Business Cycle Update: Plunging Interest Rates, Prelude To Recession And Bad Times?

Saturday's With Jim

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Dear Friends,

Alan Greenspan's Federal Reserve was masterful in raising interest rates without a recession, except for the rate bumps in early 2000 when it was clear that Y2K was a dud and the world didn't collapse. Can the current Fed repeat Greenspan's magic of raising rates and then cutting them quickly when they appeared in conflict with a certain indicator he used as an alert when the Fed raised too much and needed to cut? Now we have the Powell Fed. Greenspan's indicator now shows that the Fed needs to cut soon or risk slowing the economy excessively. But will they comply? We think that despite the atmospherics about the duel between political control and independence the Fed should take back the rate increase they made in December, the one which caused the last leg of the market correction that began in October.

We're experiencing late cycle economic and market dynamics – increased volatility (uncertainty of outcome) and interest rates that may have peaked for the cycle if the economy does not regain its momentum. We're telling you that the economy may be showing signs that a downturn is coming, yet from the street you see almost full employment, little inflation and a good environment for consumers. What's the disconnect?

Interest rates have dropped steeply, particularly in the longer maturities like 10 years and 30 years. The 30-year rate dropped from 3.3% last Fall to 2.87% today, a roughly 15% plunge in about a month and a half. Falling long-term rates will boost the economy to the extent that people want to refinance or to increase their debt, but falling rates often foretell an economic downturn to come.

Summing Up

Falling long term-rates have left them dangerously close to short-term (3-month) rates. The Federal Reserve controls the short-term debt market, so it's logical that they cut the rates they control to preserve "carry" between short-term rates and long-term ones. We think that the economy is not far from a low point as falling rates act as an economic stimulant while at the same time other major central banks and governments are stimulating their economies. Quick Fed rate cutting action will likely prolong the long bull market in stocks, high yield bonds and real estate. There remain huge challenges ahead, however. Policy mistakes not quickly corrected could sink this bull and the economy with it. But that's a story for another time.