David: Hello, and welcome to *Conversations with Commerce Trust*, our show about the markets, investment themes, and economic insights that matter to you. I'm your host, David Hagee, Chief Investment Officer with Commerce Trust. Today we'll be talking about the Fed (Federal Reserve) and the likely future path of interest rates with Scott Colbert, our Chief Economist and Director of Fixed Income (Management). Welcome to the podcast, Scott.

Scott: Thank you, David.

David: So now that we're in fall, we've seen the Fed finally start to move off of the higher interest rates, the restrictive policy that they had in place for so long. They put it in a 50-basis point rate cut, or a half percent cut in September. I'd like to talk a little bit about sort of what that cut means, what the direction of the Fed is there, but let's start with how they were able to make this cut. Scott, what's going on inside the economy?

Scott: Well, clearly economic growth is surprised on the upside. Economy grew at about a two and a half percent pace adjusted for inflation in 2023, and so far for the first three quarters of this year, we've probably grown at about a 1.5% pace (gross domestic product) the first quarter, about a 3% pace the second quarter, and it (2024 GDP) seems to be tracking at about 2.6(%). So, let's say growth is about the same this year as it was last year.

At the same time, fortunately, inflation has continued to cool and the CPI (Consumer Price Index) now on a trailing one-year basis is down to 2.5% (for August 2024.) And the Fed's favorite measure, this so-called PCE, Personal Consumption Expenditures (Price) Index, is down to 2.2%.

With inflation falling that much and cash rates still above 5%, the Fed thought they could start to, I'll call it normalize or at least bring down, or as Fed Governor Powell, or Chair Powell is saying, recalibrate the short-term cash rate relative to where inflation is. And so, they thought it appropriate to reduce cash yields by 50 basis points on September 18th.

David: As we look at that question of the Fed starting to take off the restrictive stance that they've had and moving towards a more accommodative stance, are they doing that to normalize interest rates to just get us out of that sort of fighting and inflation mode, or are they doing that to support the economy? As I look at the jobs market today, it's kind of been all over the place. August, we had a very weak print. We had a remarkably strong print in September. What are our thoughts around the jobs market at this point?

Scott: On average, we've been growing jobs at about 200,000 jobs per month so far this year. Now that's down from a more rapid 2023, and a super job growth (in) 2022 coming out of the pandemic. So, we've seen cooling job growth, but this is relative to long-term job growth. The average monthly jobs created from post subprime financial crisis to pre-pandemic, that almost nearly 11-year

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stretch, averaged 180,000 jobs. So, we're still averaging more jobs per month today being created than we did over that entire 11-year expansion.

But the job growth was cooling and particularly this past quarter, it looked like it was cooling a lot. Prior to last September's employment report job growth had averaged 115,000 jobs the previous two months. Now with revisions and a very strong September print, we're back to about 180,000 jobs for the last three months. So, the Fed is probably breathing a sigh of relief, but I do believe the first 50 basis points give on rates was simply a recognition that the risks to the economy were no longer from inflation, but more from cooling or a potential cooling in growth.

David: As this jobs market sort of goes through a red light, green light phase here, it does appear though that we have, as you mentioned, some underlying strength inside the jobs market that should be able to continue to see this economy expand. Assuming that the Fed is doing this to normalize interest rates, what's the end game for the Fed here?

Scott: I guess you'd say then what is a normal interest rate curve or what does a normal treasury curve look like? And of course, over our lifetime, say from 1970 till today, each decade has looked materially different. The average Fed funds rate in the 1970s was seven plus percent. In the 1980s it was nearly 10%, so the average cash rate for the 1980s was nearly 10%. It's come down materially since that. In the 1990s it was 5% (and from) 2010 to 2020 it was 3%. And, of course, so far into the 2020s, it's been about 2.5% that was 0% to begin. We're ending up at 5%, so it depends on kind of where you are in the economic cycle and where inflation is.

