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Economy and Inflation: Implications for Markets with Interest Rates Entering a New Cycle Towards the Presidential Elections

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The Implications for the Markets and Economy in the Face of Decreasing Interest Rates

We discuss the top six issues critical to electing the new President. In this second installment, we tackle the Economy and Inflation focusing on the upcoming interest rate-reducing cycle,

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These six issues will decide the future of the United States, Let's begin our discussion.

The Rate Cutting Cycle is Expected to Begin on September 18

Last Friday, investors heard directly from the Federal Reserve Chair Jerome Powell during the annual Jackson Hole Speech that the time for the Fed's monetary policy to shift is upon us. During his keynote at the Fed's Jackson Hole event, Chair Powell said, "It's time for our policy to Shift; the path forward is becoming clearer, but the timing and extent of rate cuts will hinge on incoming data, the evolving economic outlook, and the balance of risks."

The markets reacted positively to the much-awaited guidance on the future direction of monetary policy; lastly, the Fed Chair Powell reflected on the factors that led to 11 rate hikes from March 2022 to July 2023 to curb inflation.

Part of the speech acknowledged the progress in reducing inflation. It said that the Federal Reserve can now equally prioritize the other side of its dual mandate of ensuring the economy remains close to full employment.

We are less than 22 days away from the next Fed's Federal Open Market Committee meeting **from September 17-18**, at which point the Fed is expected to begin the new rate-cutting cycle.

The global and U.S. economies are preparing for this new lower rate cycle in monetary policy. Central banks worldwide, including the Federal Reserve, are expected to lower interest rates in response to the slowing global economy and subdued inflation.

The Fed Minutes of the last FOMC meeting held on July 30-31, 2024, were released last week, showing that Members' expectations point to a first-rate cut at the September FOMC meeting, at least one more cut later in the year and further policy easing next year.

The markets have priced two rate cuts in 2024, and some observers expect three rate cuts; our analysis points to a first-rate cut of 25 basis points.

The upcoming rate-cutting cycle will differ from other cycles; as the conditions are somewhat unique this time, the Fed is not seeking to address a collapsing economy or arrest a seizing financial system.

Inflation is coming down but needs to return to the Fed's long-term 2% target. The CPI is at 2.89%, and the Core CPI is at 3.21%, with inflation data taking center stage with the release of the Fed's preferred inflation measure, the personal consumption expenditure (PCE) index, next Friday. Inflation Nowcasting has the PCE at 2.40% inflation to fall from 2.51%, with core PCE inflation (excluding food and energy) expected to rise to 2.77% from last month's 2.63% number. Notably, both of these inflation figures are now below the Fed's projections for 2024, which anticipated 2.6% headline inflation and 2.8% core inflation. Unemployment has ticked up to 4.30% above the Fed's projection of 4%, with no signs that the labor market or the economy needs immediate life support.

The U.S. Economy: Resilience Amid A New Rate Cycle of Lower Rates

The U.S. economy, characterized by robust consumer spending and a resilient labor market, is expected to weather the impact of lower interest rates. The most recent GDPNow for the Third Quarter of 2024 was updated on August 16 and fell to 2.00% from 2.40% GDP; while there is still growth, the economy is growing much slower.

Consumer spending, which accounts for about 70% of the U.S. economy, is sure to improve as lower interest rates make borrowing cheaper. For one, lower interest rates reduce the cost of borrowing money, making loans for big-ticket items like houses or cars more affordable. This allows consumers to take on more debt and spend more.

As consumers pay less interest, their disposable income increases, increasing spending and creating a trickle-down effect throughout the economy.

Business investments increase as lower interest rates as borrowing costs can encourage businesses to expand and hire new employees, often leading to improved consumer confidence and spending.

Increased consumer spending and business investment increase aggregate demand, often translating into improved economic growth.

A negative effect of lower interest rates is that it can reduce the incentive to save, as the return on savings is diminished.

GDPNow

Third Quarter 2024

Date	GDPNow 3Q24	Change
7/25/24	2.80%	Initial Forecast
8/1/24	2.50%	-10.71%
8/6/24	2.90%	16.00%
8/8/24	2.90%	0.00%
8/15/24	2.40%	-17.24%
8/16/24	2.00%	-16.67%

Which sector benefits from Decreasing Rates

Housing Market

The housing market, in particular, benefits from lower interest rates. Between March 22, 2024, and August 24, 2024, the U.S. housing market experienced significant changes.

Housing Starts, an indicator of new residential construction, fell from 1,713,000 to 1,238,000, a decrease of 27.73%, marking a swift slowdown in the construction of new homes during this period.

Despite the drop in Housing Starts, the number of New Single-Family Houses Sold increased from 707,000 to 739,000, an increase of 4.53%, indicating that the demand for new single-family homes remains strong, even as new construction slowed.

However, Existing Home Sales, which measure the sale of previously owned homes, dropped significantly from 5,690,000 to 3,950,000, a decrease of 30.58%, showing fewer people were buying existing homes.

