Citi Wealth

# Investment Strategy *Bulletin*

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## ‘Hawkish Rate Cut’ Helps Rationalize Markets

- The Federal Reserve reduced the Fed funds rate by 25 basis points Wednesday, taking its key policy rate down by 100 basis points in 2024. However, the global market reaction was sharply negative to the Fed’s revision to its policy rate view for 2025, which rose from 3.4% to 3.9% (this means the Fed still expects two 25 basis point rate cuts next year and more beyond).
- The US 2-year Treasury yield had already risen 85 basis points since late September to 4.35% before the Fed’s announcement. This most likely overshoots the Fed’s policy path (the Fed expects the funds rate to end 2026 at 3.4%). The 1-year US T-bill yield rose just 5 basis points in reaction to the Fed’s new forecasts. This shows how much shorter-duration fixed income had reacted to strong growth and inflation news prior to the Fed’s announcement.
- The broader reaction in global financial markets late Wednesday was much stronger than in interest rates. Across all market caps, US equities fell 3.2%. The US dollar index jumped 1.0% on the day.

## Potential Portfolio Implications

- The Fed adjusted its long-term outlook for US policy rates by a mere 10 basis points from 2.9% to 3.0%. Its upgraded US growth forecast – still slightly weaker than our own – acknowledges what markets already priced: the case for very large rate cuts is weak. It pushed the timing of “full policy normalization” off by a year. The bond market had already done so.
- “News” is often a mere justification for lurches in markets driven by investor positioning. Market participation is already thinning for the year-end holiday period, leaving asset prices more volatile. “Momentum trades” of 2024 were already losing altitude before the Fed’s press conference. While some markets won’t end 2024 at their highs of the year, the drop in valuations will improve future returns.
- As we noted in our Wealth Outlook 2025, we expect rising market volatility and long-term interest rates to drift slightly higher next year. Yet we now believe global markets are less vulnerable to disappointment from the Fed.
- Like markets, the Fed will need to consider US policies on tariffs and immigration in its inflation and growth outlook. We believe the subtle slowing in the US labor market will still be the Fed’s paramount concern. While always uncertain, our base case expectation for a 3.75% policy rate is unchanged. It’s a far cry from the 1.7% US policy rate average of the past 20 years.

# Can You Say, “Slowing the Lowering”?

As 2024 comes to an end, the Federal Reserve raised its estimate for US growth this past year from 2.0% to 2.5%. It raised its expectation for core inflation by 0.3% next year to 2.5%. Despite this, the Fed concluded its final policy meeting of 2024 with another 25 basis point rate cut, taking its policy rate down 100 basis points since September. As a base case, it doesn’t intend to stop rate cuts altogether (see **FIGURE 1**).

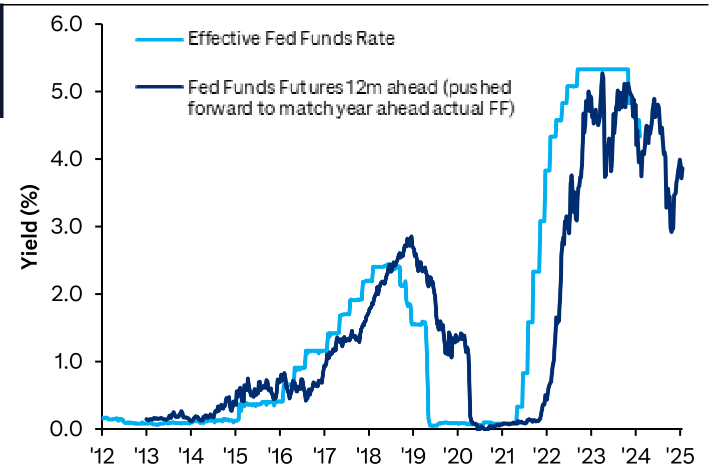
With the Fed revising its “internal consensus” of forecasts only once every three months, markets had already adjusted to stronger growth and inflation news since September. This has sent the two-year US Treasury yield higher by 85 basis points to 4.35%. This is well above the Fed’s projections for the average Fed funds rate which is near 3.9% over the period. The two-year yield should roughly mimic this. As **FIGURE 2** shows, futures markets have also priced in a mere two Fed rate cuts next year in line with the Fed’s update.