Now, what would the Fed consider to be normal? The Fed wants to target 2% PCE inflation. We think in terms of the CPI, the average person does, and the difference between the CPI and the PCE is typically about a 0.50%. In other words, if the Fed's targeting their version of inflation at 2% that probably means our version of inflation that we read about in the papers is 2.5%. And what would the appropriate spread or difference between inflation and cash be over time for the last 55 years since 1970 till today? And the answer to that is about 90 basis points more than trailing inflation, trailing CPI.

So, if we get the CPI down to 2.5%, which is exactly where it is today, on average from 1970 till today, that means that there's about a 3.4% cash rate. Cash rates today are about 5%. So, this would tell you that perhaps there's six to maybe seven interest-rate (cuts) coming to get back to what would be considered a long-term average cash rate relative to inflation.

I just talked a whole bunch there. That just happens to be right now the market's expectation for interest rate cuts.

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David: So here we're in this position, the Fed is targeting to get a real return on cash or a return minus inflation of cash of just around 1%, (or) 90 basis points as you mentioned. But what does that mean outside of the cash markets for the economy? I'm thinking about mortgage rates, consumer debt, how much energy is this going to translate into the market of having lower interest rates here?

Scott: So, then we get to how much of a yield premium or extra yield should you get by going out longer in maturity? Because typically the yield curve is positively sloped, meaning cash yields are the lowest, 10- year and 30-year (Treasury) yields are higher because you're locking up your money for a longer time. You're taking on more risks that inflation might eat up some of that over time, and because you're locking your money up, you're just getting paid more for it.

Now, most of this decade we've seen an inverted curve where cash yields are higher, but on average in the 1970s, 1980s, 1990s, and every decade on average, you've had a positively sloped yield curve. This average yield curve so far has been flat. We've had an average curve that's been flat so far, but the difference between the cash rate, that Fed funds rate we've been talking about, and the 10-year Treasury over the same long period I'm talking about, this 54-year period, has been about 110 basis points.

In other words, the 10-year Treasury, if you have a 3% cash rate, the Treasury (yield) ought to be about 4.10% on average. If it's a 3.5%, then you've got a 10-year Treasury at 4.6%. I might note that today's 10-year treasury is almost exactly 4%.

You asked now what would that mean for mortgage rates? All right, that's the next step. How much higher is a mortgage yield than the 10-year Treasury? Because of course, banks are going to have to pay 4% to hold your money, so if they're going to make you a mortgage, they're going to charge you more for your mortgage, right? Today's average mortgage rate is about 6.5%, or about 2.5% higher than the 10-year Treasury.

David: As we're looking at things, 80% of mortgages are below 5% right now. Current mortgages this fall have been floating around 6.125% or 6.15%, down from highs of about 7.5% just a few months ago. But it's probably not enough to your point, to get people unglued from their current mortgages and start the housing existing home market to really start to see some inventory loosen up here. At the margins, I think you're seeing home builders get much, much more active, and probably more profitable too, as they're no longer sort of buying down mortgages to get people into homes and getting some more activity on the new home side.

Additionally, I would say on the credit card debt side, it's a mountain of debt out there as consumers, especially in lower income brackets, have started to tack on a ton of debt here, and we're looking at debt service somewhere around 10% of disposable household income. So, any relief from higher credit card rates certainly would be welcome for consumers as they're feeling a bit pinched.

Thanks for the interesting discussion today, Scott. For additional commentary on this topic and our new *Look at the Markets* quarterly review, which offers concise and insightful perspectives on the economy and financial markets, please visit our website at www.commercetrustcompany.com.

Also, if you've enjoyed what you've heard, you can subscribe to our show on Apple Podcasts, Spotify, Amazon Music, or wherever you get your podcasts from. Thank you for joining us on *Conversations with Commerce Trust*. I'm David Hagee, we'll talk again soon.

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October 8, 2024
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