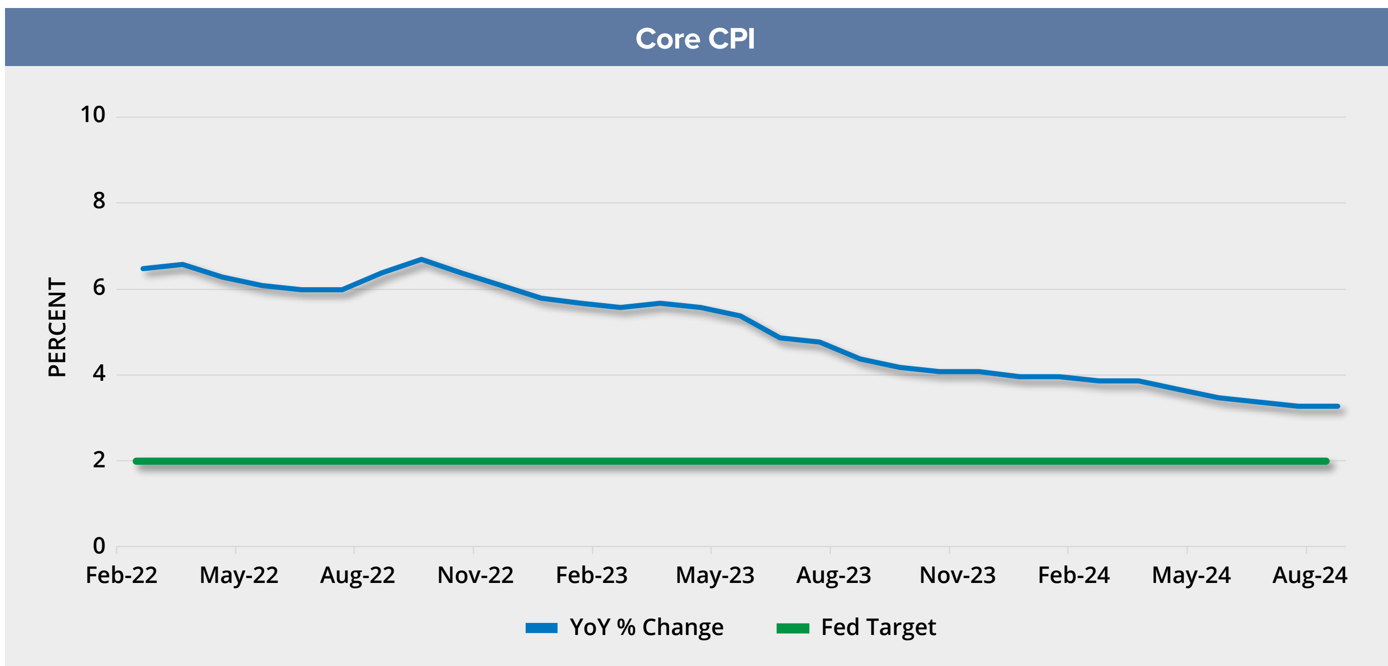
A New Direction With an Uncertain Path

When the Federal Reserve began raising interest rates in March of 2022 to tackle surging inflation, the general expectation was that higher borrowing costs would inevitably slow down economic growth, possibly tipping the U.S. into a recession. Even Fed Chair Jerome Powell acknowledged higher interest rates would "bring some pain to households and business"[1] in his Jackson Hole address that summer.

Fast forward to 2024, and the economic landscape appears more resilient than initially feared. Inflation has moderated while economic growth has sustained its expansion momentum. At this year's Jackson Hole event, Powell declared "the time has come for policy to adjust."[2] As the Federal Reserve embarks on a rate-cutting cycle, the question of pace looms over market sentiment with recent with signs of cooling in the labor market raising concerns that momentum may be at risk of fading.

Inflation Trends and the Fed's Dilemma

Inflation has been a central focus of monetary policy both domestically and internationally since 2022. The most recent data shows that inflation has been cooling in the US, with the Consumer Price Index (CPI) moderating significantly throughout 2024. As of August 2024, core inflation, which excludes volatile food and energy prices, has continued its downward trend, much to the delight of policymakers and market participants alike. The August CPI report indicates a broad-based decline in price pressures, with the core goods component exhibiting deflation. However, some temporary upticks along the way, like the recent spike in monthly inflation readings during the first quarter, highlight the continued volatility that the Fed must consider in its policy decisions.



