Three Reasons Why the Fed Continues to Be Late

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The Federal Reserve made the splashy announcement of a 50 basis point cut to the Federal Funds rate, lowering the target rate to 5.00% from a peak of 5.50%. We believe they continue to be late on properly setting the correct interest rate policy.

Last month, the Federal Reserve Board of Governors made the splashy announcement of a 0.50% cut to the Federal Funds rate, lowering the target rate to 5.00% from a peak of 5.50%. Absent an impending recession or economic shock, the Fed has historically reduced interest rates by 0.25% per cut. After foregoing its opportunities to begin the interest rate easing cycle at both the June and July meetings, to many investors, the Fed's outsized rate reduction in September seemed like a dramatic way to catch up on the missed opportunities earlier in the year.

It is no secret that our Investment Team felt the Fed should have started reducing interest rates earlier in the year. The premise of our argument was first that the Fed Funds rate was far above the average spread versus two inflation indicators: the core consumer price index (CPI), and the core personal consumption expenditures (PCE). Second, the Fed Funds rate currently sits substantially above the 2-year U.S. Treasury note rate, where on average it would be slightly below.

We felt the Fed had a dual problem in that the Fed Funds spread was too high, while at the same time inflation and intermediate-term interest rates were falling. The result – we believe the Fed has been, and continues to be, dangerously behind the curve and that the risk of a recession is increasing.

Although the 0.50% point reduction was a decent start, we believe the Fed continues to be late in setting the correct interest rate policy even if you assume inflation and interest rates do not fall any further. The same three reasons we cited throughout the year continue today.

First, using the past three decades of data, the average spread between the Fed Funds rate and core-CPI is 0.20%. On average, the Fed Funds rate has been 2.60%, with a range of 0% to a high of 6.50% in 2000 as the internet bubble burst. Meanwhile, on average, core-CPI has been 2.40% with a 30-year range of 0.60% and 6.64%. Today, the Fed Funds is 5.00% and core-CPI is 3.26% and trending towards 3%. As shown in the following chart, this spread of 1.74% is about 1.50% above the multi-decade average.

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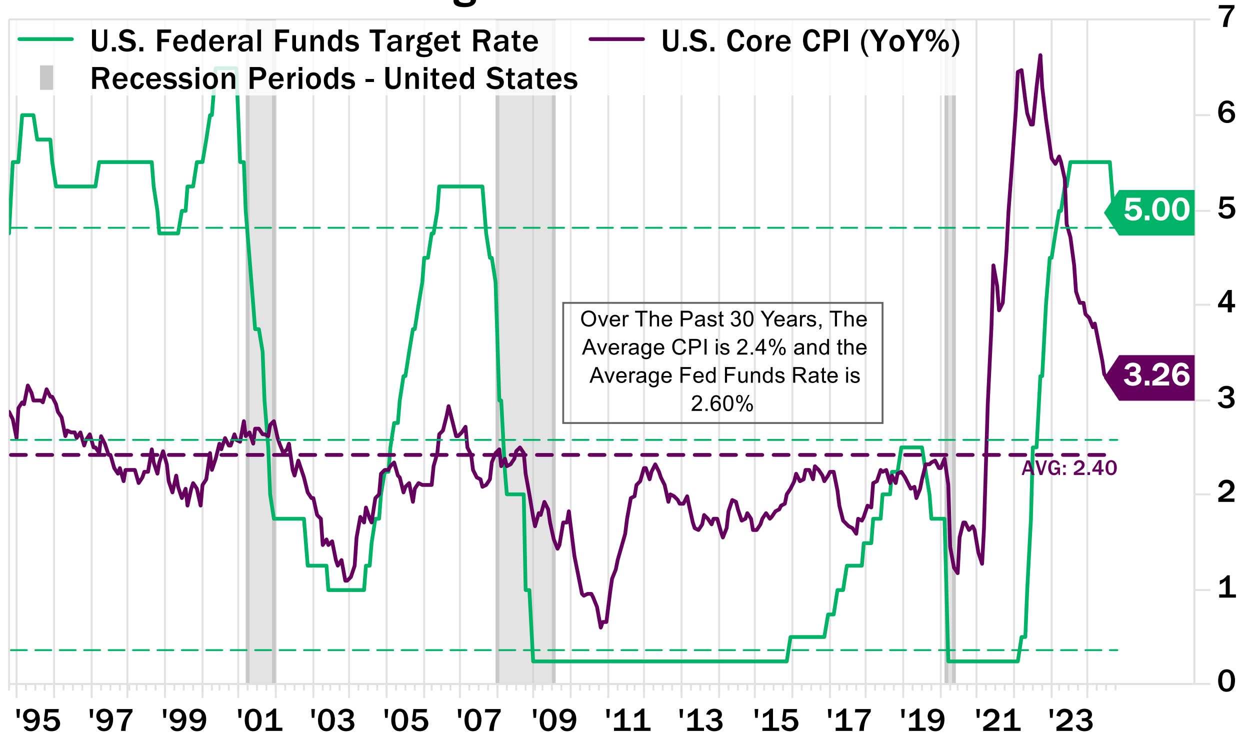

Two important items to note. First, even if you assume inflation is sticky and stops normalizing at 3.26%, the Fed Funds would have to be reduced another 1.50% to match historic norms. Second, notice what happened in the past when the Fed was too late in cutting the Fed Funds rate – the grey areas show periods of recession. As the Chief Investment Officer of Osborne Partners, I have long noted, “when they’re late, the economy deflates.” Conclusion: The Fed continues to be at least 1.50% behind in the rate cutting cycle.

