CITY NATIONAL ROCHDALE
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The Bottom Line
Relevant Insights for the Savvy Investor

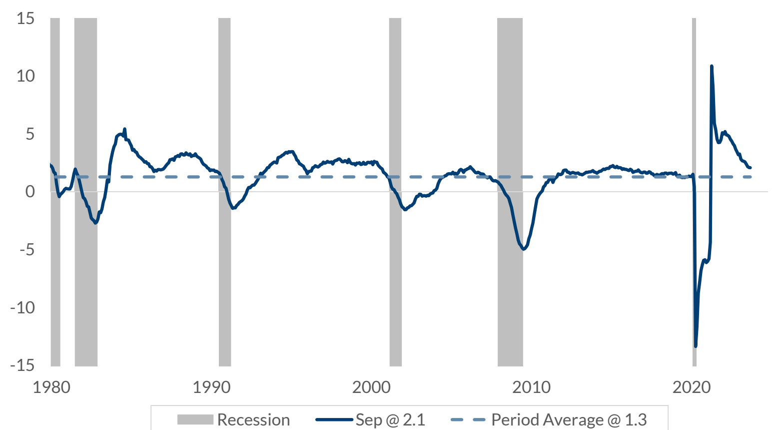
Walking on a Razor Edge

For the Federal Reserve (Fed), the economy is in a sweet spot. Inflationary pressures have moderated significantly from last year, and demand for labor has slowed (chart 1). This helps reduce the cost of labor, a primary goal of the Fed in its attempt to bring inflation back down to 2.0%.

Also, the Fed updated its outlook for Gross Domestic Product (GDP) growth next year, and they project the growth will be 1.5%, better than the June projection of 1.1%.

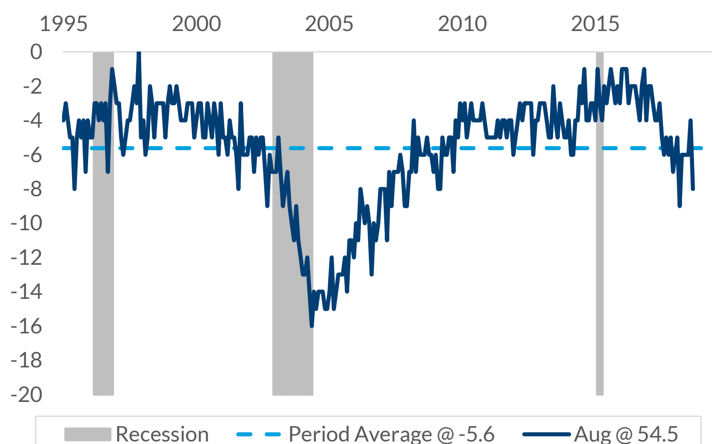
At the same time, it is also a tricky time for the Fed. In this cycle, the Fed has raised the federal funds rate by 5.25 percentage points. It is one of their most aggressive interest rate hiking programs in recent history and pushed the rate well into the territory of restricting economic growth. Additionally, banks have become more stringent in lending policies, and small businesses are frustrated with the difficulty of accessing credit (chart 2).

CHART 1: Total Nonfarm Payrolls: Yearly Change
% change y-o-y, seasonally adjusted



Source: Bureau of Labor Statistics, as of September 2023. Information is subject to change and is not a guarantee of future results.

CHART 2: NFIB: Small Business Credit Conditions Availability of Loans
%, seasonally adjusted



Source: National Federation of Independent Business, as of August 2023.

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Famed economist Milton Friedman frequently talked about the long and varied lags of monetary policy. That is what is at play for the current Fed, as it has a tricky balancing act ahead of itself. In past cycles, after 18 months of tightening monetary policy, the Fed got the economic slowdown they wanted in most cases, and they started lowering interest rates (chart 3). That hasn't happened this time around; consumer spending remains robust, which is keeping overall growth above trend. Also, inflation remains too high.

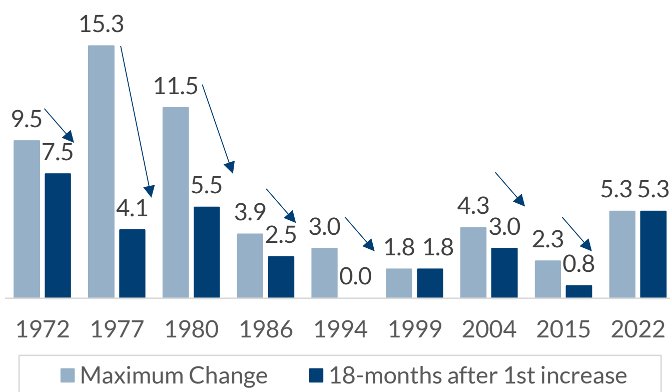
Fed policymakers must keep interest rates high long enough until they are convinced inflationary pressure will decrease and can be sustained at 2.0%. At that point, they may begin to lower interest rates to keep economic demand strong enough to support continued economic growth at a sustainable pace. The timing of that move will probably be in the second half of 2024, as the Fed waits out the lagged impact of the interest rate moves they have already put in place.