All of this should have been a recipe for “non-reaction” in markets. The Fed’s forecast is not surprising. But instead, US equities markets fell sharply and the US dollar surged 1% across currencies late Wednesday.

**FIGURE 1**: Updated Summary of Economic Projections (SEP) from the Fed

| Variable | 2024 | 2025 | 2026 | 2027 | Longer run |
|---|---|---|---|---|---|
| Change in real GDP | 2.5 | 2.1 | 2.0 | 1.9 | 1.8 |
| September projection | 2.0 | 2.0 | 2.0 | 2.0 | 1.8 |
| Unemployment rate | 4.2 | 4.3 | 4.3 | 4.3 | 4.2 |
| September projection | 4.4 | 4.4 | 4.3 | 4.2 | 4.2 |
| PCE inflation | 2.4 | 2.5 | 2.1 | 2.0 | 2.0 |
| September projection | 2.3 | 2.1 | 2.0 | 2.0 | 2.0 |
| Core PCE inflation | 2.8 | 2.5 | 2.2 | 2.0 | |
| September projection | 2.6 | 2.2 | 2.0 | 2.0 | |
| Federal funds rate | 4.4 | 3.9 | 3.4 | 3.1 | 3.0 |
| September projection | 4.4 | 3.4 | 2.9 | 2.9 | 2.9 |

**FIGURE 2**: Fed funds rate and futures expectations




Source: Federal Reserve and Haver Analytics as of December 18, 2024. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. **Past performance is no guarantee of future results. Real results may vary.**

Historically, December is a time when the Fed usually attempts to minimize its impact given poor year-end market liquidity. It might well have viewed markets as well positioned for the updated forecast for reasons we cited above. Yet in effect, financial markets experienced a tightening of financial conditions (the US dollar and yields across all credit types rose while equities fell.)

Yet context is most important. At its December high, the S&P 500 generated a 29% year-to-date total return. This is with a less than 10% EPS gain estimated for 2024. At its recent high, the Nasdaq composite was up 33% for 2024.

Meanwhile, “market breadth” has been stalling this month as the market couldn’t stretch to higher levels (see **FIGURE 3**). The “easy money” trades of 2024 – from gold to tech stocks – have seen a break in the upward momentum (see **FIGURE 4**). This started before the Fed’s press conference of December 18. In essence, the Fed’s message simply served as an excuse to clear out some excessive risk taking.

**FIGURE 3:** S&P 500 and net advancing issues

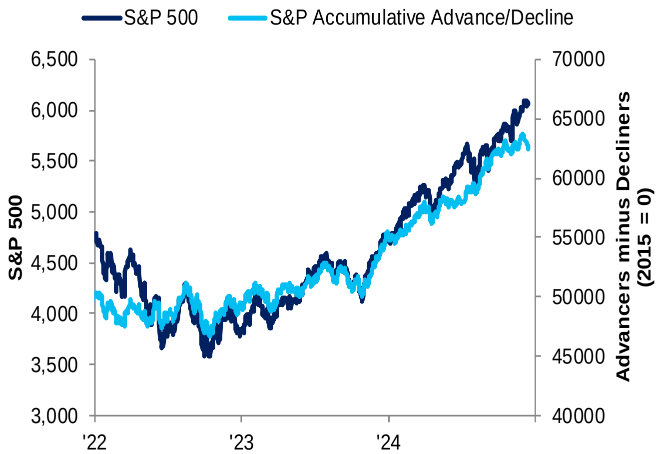
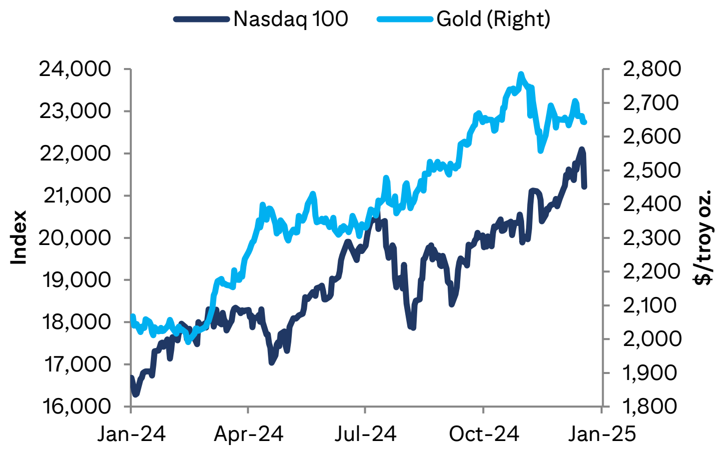



