Unthinking the Fed

There has been a lot to process since 2pm ET yesterday. First the dots and then the press conference.

I wanted to title this morning's piece **Rethinking the Fed**, but unthinking seems more appropriate. Thinking hasn't necessarily been a good thing in these markets – we've been bullish, but resorted to channeling *Wayne's World* and *Beavis and Butt-Head* – certainly not known as "thinkers."

Let's unthink a couple of things.

We saw 4.3% as a target for 10s and viewed that below 4.2%, lower yields would NOT be supportive for stocks. But that was under the assumption, or view, that the Fed had its foot on the brakes and was willing to risk slowing the economy down too quickly versus letting inflation reignite.

The dots gave some indication that the Fed's "reaction function" had changed. It was 3 cuts instead of 2 in 2024, taking us to 4.625% from 5.125%. Exactly back to where they were in their June projections and well above the 4.25% dots from their March projections. **The dots, I thought, could be somewhat ignored, though they signaled a mindset shift.**

It was the press conference that was extremely telling:

- Powell did not push back on markets or try and "undo" any of the bullishness that the dots and statement elicited (he has in the past, so that was important).
- **He was almost dismissive of any questions regarding how much markets had eased financial conditions since the last meeting**. This shocked me the most as he had every opportunity to use the dramatic market moves to sound hawkish. Hawkish rhetoric was handed to him on a silver platter, and he dismissed it.
- Finally, while not quite doing donuts in a NASCAR or F-1 style victory celebration, he pretty much took a victory lap. We've been pounding the table that inflation fears remain overdone, but even we are struggling to see how the data has changed that much since the last meeting. Feeling more comfortable with the lower inflation calls, but we weren't calling it a victory yet. However, here was the Fed Chair, virtually saying that it was. That too was a major change.

Academy had the privilege of being on Bloomberg TV this morning, and in addition to some of these thoughts, we did address something that we've mentioned a few times since the end of the summer. Basically, we felt that the Fed would be far more reluctant to trigger a recession during an election year, than they were in 2023. We are not saying that the Fed is political. What we are saying is that they know that recessions influence elections (negatively for the incumbents) and we suspected that they would want to avoid that. The tone out of D.C. on inflation and rates has changed noticeably over the course of the year, which supports this somewhat awkward (but realistic) view. So maybe, that played into the shift in tone from the Fed yesterday?

Back to Unthinking the Fed

With all that said and done, our "thought process" (yes, I know I said we don't think, but yeah, there is a thought process) was basically:

- **Below 4.2% on 10s would be difficult UNLESS the data was awful.**
- **If the data was good, the Fed would at least threaten to tap the brakes.**

Neither of those "thoughts" seem valid after yesterday.

My initial reaction was to "fade" the move. I was literally dying to fade the move as we already expressed concern about overstaying our welcome at this party.

But, as we digest everything that went on, we are left wondering if this has just been the "pre-party?"

The Russell 2000 has outperformed the Nasdaq 100 by almost 7% since November 9th (15.6% return versus a 9% return). If futures are any indication (and yes, there are Russell 2000 futures), that outperformance will increase today.

So, we've liked the laggards:

- Small and regional banks
- Small caps
- Commercial Real Estate
- "Disruptive" Tech (they have performed in line with the Nasdaq, but they should be a much higher beta, so it seems like they have lagged, to me)
- I am finally prepared to add energy to this list

Why shouldn't they continue to do well? If the Fed Put is back and if the Fed is going to err to the side of letting things run rather than over-fighting inflation, then why shouldn't we see a big rotation?

Not only are yields lower (helps all potential borrowers) and rate cuts are likely coming (helps floating rate borrowers), but spreads have also compressed! CDX IG, a CDS index of investment grade credit, is at 55 bps, its lowest since 2021. We were looking for it to trade in the 50's (we are here), but with the pivot in the Fed, that index should probably get to the 40's. Maybe high 40's, but 40's nonetheless.

This is all good for the economy and stocks.

Bottom Line

I like the "laggards" even more than I did ahead of the Fed.

I am mildly bullish on the Nasdaq 100, versus neutral. The returns will be heavily skewed towards the laggards.

Credit, already tight in terms of spreads, will see lower spreads.

Rates, probably too far too fast, from 5% to 3.95% in less than two months, but the range has shifted again, this time due to the Fed's stated reaction function.

I would not be surprised to hear some FedSpeak pushing back on yesterday's messaging, but the genie is out of the bottle and isn't going back in any time soon.

We will watch earnings and data, but how we react to that will have shifted as the Fed gives us "hope" that they have given us back our beloved Fed Put!

Finally, we have not seen anything positive out of China, and I still expect to see something where either we produce an olive branch, or they do their own stimulus, or both, which would provide more momentum for all assets!

By the way, **our rising Treasury debt problem has not gone away**, and that will come back as a discussion point, limiting how much lower bond yields can go. But it won't hurt stocks that much (should help the Nasdaq 100 vs Russell 2000 trade I like so much).

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