Aside from the current tightening cycle, since 1955, the Fed has had 12 significant tightening cycles. Three of those have resulted in a soft landing when the Fed raised interest rates just enough to slow the economy and reduce inflation and then reduced them without causing a recession (chart 4). The remaining nine times, a recession followed. The Fed didn't cause all those recessions; for example, the pandemic caused the recent recession. But when interest rates move quickly, some businesses are more stressed than others, and sometimes there are dire economic consequences.

This becomes the Fed's walk on a razor's edge. They have difficulty finding the precise time to move monetary policy and to determine by how much. If they hold interest rates high for too long, the economy risks entering a recession. If they lower them too soon, there is the risk that inflation may pop back up.

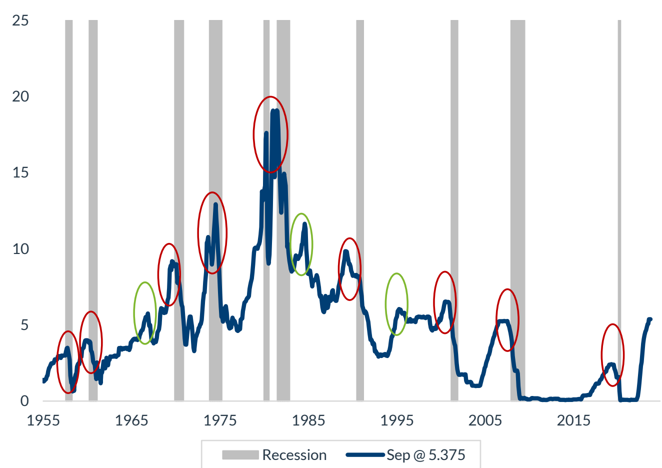
CHART 3: Federal Funds Rate

change in the rate in recent tightening cycles, percentage points



Source: Federal Reserve Bank, as of September 2023.

CHART 4: Effective Federal Funds Rate (%)



Source: Federal Reserve, CNR Research as of September 2023.
Information is subject to change and is not a guarantee of future results.

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Market Trends

Despite strong economic momentum, financial markets remain under pressure at the start of the fourth quarter, with the Israel-Hamas war and a potential U.S. government shutdown now adding to concerns over rising bond yields. While the pullback in stock prices is creating more attractive buying opportunities, we suspect markets may remain volatile in the near term prompted by temporary uncertainties, as well as more structural challenges like the impact of higher interest rates on the economy and corporate profits.

Job gains have been moderating over the past couple of years, helping to reduce pressure on wage gains, which have grown 4.2% in the past year, the smallest increase in nearly two years.[1]

Fed Chair Jerome Powell recently stated that the run-up in longer-term Treasury yields could allow the Fed to suspend another hike in the federal funds rate since it produces tighter financial conditions.[2]

Mortgage rates are close to 8.0%, more than twice as high as what the average household is currently paying; this prevents many homeowners from selling their home to buy another with a much higher mortgage rate.[3]

With the unrest in the Middle East, oil prices have increased around 10%, but if the conflict remains contained, oil prices are not expected to move much higher.[4]

Although the yearly change in inflation remains at 3.7%, recent upward pressure on housing costs is a reminder that it will be a long process to get inflation back toward the Fed's target of 2.0%.[5]

The federal deficit for the last fiscal year, which ended on September 30, was $1.7 trillion, about $300 billion more than in 2022, due to lower income from capital gains and several bipartisan spending bills.[6]

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Sources

1. Bureau of Labor Statistics, September 2023
2. The Federal Reserve, August 2023
3. Freddie Mac, CNR Research, October 2023
4. Bloomberg Energy, CNR Research, October 2023
5. Bureau of Labor Statistics, September 2023
6. U.S. Treasury, October 2023

Index Definitions

The consumer price index (CPI) measures the monthly change in prices paid by U.S. consumers.

The S&P 500 Index is a market-capitalization-weighted index of 500 leading publicly traded companies in the U.S.

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