Next, we see a similar situation in the multi-decade history of the spread between the Fed Funds rate and core-PCE, another key inflation measure. Over the long-term, the Fed Funds rate averages 0.50% above core-PCE. Today that spread is 2.43%, while core-PCE itself, is just less than 0.50% above its long-term average of 2.10%. The result is we feel the Fed is about 1.75%-2% behind the curve if you assumed inflation was at a terminal rate.

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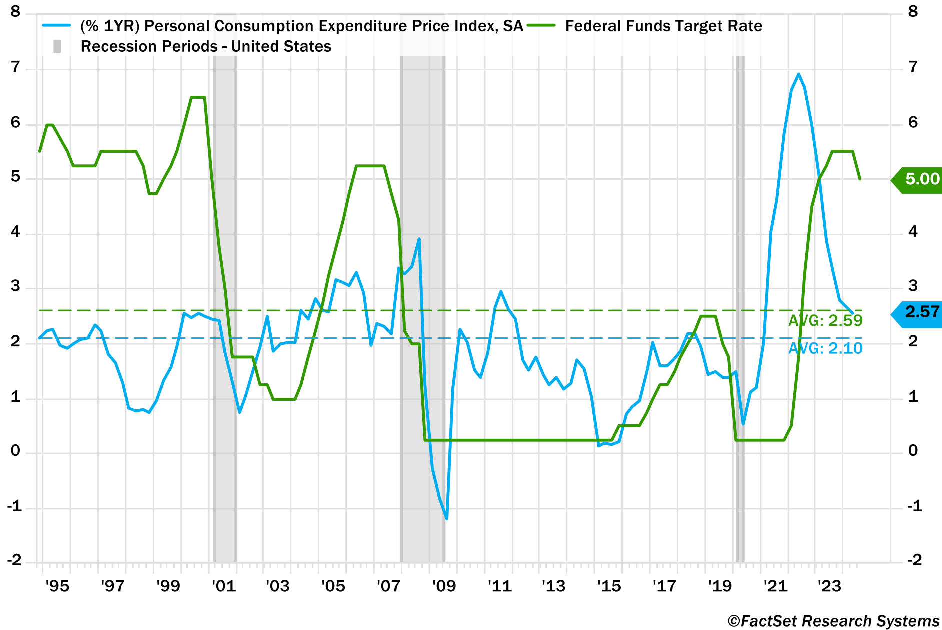
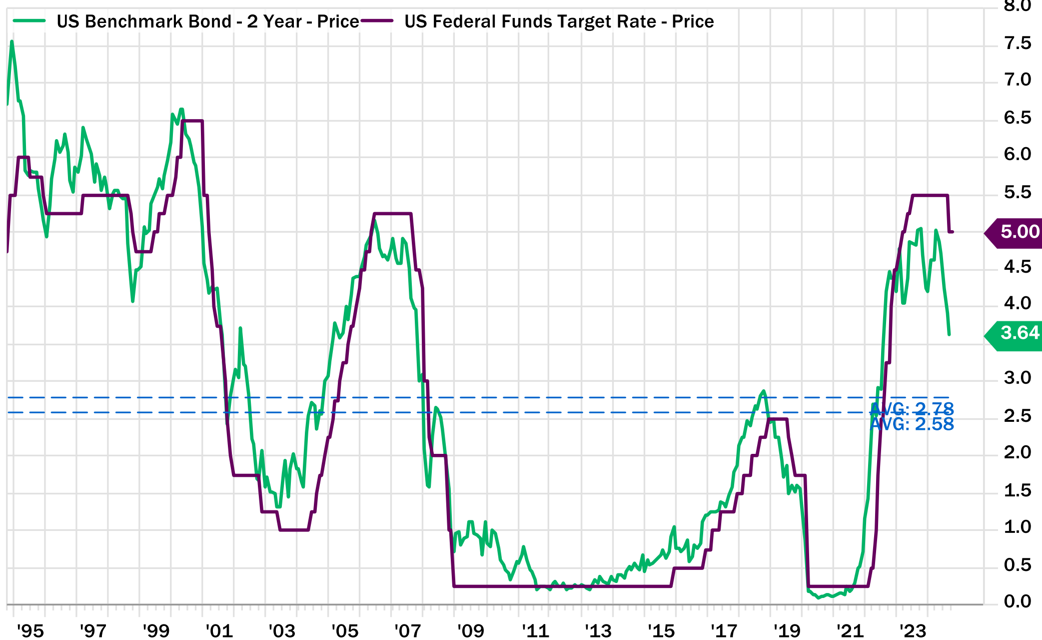


Finally, the analysis is the same if you switch the comparison from inflation measures to intermediate -term interest rates. History indicates that the average spread between the 2-year U.S. Treasury and Fed Funds is about 0.20% with the Treasury note typically sporting a higher rate than Fed Funds. This comparison is important since the bond market is usually more prescient in showing proper interest rate levels and the direction of the economy. So, if the average spread of the 2-year U.S. Treasury is 0.20% above Fed Funds, where does the spread sit today?



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Although the 2-year U.S. Treasury indicates the Fed Funds should be around 3.50% (3.64% minus the average long-term spread of 0.20%), the actual Fed Funds rate is 5.00%.

Not only are all three of these spreads out of line with 30 years of history, all three point to the Federal Reserve being 1%-2% behind in easing interest rates…if you assume inflation has stopped normalizing lower. The divergence between the Fed Funds rate and these three measures has rarely been this high and has always reverted to long-term averages. Unless inflation and longer-term interest rates make a quick U-turn, the Fed will have outsized easing measures in its future to properly set interest rate policy and avoid a recession. ■

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