**FIGURE 4**: Nasdaq 100 vs gold price per ounce




Source: Factset as of December 18, 2024. The S&P Accumulative Advance/Decline is calculated as the cumulative daily number of advancing names by the number of declining names. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which wo uld lower performance. **Past performance is no guarantee of future results. Real results may vary.**

## Higher volatility and more moderate returns

As we discussed in last week's CIO Bulletin, the 54% gain for the S&P 500 in the past two years came from a depressed 2022 (-19% that year). Still, the pace of equity market gains has been unsustainably rapid.

We expect overall corporate profits to grow at high single-digit pace in both 2025 and 2026 and the Fed to carry through with a further modest policy easing to protect the labor market.

As we discussed in our Wealth Outlook 2025, the weakness in corporate profits and the economy in 2023 leaves the economic recovery at a less advanced "age" than many believe. With this, we continue to expect a wider swath of US and global equities to make progress in 2025.

As Fed Chair Powell noted, the "lags" in normalizing the economy are still at work. He used the late timing of realized insurance costs, in some cases ratified by state governments, as a prime example of why consumer prices have not come down quickly. These same dynamics do not bear on the future inflation outlook.

At a much larger share of US inflation measures than insurance, shelter price inflation is coming down with the usual long lag in measurement (see **FIGURE 5**). Early year price spikes may again spook markets in 2025. And as Powell noted, the Fed will have to take tariffs and other new administration policies into account. It is unlikely, however, that the Fed will see itself as failing to return inflation to a level consistent with its long-term target.

## Fed policy expectations are highly variable

As **FIGURE 2** showed, market expectations for Fed policy rates are highly erratic. At the same time, we hear many investors argue that the Fed should set rates at a stable level and not "tinker." This is simply inconsistent with the Fed's historic behavior. The Fed has constantly adjusted monetary policy to evolving US labor market conditions which are much more variable than in other economies. As **FIGURE 6** shows, a substantial decline in open job postings is consistent with a rising unemployment rate. As Powell has said, the Fed has no desire to see this continue. For this reason, we continue to expect three quarter-point rate cuts in 2025, taking the Fed funds rate to 3.75% at its higher bound.

**FIGURE 5:** US CPI for shelter and new tenant rent Y/Y%

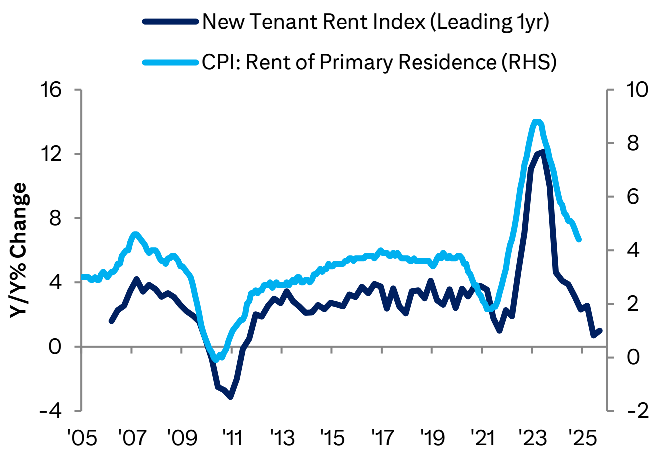
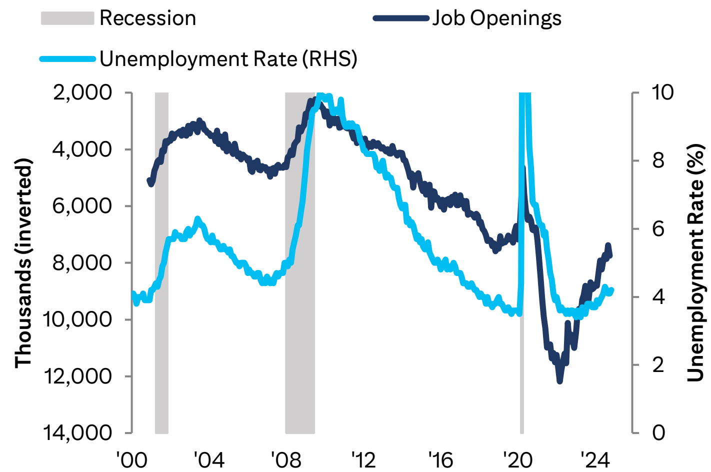