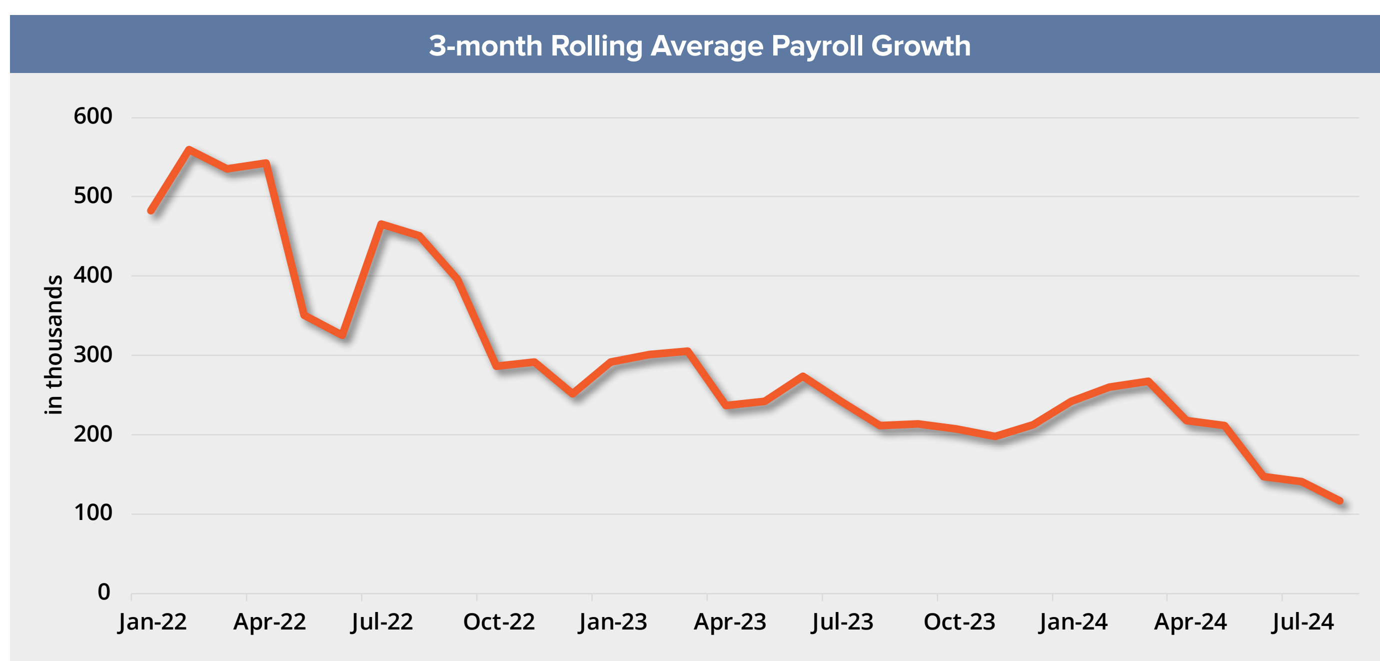
Source: Bloomberg, Bureau of Labor Statistics, 9/12/2024[3]

[1] https://www.federalreserve.gov/newsevents/speech/powell20220826a.htm
[2] https://www.federalreserve.gov/newsevents/speech/powell20240823a.htm

The moderation in inflation suggests that the tight monetary policy has been working as intended, and with the Fed's 2% target in sight, the question has become how fast and how far to go in easing restrictiveness. Powell has made it clear that the Fed now views the risks to growth and inflation on equal footing. The current economic narrative suggests that while inflation appears on track to return to the 2% target level, the Fed is still cautious about reversing course too quickly, especially if the inflation downtrend stalls.