One factor contributing to these trends is the increase in the 30-year Mortgage Rate. Over this period, the rate rose from 4.67% to 6.46%, an increase of 138.33%. Higher mortgage rates can make home-buying more expensive, decreasing Housing Starts and Existing Home Sales. However, the increased sales of new single-family homes suggest that other factors may also be at play, such as rising prices and limited inventories, among other things.

US Housing Starts,US New Single Family Houses Sold, US Existing Home Sales and 30-Year Mortage Rate

March 2022 Versus August 2024

Housing Stats Comparison Metric	Date	Date	Change
	3/22/22	8/24/24	
Housing Starts	1,713,000	1,238,000	-27.73%
New Single-Family Houses Sold	707,000	739,000	4.53%
Existing Home Sales	5,690,000	3,950,000	-30.58%
30-Year Mortgage Rate	4.67%	6.46%	138.33%

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The data suggests a mixed picture for the U.S. housing market between March and August 2024, with indicators pointing to strengths and weaknesses.

Automotive Sector

The automotive sector could also see a boost from lower interest rates, but it has been relatively unaffected. Cheaper auto loan rates often increase car sales, benefiting automakers and auto dealerships. The average auto loan now ranges from 7.24% to 9.74% for new cars and 13.92% for used cars.

The Total Vehicle Sales in the United States in June 2024 fell to 15.79 million, down from 16.42 million in May 2024, down from 16.61 million one year ago, and up from 13.75 million in 2022.

Financial Sector

The financial sector might face some headwinds as lower interest rates squeeze net interest margins, a key source of profitability for banks. Banks earn interest on their loans, typically higher than the interest they pay on deposits. When interest rates fall, this spread can narrow, reducing banks' profits. However, lower rates could also reduce the number of loan defaults, which would be a positive for the sector. In total, the six U.S. largest banks, including JP Morgan Chase, Bank of America, Citigroup, Goldman Sachs, Morgan Stanley, and Wells Fargo, have total Assets of $14.645 Trillion, 2Q24 revenues of $144.177 Billion, and 2Q24 Net Income of $39,316 Billion.

The three Puerto Rican banks, including Banco Popular, FirstBank, and Oriental, reported second-quarter earnings with combined revenues of $1,137.71 billion and a net income of $304.769 million.

Equity Markets

In the equity markets, lower interest rates typically lead to higher stock prices. As borrowing costs fall, companies can invest in new projects, boosting their future earnings potential. Additionally, lower rates make stocks more attractive compared to bonds, leading to an inflow of capital into the stock market.

Dow Jones, S&P 500, Nasdaq Composite, Birling PR Stock Index & Birling US Bank Index YTD Returns 8.23.24

As of today, the five indexes we follow have not been affected by high rates as they show double digits returns and only one single digits return below the YTD Returns:

- **Dow Jones Industrial** has a YTD Return of **9.25%.**
- **S&P 500** has a YTD Return of **18.13%.**
- **Nasdaq Composite** has a YTD Return of **19.10%.**
- **Birling PR Stock Index** has a YTD Return of **14.83%.**
- **Birling U.S. Bank Index** has a YTD Return of **23.29%.**

Bond Markets

In the bond market, lower interest rates lead to higher bond prices. This is because the fixed interest payments of a bond become more attractive compared to the lower interest rates available elsewhere. However, while this is good news for current bondholders, it also means that new bonds issued will offer lower yields, hurting those who rely on bond income. To highlight this point

the yield for on-the-run 10-year Treasuries at its highest point on April 26, 2024, was 4.70%, compared to August 23, 2024, The yield for on-the-run 10-year Treasuries was 3.81%, and the Federal Funds Target Rate is 5.25 - 5.50%, with the prospect of being lowered by at least 25 basis points on September 18.

The Final Word: Low Inflation, Solid GDP, and Low Interest Rates are a recipe for winning elections.

The anticipated decrease in interest rates slated for September will produce far-reaching effects on both the global and U.S. economies. While specific sectors may stand to gain, others could encounter difficulties. Many moving parts interconnect into diverse groups; these include people saving for college and retirement and retirees who often depend on interest income from their savings or investments. As interest rates decrease, it becomes detrimental to their daily lives as their income will decrease correspondingly. However, the potential benefits of lower rates must be balanced against their risks.

In the context of presidential elections, these economic conditions could be influential.

Low interest rates, low inflation, and solid GDP growth are vital factors that sway voter sentiment in favor of the incumbent's or the incumbent's party. We shall soon see that this 2024 presidential election is neck and neck.

In these uncertain times, a well-diversified portfolio that aligns with one's financial goals and risk tolerance can be the best defense. Policymakers and investors alike will need to navigate this changing landscape with caution. As we transition into this new era of lower rates, the watchword will be cautious, as the full impacts of these changes will only become apparent over time. It's important to remember that while these economic indicators are critical, other issues, such as national security, healthcare, and social policies, also play a crucial role in shaping voter preferences.

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