed an isolated case, then the business cycle would not be impaired. However, a broader look at the U.S. economy has started to show some signs of stress and weakness. It has been a year since interest rates have hovered at over two decades high and this has started to weigh on the U.S. consumer. According to major retailers such as Target and Walmart, consumers are still spending but they are now hunting for bargains. The U.S. consumers are no longer splashing, with shoppers becoming much more careful with their spending.

The possibility that fears of a recession could cause an actual recession is increasing. In theory, if U.S. consumers start tapping out, this would spell more trouble for the job market. This is key, because consumer spending is the main engine, accounting for about two-thirds of U.S. economic output. If corporate managers pull back on hiring and capital investments due to fears of a coming recession, then this fear may and has historically caused or furthered a slowdown which translates into a recession. Putting these forces together, investors should buckle up for what looks to be a further turbulent ride in the near term. While easing is clearly coming, it is less clear that it will be about forestalling an imminent hard landing or rather more about ensuring the soft landing continues. Whatever the case may be, one thing is certain going into the September 17-18 Fed meeting, volatility will be elevated. It is therefore paramount to remind investors that near-term market volatility is the cost of investing. However, if investors can hold through that volatility, it is the greatest source of long-term capital appreciation.

Sources: Bloomberg Economics

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