Pinnacle Capital Management, LLC

July, 2019

COMMENTARY

What if the Fed Does Cut Rates?

The Fed watchers are out. From mid 2015 through earlier this year, the key questions were when, how often, and how far will the Fed raise interest rates? A related question was, could the economy withstand an increase in interest rates given anemic economic growth up until 2015. Between 2010 and 2015 quarterly GDP growth averaged 2.6%, hardly worthy of an expansion after a deep recession.

The Fed gingerly put its toes in the waters and raised its Fed Funds rate by 0.25% (25 basis points or 25 bps.) in December of 2015. All indications were that we'd see at least three more raises in 2016. But not wanting to upset the economic apple cart prior to a presidential election, the Fed waited until December to raise rates another 25 bps. The economy held up during that year though growth was still below 2%.

As the equity markets took off in 2017 following Donald Trump's election, the Fed regained its confidence. And being the men of conviction they are, they took their cues from the market and did raise the Fed Funds Rate three times during the year. Somehow, in the face of all three rate increases, the economy did not plunge into recession. Confidence picked up, as regulatory red tape became less of a threat. The year culminated in the passage of tax cuts, including a large reduction in the marginal rate for corporations.

Given an economy that was picking up, many expected increased inflation. There was continued confidence as the tax cuts took hold and corporate profits expanded in 2018. Despite a correction in the stock market early in the year, the equity markets advanced through the first nine months of the year. But then, a funny thing happened. President Trump began to follow through on another one of his campaign promises – to take on the Chinese and their trade practices.

Now we're not going to go over the merits of President Trump's trade policies here. And as we write this (7/1/19), there is a truce in effect. But trade issues are not yet solved. What is important is that economic confidence began to wane, and the equity markets fell in the fourth quarter of 2018. The Fed maintained its composure for one more round of interest rate increases in December 2018.

But then, fixed income markets didn't work the way the Fed had hoped. Only short term-rates seemed to move up. The yield curve – the line that plots interest rates over increasing maturities – flattened, and in some ranges sloped downward. A downward sloping yield curve has often been a precursor to a recession; and many thought the Fed may have gone too far with its rate increases. The President was one of those people. In 2019 as the trade war has heated up, Mr. Trump loudly called for Fed Chairman Powell to lower interest rates. In response, the Fed halted the rate increases (giving no credence to threats by the President) and cited risks to the economy which might lead it to lower interest rates.

With a truce in effect with China, we can debate what happens going forward. But let's not. Instead as the subtitle of this Commentary asks, what if the Fed does cut rates? Let's start with the underlying assumption of the benefit of lower rates. Anyone who knows anything about basic supply and demand understands that lower prices – in this case interest rates – will stimulate higher demand. Lower rates, therefore, should spur investors to borrow more money and invest in the productive and consumer side of the economy.

We used to think that anyone who knows anything about supply and demand would also understand that lower prices reduce supply. We were wrong, as Fed Governors, economists, and many professionals on Wall Street forgot this. With interest rates so low, banks and other lenders have very little incentive to take on risks given the low returns they earn. They might make exceptions for the highest-grade credits. But for the most part, as the experience of the last 10 years tells us, the money will get parked in Treasuries. And just so you don't think that this is a one-off case and a result of the unique nature of the last recession, the Japanese have tried stimulating their economies with lower rates since the 1990s with very little success.

But didn't lower rates drive the equity markets higher? We will admit that the influx of liquidity in 2008 did help prevent a complete melt down of the economy, and that obviously helped stocks bottom. And we admit that lower interest rates have resulted in higher valuations on stocks than they would otherwise have given their level of sales and profitability. But that last point is the key. We argue that if rates were higher, banks and institutions would have lent more, and the economy would have grown faster. Sales and earnings would be higher. So we might have lower valuations. But we think given higher profitability, stock prices would have been higher as well.

Nothing, in our opinion, has changed. Right now, we believe the economy is more dependent on a resumption of trade on a global basis than it is on lower interest rates. Resolution of the trade battles are needed. Lower interest rates are not likely to help. In our opinion they will be a continued drag on lending, notwithstanding the lure of cheap money for borrowers. They may want to, but only the best credits will have much success.

Low rates might even have an additional negative impact. Seniors who rely on fixed income have watched their incomes plummet. Low interest rates have been an effective tax on their savings. As the wave of baby boom retirees continues, there is the risk that domestic consumption falls off.

As opposed to being good for the economy, artificially low rates are good for a government that wishes to borrow cheaply as well as for a few select borrowers. It is why, in our opinion, new business formation remains low 10 years after the end of a recession.

We recognize that the markets may react positively to lower rates. We'd be surprised if they didn't. But if GDP does accelerate, ask yourself what else is going on? And of course, if GDP does not accelerate, count on the Fed to try to drive rates lower. It seems to us almost an axiom of government, if something isn't working, more is needed. So if record low interest rates never really stimulated the economy well, let's lower them again.

PINNACLE
Capital Management, LLC

100 Limestone Plaza
Fayetteville, NY 13066
(315) 234-9716 • Fax (315) 637-0090

244 North Main Street
Mansfield, MA 02048
(774) 719-2759

www.pcm-advisors.com