The "Fed put" is back

18 December 2023

Dear Clients and Partners,

With somewhat unexpected timing, Jerome Powell has sent a powerful message to investors around the world: The Fed means to leave behind its restrictive monetary policy in 2024. Risky assets as a whole are favourably impacted by this pivot in US monetary policy.

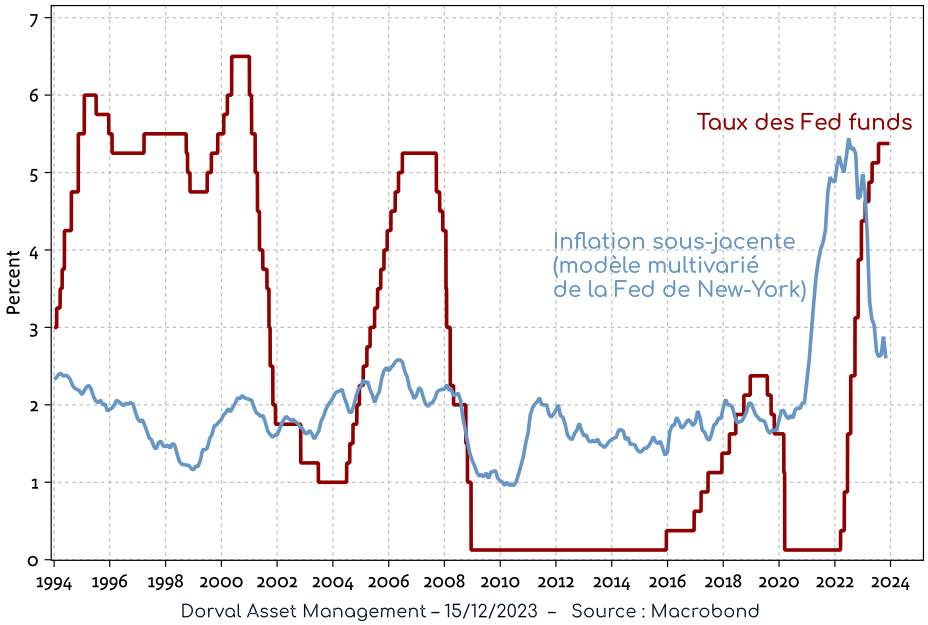
Jerome Powell announced on 13 December that although the possibility of further rate hikes could not be ruled out, the timing and extent of rate cuts would drive internal discussions within the Federal Reserve. Confirming a Fed pivot, he clarified that the Fed would not wait for year-on-year inflation to return to 2% before cutting rates, as it must act preventively. With rates close to 5.5%, core inflation likely already close to 2% and the expected economic impact of the strongest rate hikes since the start of the 1980s, the Fed considers its policy to be decidedly restrictive – a policy which is less and less justified (cf. chart 1).

The Fed considers its policy to be decidedly restrictive

Fed rates are significantly above inflation, having risen hard and fast

La Fed se considère comme nettement restrictive

Les taux Fed sont nettement au-dessus de l'inflation, et ils ont monté vite et fort



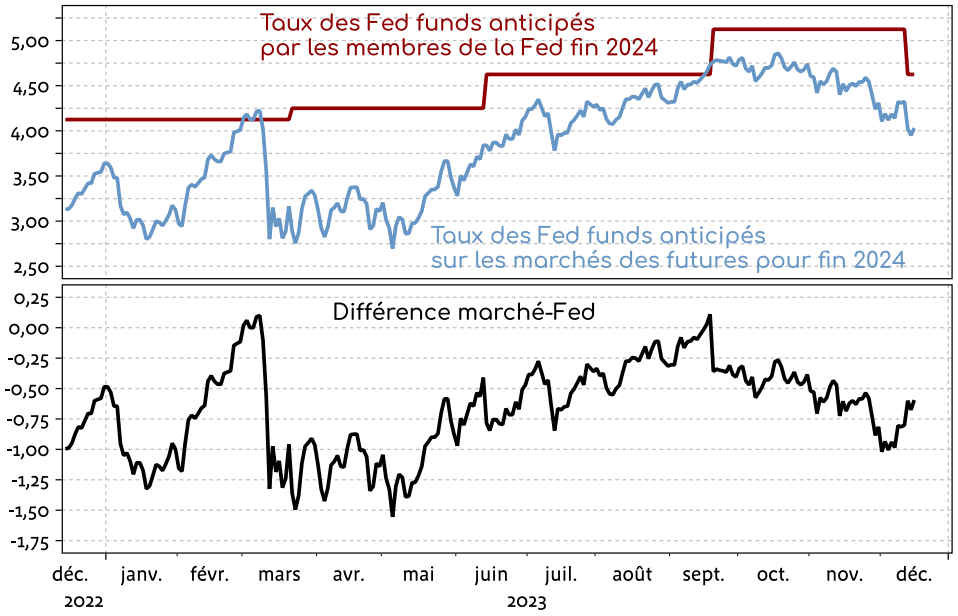
Dorval Asset Management – 15/12/2023 – Source : Macrobond