Labor Market Dynamics

The labor market has played an increasingly significant role in shaping the Fed's thinking. Recent data indicates that while job growth continues, there are signs of softening. In August 2024, the U.S. economy added 142,000 jobs (Bureau of Labor Statistics), an acceleration from July, but overall, the pace of job creation has slowed compared to the robust gains seen in previous years. The unemployment rate remains relatively low but has inched up slightly, reflecting a more balanced labor market.



Source: Bureau of Labor Statistics, 9/12/2024

Job openings have also decreased, and wage growth has moderated, suggesting that the tight labor conditions of 2022 and 2023 are easing. This slowdown in the labor market is not necessarily a negative signal but rather a sign of an economy moving towards equilibrium. However, a weakening labor market could compel the Fed to consider more aggressive rate cuts to avoid a deeper slowdown.

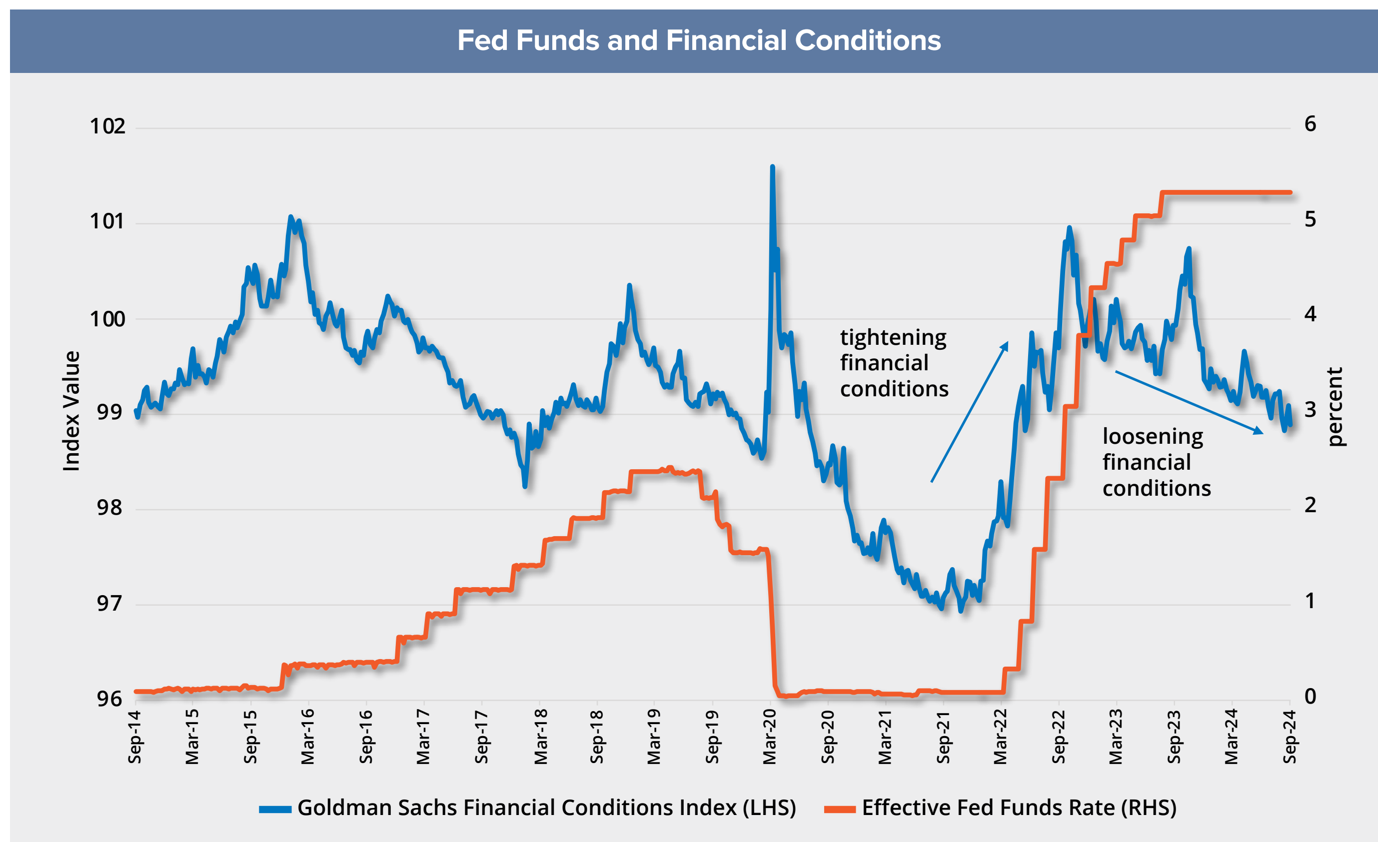
Powell and other Federal Reserve officials have stressed the importance of closely monitoring labor market conditions as they balance the risks of slowing economic growth against the possibility of inflation resurging. Layoffs, tracked by initial weekly jobless claims, serve as a reliable leading indicator of labor market health and will be closely monitored. So far this year, seasonally adjusted initial jobless claims have averaged a modest 222,000 per week (Bureau of Labor Statistics) through September 6.