**FIGURE 6:** US job openings (inverted scale) and unemployment rate




Source: Haver Analytics as of December 18, 2024. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. **Past performance is no guarantee of future results. Real results may vary.**

The history of the past two decades, with the Fed's US policy target rate averaging a mere 1.70%, is unlikely to be repeated in the decade ahead, even if some future recession brings the rate to such a level temporarily. However, as **FIGURE 7** shows, peak rates are not lasting even if investors are back to worrying about "higher for longer" at this moment.

The drop in US equities from December's highs, and especially, the drop in global equities from pre-US election highs, has improved the return outlook for 2025 even if returns were never set to match the 2023-2024 pace. While we still expect long-term bond yields to edge up next year, it is only because of our expectation of persistent growth. With the market reaction of the past month, the probability that monetary policy shocks or disappoints in the coming year has been greatly reduced.

While it would be hard to argue that a 3%-4% pullback in US large cap equities represents greatly diminished expectations, it is consistent with "diminished froth." As discussed in Wealth Outlook 2025, the vast dispersion of value in global equity markets remains the potential opportunity for portfolios, not a return to "hugging cash" in an attempt to time markets (see **FIGURE 9-10**).

**FIGURE 7:** Fed funds rate, 2yr US Treasury yield, and US money market fund average rate

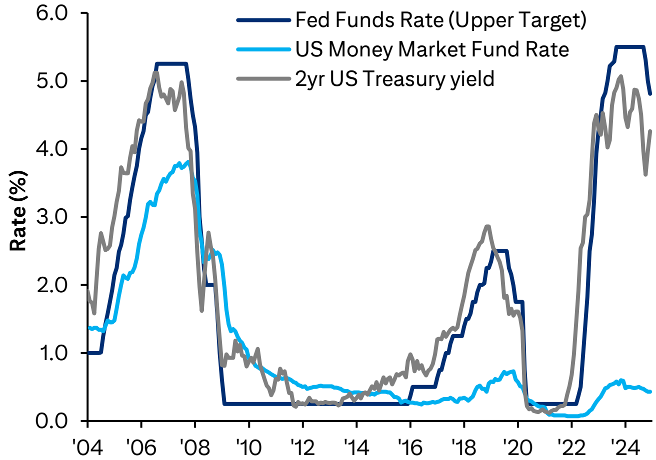
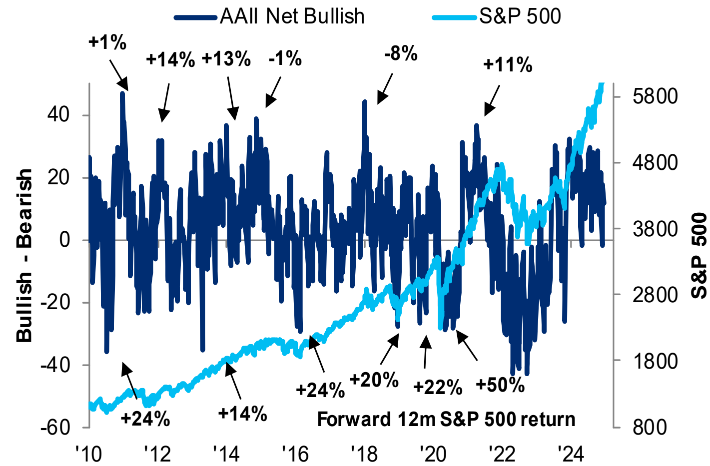



