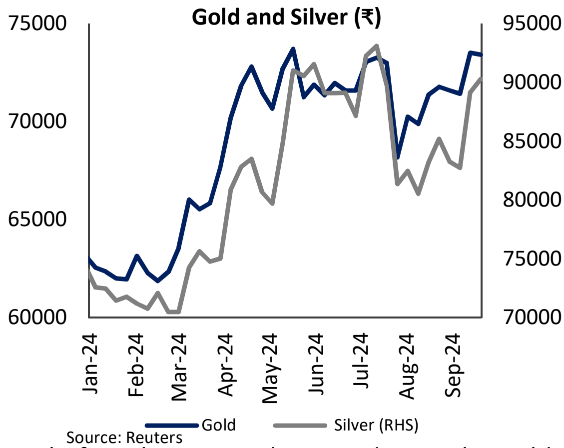
MOTILAL OSWAL
WEALTH MANAGEMENT

COMMODITIES INSIGHT

Fed on the 'Loose'!!!

19th September 2024



Source: Reuters

Gold marked all time on COMEX marking ~25% YTD gains, similarly Silver has posted YTD gains of ~30%. There have been several factors supporting this rally on higher side for both metals like Geo-political tensions, rally in industrial metals, speculative buying, mixed economic data points and a few others. However, one of the most important factor especially this year which has triggered volatility in safe haven assets is the expectations of rate cut by the Fed. Expectations for an early rate cut is being priced into markets since the beginning of the year, while Fed policymakers have been easing those concerns, keeping market participants on the edge.

The central bank raised rates 11 times starting in early 2022 in a bid to curb sky high inflation. Now the Fed cut rates for the first time in four years i.e. after pandemic. The effect of rate cuts shows even before they start. This is evident in the yield on the 10-year Treasury, which has fallen to ~3.65%. This puts it a full percentage point below where it was in April'24 and well below the 5% in hit last October. Dollar Index has also witnessed higher swings in the past few months on the back of mixed economic data and change in interest rate cut expectations.

Fluctuations till now

This year, Governor Powell and Federal Reserve officials have consistently prepared the market for potential reactions ahead of each meeting. Throughout 2023, market participants largely anticipated a 25 basis point rate cut, but Fed officials have repeatedly cautioned against this expectation, suggesting a possible pause instead. However, during the Jackson Hole symposium, Governor Powell reignited discussions around the prospect of a rate cut, shifting the narrative. For the first time before the September meeting, the debate evolved from simply considering a pause versus a 25 basis point cut to weighing the possibility of a 50 basis point cut. This shift marked a significant turning point in market sentiment, as evidenced by increased volatility driven by the CME Fed-Watch Tool. This tool has become a critical indicator, reflecting and influencing traders' expectations as they navigate the complexities of monetary policy. As the Fed continues to assess economic conditions, the evolving debate around interest rates highlights the delicate balance officials must strike to guide the economy while managing market reactions.

Major Economic indicators

The possibility of a Federal Reserve rate cut hinges on a nuanced analysis of current economic indicators. From the peak of 9% in 2022, the U.S. Consumer Price Index (CPI) has shown a significant easing, reflecting a deceleration in inflationary pressures. This decline could signal to the Fed that the aggressive monetary tightening of the past is yielding results, potentially creating room for a more accommodative policy stance. Meanwhile, the U.S. GDP remains stable, consistently above 2%, suggesting that economic growth is resilient despite rising interest rates. Additionally, while the labor market is showing

Major economic indicator signalling a rate cut		
US CPI		Since Jan'24
US GDP		Since Mar'22
US Non-farm Payroll		Since Jan'24
US Unemploment rate		Since Jan'24

Source: Reuters

signs of easing—indicated by a slight uptick in unemployment claims and reduced job openings—it remains relatively strong, with wages continuing to grow. Till now all focus was on bringing inflation down, however with unemployment rate above 4% and slowdown in job additions, Fed officials looked this as right time to put rate cut discussions on table.

