CETERA® INVESTMENT MANAGEMENT

COMMENTARY

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What Changing Fed Policy Means for Portfolios, Money Market Assets

- With inflation moderating, the Fed will likely pause their interest rate hikes soon.
- A change in Fed policy impacts asset classes differently.
- Depending on objectives, reassessing money market allocations may be warranted.

Many investors have been tactically holding more cash in their portfolios as the Fed has pushed short-term interest rates from close to zero to over 5%. Subsequently, money market assets have climbed from nearly $3.5 trillion before the pandemic to over $5.5 trillion. However, the likelihood of an upcoming Fed pause, and eventual pivot, could prove to be a great opportunity to put some excess cash back to work in more traditional risk asset classes, like equity and fixed income.

Federal Reserve (Fed) Chair Jerome Powell recently delivered an update on the outlook of the American economy, following days of meetings with fellow central bank officials in Jackson Hole, Wyoming for their yearly economic symposium. While acknowledging the progress against the fight against inflation, he was stern that future rate hikes could be necessary. Also, while we don't know when the Fed will pause and eventually pivot, investors are forward-looking, and the stock market is often said to anticipate nine months in the future. The stock market could begin to price in the optimistic news well before the Fed's actions.

So why do so many people think the Fed will pause soon and perhaps cut rates in 2024? If we listen to the Fed, they have repeatedly said they would be data dependent. If we look at the data, the headline Consumer Price Index (CPI) for July was 3.2%, down from June 2022's peak of 9.1%. Core CPI (which excludes volatile food and energy) remains more elevated at 4.7%, but that's similarly down from 2022's high of 6.6% in September. Inflation data seems to strongly suggest that the worst of inflation is likely behind us.

An interest rate pause and/or cut would be welcomed by equity investors, as equities could benefit from lower rates. Lower rates equate to lower borrowing costs to expand operations, and thereby generating more growth. And when companies can more cheaply borrow and deploy extra cash to expand operations, investors are often willing to pay more to own a slice of those companies, hence driving equity prices higher. An overall market environment of falling rates is generally seen as stimulating for the economy and equity markets.

However, a pause in rate hikes might signal that Fed officials believe a recession could be lurking. While equity investors should be optimistic about a Fed pause and the potential of future rate cuts, they should not underestimate the reasons for the pause and rate cuts. While we currently think a possible recession could be mild, one should consider long-term objectives when allocating to equities. There could be more volatility in the near term.

Bond investors on the other hand could potentially benefit from both a recession and corresponding rate cuts. In a recession, investors usually flock to high quality bonds for safety, driving up bond prices. Additionally, bond prices move inversely to bond yields. If the Fed cuts rates, this could drive up bond prices more. Any price appreciation would be in addition to the bond yields investors are already receiving. While bonds currently yield less than money market rates, money market rates will drop when the Fed cuts rates and they won't benefit from any price appreciation.

We reiterate the importance of having a long-term investing plan that comprehensively addresses personal goals, time horizon, risk tolerance, and many other factors unique to each investor's situation. Investors should consider whether now is an appropriate time to reassess their cash allocations, since many investors have been tactically keeping cash on the sidelines. Both equities and fixed income strategies could benefit from a change in Fed policy. As always, please connect with your financial professional with any questions on tailoring the appropriate portfolio to your personal situation.

This report is created by Cetera Investment Management LLC. For more insights and information from the team, follow @CeteraIM on Twitter.

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Glossary

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