**FIGURE 8**: Individual investor net bullishness vs S&P 500




Source: Haver Analytics and Bloomberg as of December 18, 2024. RHS: arrows and data points represent forward 12-month S&P 500 returns during periods of severely bullish or bearish periods. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. **Past performance is no guarantee of future results. Real results may vary.**

**FIGURE 9:** S&P 400, 500, 600 forward P/E

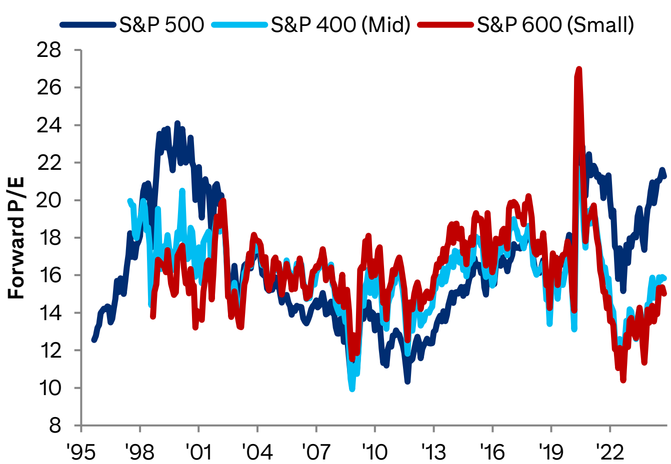
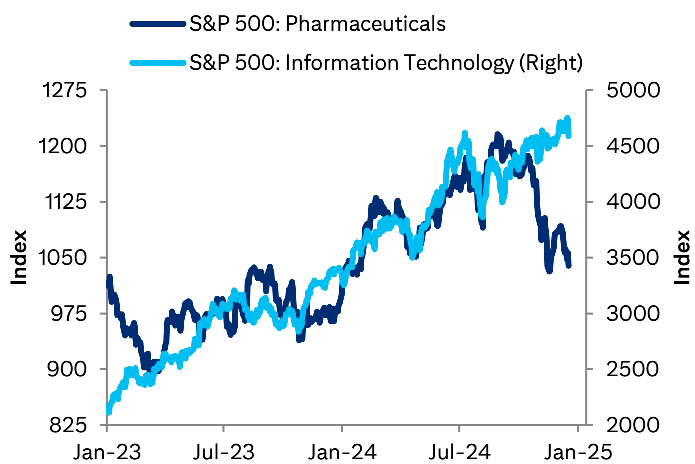



**FIGURE 10**: S&P 500 pharmaceuticals vs information technology




Source: Bloomberg as of December 18, 2024. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. **Past performance is no guarantee of future results. Real results may vary.**

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|---|---|---|---|
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| Highest quality | Aaa | AAA | AAA |
| High quality (very strong) | Aa | AA | AA |
| Upper medium grade (Strong) | A | A | A |
| Medium grade | Baa | BBB | BBB |
| **Not Investment Grade** | | | |
| Lower medium grade (somewhat speculative) | Ba | BB | BB |
| Low grade (speculative) | B | B | B |
| Poor quality (may default) | Caa | CCC | CCC |
| Most speculative | Ca | CC | CC |
| No interest being paid or bankruptcy petition filed | C | D | C |
| In default | C | D | D |

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- volatility of returns;
- restrictions on transferring interests in the Fund;
- potential lack of diversification and resulting higher risk due to concentration of trading authority when a single advisor is utilized;
- absence of information regarding valuations and pricing;
- complex tax structures and delays in tax reporting;
- less regulation and higher fees than mutual funds; and
- manager risk.

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