Below mentioned table shows us the market reaction of Fed this year on Dollar Index, Gold and Silver prices:

	Dollar Index				Silver ($)				Gold ($)		
Fed meeting Date	**1 week prior**	**On the day of Fed meeting**	**1 week post**		**1 week prior**	**On the day of Fed meeting**	**1 week post**		**1 week prior**	**On the day of Fed meeting**	**1 week post**
31-Jul-24	-0.28%	-0.44%	-0.86%		0.17%	2.29%	-8.40%		2.11%	1.65%	-2.72%
12-Jun-24	0.36%	-0.56%	0.58%		-1.03%	1.50%	0.19%		-1.37%	0.27%	0.21%
01-May-24	-0.10%	-0.44%	-0.20%		-1.97%	1.37%	2.63%		0.09%	1.41%	-0.40%
20-Mar-24	0.61%	-0.41%	0.90%		2.30%	2.81%	-3.71%		0.53%	1.33%	0.37%
31-Jan-24	0.04%	-0.12%	0.76%		0.97%	-1.07%	-3.19%		1.22%	0.05%	-0.15%
13-Dec-23	-1.23%	-0.96%	-0.45%		-0.53%	4.38%	1.61%		0.07%	2.37%	0.14%

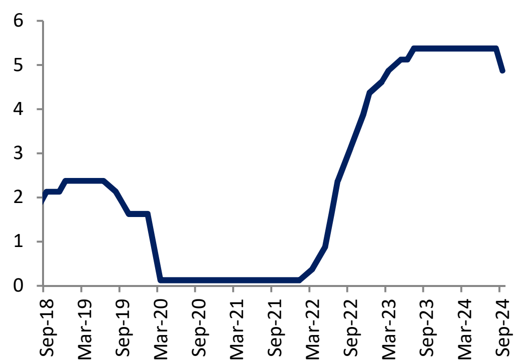
Source: Reuters

What happened in the September meeting?

Federal Reserve cut its benchmark interest rate by half a percentage point and signalled more reductions would follow, launching its first easing cycle since the onset of the pandemic. The US central bank's first cut in more than four years leaves the federal funds rate at a range of 4.75 per cent to 5 per cent. Michelle Bowman, a member of the Federal Open Market Committee, voted in favour of a quarter-point cut — the first Fed governor since 2005 to dissent from a rate decision.

In the latest "dot plot" of officials' forecasts, most expected the policy rate would fall to 4.25 per cent to 4.5 per cent by the end of 2024, suggesting another large half-point reduction at either of the two remaining meetings this year or two quarter-point reductions. Overall, that is a significantly larger reduction than the quarter-point cut projected by most officials in June, when the dot plot was last updated. FOMC officials raised their expected unemployment rate this year to 4.4%, from the 4% projection at the last update in June, and lowered the inflation outlook to 2.3% from 2.6% previous.

Fed's Target Rate (%)



Source: Reuters

Impact and Reactions

In an immediate reaction, Gold and Silver prices were up by more than 1% post the announcement. However, Governor Powell in his comments mentioned that rates were not on a "pre-set" path, noting that if inflation proved sticky the Fed could "dial back policy restraint more slowly". Equally, the central bank was "prepared to respond" if the labour market weakened unexpectedly, he added. While the Fed approved the rate cut, it left in place a program in which it is slowly reducing the size of its bond holdings. The process, aka. "quantitative tightening," has brought the Fed's balance sheet down to $7.2 trillion, a reduction of about $1.7 trillion from its peak. The Fed is allowing up to $50 billion a month in maturing Treasury's and mortgage-backed securities to roll off each month, down from the initial $95 billion when QT started.

Overtime these cuts will ripple their way through the economy. Every rate cutting cycle is different than the other and economy's response is both long and variable. It takes time for lower interest rates to translate into faster investment growth. Infact, Milton Friedman speaking before congress in 1959 linked the changes in Fed's policy changes to "a water tap that you turn on now and that then only starts to run 6,9, 12, 16 months from now. Normally there is a template and a pattern wherein the balance between growth and inflation is very important to maintain. By the time Fed starts to cut rates the economy is already is in a big trouble, however that is not the case now.

Outlook:

In conclusion, recent Federal Reserve rate cut marks a pivotal shift in monetary policy, influenced by a complex interplay of economic indicators. With inflation showing signs of easing and the labor market also showing signs of concerns, market participants seems to pricing in more accommodative stance from the Fed ahead. The decision to cut rates, the first in over four years, reflects a strategic response to maintain a balance between inflation and growth in the US economy. Governor Powell's remarks put slight cold water on these rate cut announcements, as he toned expectations of further rate cuts and also no announcement regarding Quantitative easing. This nuanced approach indicates the Fed's intent to foster a resilient economy while navigating emerging challenges. We continue to maintain buy on dips strategy for both Gold and Silver, as we believe there could be a delayed reaction on this rate cut. As per last quarterly reports, we maintain the targets of Rs. 76000 on domestic front and $2650 on COMEX.

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