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Soft Landing and Low Rates are not Compatible

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Markets rallied from October to early December on hopes that the Fed's rate hike campaign has reined in inflation, without damaging the economy significantly, and that the Fed will be in the luxurious position to cut rates for little reason next year, juicing stock returns yet again. Inflation seems to have peaked and is in decline, with the latest reading of November's inflation report coming in at +.1%, better than consensus +.3%, with the headline number at 7.1%. Oil prices are down into the $70's (flat for the year despite the disruption to Russian oil supplies), lower house prices are gradually finding their way into the CPI inflation calculation, and China is slowly opening their economy, which should help supply chains. Meanwhile, the US economy has held up, posting an estimated 2.9% GDP growth for Q3 along with very low unemployment (3.7%). Heading into December the S&P 500 was trading at nearly 18x estimated 2023 earnings (based on $230 consensus), reflecting a fair amount of optimism for next year, despite the bear market and loads of uncertainty.

I hear a lot of talk about inflation being tamed next year and lower interest rates in response to a mild recession that amounts to a tidy soft landing for the economy to reset and get ready for the next robust rebound. While there are market data points that support this, such as the combination of modest credit spreads despite the severely inverted yield curve (see "What is the bond market telling us right now? That depends…"), there are a lot of flaws in this idealist thinking. It will take time for investors to adapt, but we are in a new world, different than the past thirty years, where job #1 for the Fed is keeping inflation at bay instead of stimulating the economy. In this world, stimulus needs to be used far more sparingly than we are accustomed to.

If it is a soft landing, then significant rate cuts into the stimulative zone are unlikely. In the soft landing scenario, the economy hangs tough with a minor slowdown, and inflation subsides enough that the Fed can slow and eventually stop tightening. Job loss is not significant, and neither are defaults. That is certainly a good scenario and is one that the current stock market rally is reflecting. But if this were the path for the economy, it is unlikely the Fed would deliver the rapid pace of rate cuts that the bond market is starting to price. If a soft landing is coming, the bond market, with its 3.5% 10yr yield, could be setting itself up for disappointment.

On the other hand, it could be the bond market that is correct, but those hoping for rapid rate cuts should be careful of what they wish for. With the Fed highly focused on containing inflation, the only motivation for a rapid series of rate cuts would be staring into the eyes of a sizeable recession or to save the stock market after some scary days.

Like always, the truth likely lies somewhere in the middle. Maybe the economy slows and remains uninspiring for some time, rates hikes shrink to 25bp per meeting but continue longer than people think and stay persistently elevated further out the calendar than what is anticipated now. This is not a terrible scenario either, but one that could likely bring additional volatility (in both directions) as expectations are continually revised, markets overreact, and earnings expectations adjust.