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Fed policy remains key for markets in 2024

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Disinflation was our choice for finance Word of the Year (WOTY) 2023. Yet, there's an even better candidate: resilient. Disinflation has been essential for the equity rally, but it's very unlikely the S&P 500 would be up 23% this year if not for surprisingly resilient US growth.

If anything, disinflation would have been faster had there been a recession, and the S&P wouldn't be above 4,700 in that event. Still, what really drove markets this year was "immaculate disinflation"—falling inflation without any sacrifice to growth.

So, what's our prediction for the 2024 finance WOTY? It's "put"—as in Federal Reserve put. The main market debate over the past month has been about when and by how much the Fed will cut rates next year, and whether it will do so preemptively—meaning cut rates even if growth is holding up because inflation has fallen sufficiently. The word "put" gets at what is probably the most important question investors will be asking next year: How much support can they expect from the Fed in 2024?

The focus on Fed policy is unlikely to diminish next year… After two years of Fed policy tightening weighing on markets and causing volatility, one might think the Fed's influence will diminish next year now that it has pivoted. But investors have become conditioned over the past two decades to expect a Fed put when growth weakens and inflation is under control. In this cycle, investors seem especially eager to jump on any signs that rate cuts could happen sooner rather than later. In other words, they'll buy first and ask about the Fed put later.

…but the Fed put need not be invoked quickly… Relative to market pricing for nearly 150 basis points of rate cuts next year, our call for only 75bps implies a Fed put that is still quite a bit out-of-the-money. Fed officials have started to push back against these elevated expectations: First, last Friday with New York Fed President Williams and again on Monday, with Cleveland Fed President Mester saying that markets were “a little bit ahead” in their pricing of rate cuts, and Chicago Fed President Goolsbee stating that he “was confused a bit” by the market reaction.

…nor is it a reason to be overly bullish on risk assets in 2024. Markets are already pricing a swift exercising of an in-the-money Fed put. The bar is high to be positively surprised by Fed actions and relatively low to be disappointed. This is why we still favor quality stocks and bonds. Yet, we also have to respect how potential Fed cuts can influence investor behavior and market rotations, which was one reason for our recent upgrade of US small-cap stocks to most preferred.

The bottom line is that the Fed was a market foe in 2022 as it intentionally tightened financial conditions to bring down inflation. It became a market friend in 2023, especially once a pivot became imminent. Whether the Fed will be more friend or foe in 2024 will depend on how willing it is to cut rates. This year, markets oscillated based on investors shifting probability between soft landing and recession outcomes. Next year, market dynamics are likely to hinge on shifting expectations for rate cuts—i.e., whether the Fed put is perceived to be near versus still far out-of-the-money.

This article is based on “Word of the year III,” by Jason Draho, Head of Asset Allocation, CIO Americas. Read the full blog **here.**

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