- *Federal funds rate / Core inflation (New York Fed multivariate model)*

With just one exception, almost all Fed members now believe that interest rates will drop in 2024, with most of them predicting a fall of 50 to 100 basis points. The markets are now going further, anticipating a drop of 125 to 150 basis points. This difference is nothing out of the ordinary, however; its level sits within the mid-range of what we have seen since the start of the year (cf. chart 2). These anticipations will of course continue to be influenced by macroeconomic data and comments from Fed members. Barring any shocks, Jerome Powell's pivot should nevertheless help to cement expectations on the more optimistic side. Finally, the fact that inflation has virtually disappeared despite a dynamic economy is encouraging investors to anticipate sharp Fed rate cuts should the economy slow down in 2024 as forecast by consensus. The famous "Fed put" is back.

The markets are more optimistic than the Fed, but not unusually so

Les marchés plus optimistes que la Fed,
mais pas plus que d'habitude



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- *Fed funds rate anticipated by Fed members for the end of 2024 / Fed funds rate anticipated on the futures markets for the end of 2024*
- *Difference in market and Fed rate anticipations*
- *Dec. Jan. Feb. Mar. Apr. May Jun. Jul. Aug. Sep. Oct. Nov. Dec.*

This resurgence of central banks creating positive asymmetry on the financial markets – no rate hikes if the economy is doing well, sharp rate cuts if it is not – has yet to be implemented in Europe. Lagging a few quarters behind the United States, and with particularities linked to the energy shock of summer 2022, European inflation still has not entirely reassured the ECB. There are sometimes still second-round effects on certain service sectors and wages, and, despite the very strong recent inflation figures, Christine Lagarde has not yet indicated that there is consensus regarding a pivot. But with the economy flagging, it is hard to believe that the ECB will hold firm in this stance for long; indeed, some members are no longer hesitant to speak openly about rate cuts.

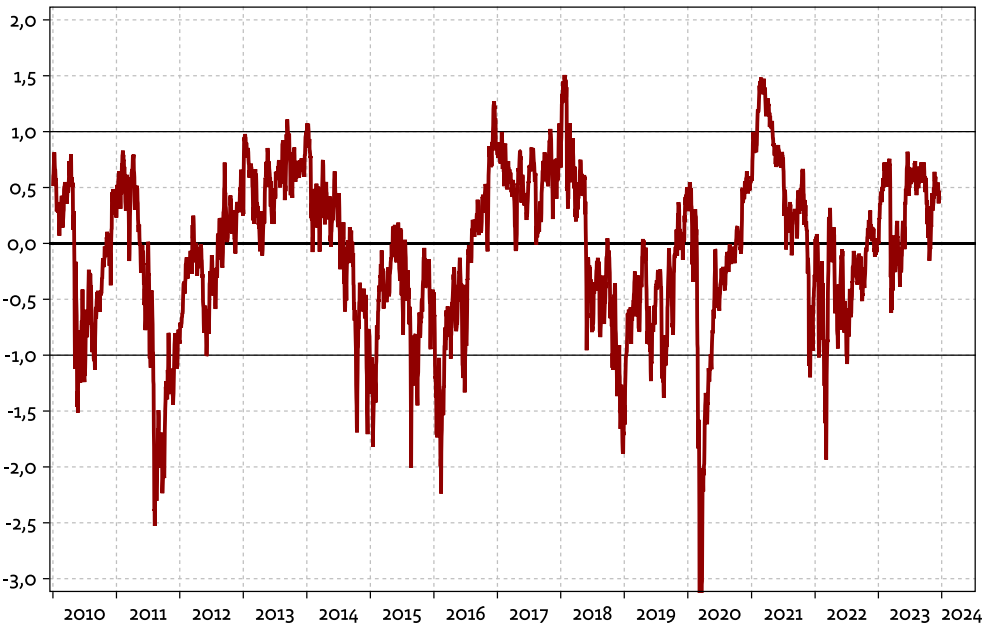
As ever, the financial markets have mainly listened to the Fed's message. Changes in US monetary policy remain the ultimate guide for financial markets worldwide. Following the good news and the rapid increases in the markets over the last few weeks, a consolidation is certainly possible. Barring any shocks, risk appetite should remain strong, although it has not yet reached extreme levels according to indicators compiled by Goldman Sachs (cf. chart 3).

The Fed pivot should bolster risk appetite

Goldman Sachs indicator of risk appetite on the global markets

Le pivot de la Fed devrait soutenir l'appétit pour le risque

Indicateur Goldman Sachs d'appétit pour le risque sur les marchés globaux



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As the scenario underpinning our global diversified funds already includes a potential "put" by central banks, our positioning remains as follows: overweighting of equities, a moderate bond duration for hedging, and returns on money market instruments in euro. We have, however, added a position in 10-year Italian bonds in anticipation of an ECB pivot. By the same token, we are maintaining a high exposure to equities in our flexible European funds.

Our exposure rates are as follows:

- **Dorval Convictions:** The equity exposure rate is 81%.

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