This Crazy Rate Cut

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The narrative that the U.S. economy is in trouble – some say teetering on the edge of recession - has become so powerful and persuasive that few investors give it a second thought. So of course, they believe, the Fed should cut interest rates. We haven't seen anything like it since the Fed was hiking rates in the deflationary late- '90s. Those rate hikes, which were totally unwarranted, ended up causing a recession.

The rate cuts that the Fed now seems to be planning are equally unwarranted. The dovish tones arose back in the fourth quarter of 2018, when the U.S. stock market experienced a correction while the Fed was lifting rates. Many believe this correction ended when the Fed signaled an end to rate hikes. But simply put, no one really knows if this was correlation or causation. We believe it was the former...pure happenstance.

The Fed is not tight. No way, no how. The federal funds rate is currently 2.375% and no one can look at us with a straight face and say that this interest rate is keeping anyone, anywhere from making an investment.

Of more important note, every prior Fed-induced recession happened because the Fed withdrew reserves from the system, pushing up interest rates. It was the lack of money - the squeeze on reserves – that pushed interest rates higher and caused the recession. Rates themselves don't cause recessions, it's the reason rates move that really matters.

Today, the Fed still has $1.4 trillion in excess reserves in the system, so it can hardly be called tight by any stretch of the imagination. It is when the Fed withdraws too many reserves, pushing the federal funds rate above the pace of nominal GDP growth, that the economic tides turn toward recession. So how close are we now? Over the past two years, nominal GDP is up at a 4.8% annualized rate, twice the current federal funds rate.

Some argue a slowdown in foreign growth should have the Fed concerned. But we know of no U.S. recession ever caused by weakness overseas. Japan collapsed in the 1990s, the U.S. boomed.

It is true there have been some weak economic data points of late. The bears have been pointing, for example, to the Markit Services and Manufacturing indices. But, these are surveys and have never, to our knowledge, been successfully used to predict a recession.

Others are fretting over the tepid 75,000 new jobs added in May. But since this recovery began, the initial payroll reports have come in weak on multiple occasions without signaling recession, just look at May 2012, or December 2013, or May 2016, or September 2017, or February 2019. All months at first came in weaker than the May report and not one signaled recession.

What investors should be focused on is initial unemployment claims as a share of total employment at the lowest reading ever. Job openings, meanwhile, are 1.6 million greater than the total unemployed. Retail sales are booming, up 10.9% in the past three months at an annual rate. After revisions, real GDP likely grew 3.3% at an annual rate in Q1 and is likely to rise 2.0% in Q2 (held down by a 1.0 point slowdown in inventories). There is absolutely no evidence of recession.

The worst part of the proposed rate cut is that all those who think they see a recession will become convinced that the Fed avoided it, even though it was never coming.

It's true that inverted yield curves, as we now see between the 3-month and 10-year Treasury yields, often proceed recessions. But typically, those inversions have happened when the Fed took out too many reserves from the system, which is not the case today. Instead, today's inversion is based, completely, on the market pricing in rate cuts. This is not your father's yield curve inversion.

We think a rate cut is crazy. However, it makes our bullish case for stocks even easier to defend, in spite of the fact that we think the Fed would be sowing the seeds of future economic problems.