Factoring in Broader Financial Conditions

Calibrating monetary policy to the evolving economic circumstances is a complicated task. Changes to the fed funds rate do not work in a vacuum. They work through a transmission mechanism of financial

conditions that influence economic activity. “Financial conditions” refers to the overall environment that affects borrowing, lending, and investment decisions. They encompass various factors, including interest rates, credit availability, stock market performance and exchange rates.

With the S&P 500 Index near all-time highs and narrow corporate credit spreads, the Fed must be cautious about adding fuel to the financial market risk-taking fire. The chart below is a measure of financial conditions by Goldman Sachs. Despite the subsequent increases in the fed funds rate, financial conditions, as measured by the Goldman Sachs Financial Conditions Index , have been easing since peaking during the fourth quarter of 2022 and now stand near per-pandemic levels.



Source: Bloomberg, Goldman Sachs, 9/13/2024

Balancing Act: Timing and Pace of Rate Cuts

As the Fed contemplates its next steps, the timing and pace of rate cuts will depend on a mosaic of incoming data. The Fed must carefully balance the need to support economic growth with the imperative of preventing a resurgence of inflation. A cooler labor market could warrant more aggressive cuts, while persistent inflation risks might limit their flexibility to stimulate the economy. Powell has indicated that the Fed will likely proceed cautiously, acknowledging the heighted uncertainty of a post-pandemic economy.

One critical factor will be how quickly inflation moves towards the Fed’s target of 2%. If inflation continues to moderate, the freedom for more aggressive rate cuts improves. However, any signs of inflation picking up, even temporarily, could cause the Fed to scale back on the easing required to support growth. When push comes to shove, the Fed has made it clear there is no greater problem than an inflation problem.

[3]The Goldman Sachs Financial Conditions Index (GSFCI) measures the overall tightness or looseness of financial conditions in an economy. It incorporates factors like interest rates, credit spreads, equity prices, and exchange rates to provide a comprehensive view of the financial environment. A higher index value indicates tighter financial conditions, which may constrain economic activity, while a lower value reflects looser conditions, supporting growth.

A Careful Path Forward

The U.S. economy's unexpected resilience amid high interest rates is a testament to the adaptability of businesses and consumers. As the Fed navigates the path of rate cuts, it will need to carefully weigh the risks of easing too quickly versus easing too slowly. The trajectory of inflation, labor market conditions, and overall financial conditions will guide these decisions, with the goal of achieving a balanced and sustainable economic environment.

At the beginning of the rate hiking cycle in 2022, the mission was unambiguous, yet the ultimate policy path and destination surprised most forecasters. As the Fed embarks on this rate cutting cycle it must be attentive to both sides of its dual mandate. With potentially competing threats in play, the outlook for the future path of monetary policy will be even more uncertain.

James St. Aubin

Chief Investment Officer (CIO)

James St. Aubin, CFA®, CAIA®, is Chief Investment Officer for Sierra Investment Management. He has oversight of all Investment Management department activities, in collaboration with Sierra Co-founders David Wright and Kenneth Sleeper. An experienced investment management executive, his career of more than 20 years includes leadership roles in asset allocation, manager research and portfolio construction. James earned a Bachelor of Science in Finance from DePaul University and is a CFA® and CAIA® Charterholder.

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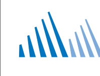

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