Alley Company Quarterly Letter
Recalibrating

October 14. 2024

Beginning in March of 2022, the Federal Reserve embarked on the fastest "tightening" cycle in decades as it lifted the Fed Funds target rate by 525 basis points, or 5.25 percentage points, in a matter of just 16 months. Supply and demand imbalances during the Covid-19 pandemic combined with an abundance of fiscal and monetary stimulus ignited rising inflation, prompting the Fed's aggressive policy stance. Despite a constant refrain from pundits that a Fed-induced recession was inevitable in the near term, the U.S. economy has remained resilient, and the inflation "genie" has largely been put back into the bottle with the most recent CPI reading at a reasonable 2.4 percent.

With inflation retreating, the Fed now has latitude to *recalibrate* interest rates to lower levels. The bond market, in its infinite wisdom, has been ahead of the curve and has been signaling for the past several months that policymakers ought to shift course and lower interest rates. With a 50 basis point cut to the Fed Funds target rate several weeks back, an interest rate "easing" cycle has begun in an effort to protect the job market and allow this current economic expansion to persist. While the extent of the Fed's interest rate cuts is unknowable, the directional shift is a positive on many fronts.

Consumers and businesses alike should benefit from the lower cost of borrowing. In theory, this should spur greater economic activity and provide positive implications for corporate earnings. As it relates to the stock and bond markets, interest rate cutting cycles since 1972 (see exhibit below) have often produced positive returns in the 12 months following the initial interest rate cut. To be sure, the below returns are "on average" and there have been a few periods of negative returns a year after an initial rate cut that were coincident with a recession.

Exhibit 1: Average Stock and Bond Market Returns after Initial Interest Rate Cut

	Since 1972		Since 1972 (Recessionary)		Since 1972 (Non-Recessionary)	
	US Treasuries	S&P 500	US Treasuries	S&P 500	US Treasuries	S&P 500
+3M	2.49%	3.77%	1.82%	-1.44%	3.43%	11.07%
+6M	5.92%	8.15%	6.87%	2.25%	4.58%	16.42%
+9M	7.60%	10.79%	9.13%	4.14%	5.46%	20.10%
+12M	9.28%	14.04%	10.43%	9.98%	7.67%	19.74%

Source: Bloomberg, Macrobond, S&P Global. Recessionary indicates the economy entered into a recession during the interest rate cutting cycle, while Non-Recessionary indicates the economy avoided a recession and the expansion continued during the rate cutting cycle.

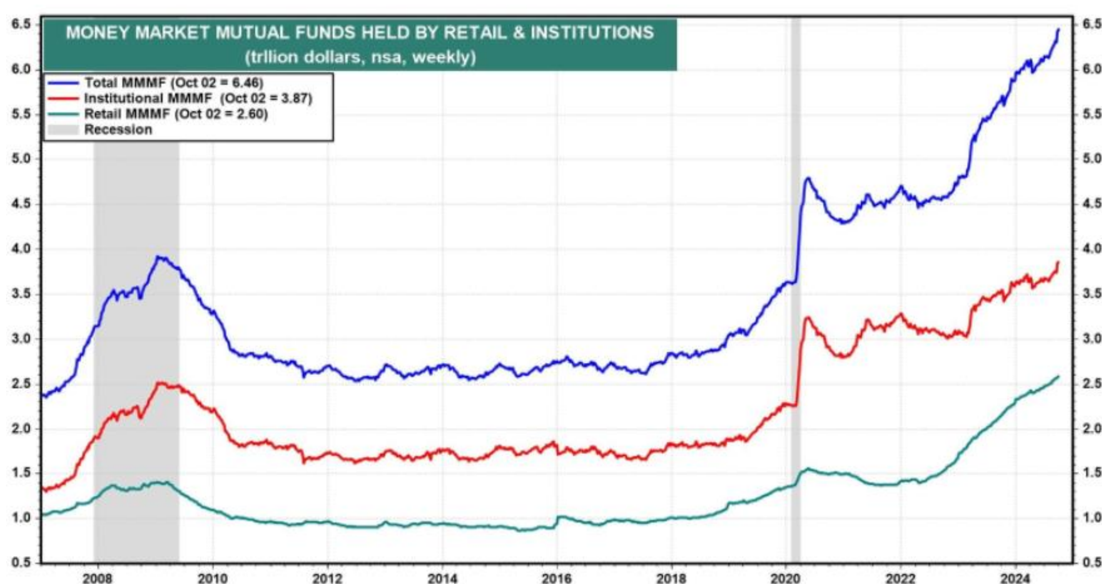
Alley Company
272 Market Square, Suite 214
Lake Forest, IL 60045
Phone 847-482-0938
www.alleycompanyllc.com

As the exhibit shows, the magnitude of stock market returns can vary substantially depending on whether the Fed is cutting rates into a recessionary period or if rate cuts are part of a softer landing where a recession is avoided. Today, a soft landing is increasingly becoming the consensus view due to stable employment trends and corporate profits grinding higher. The bond market, not surprisingly, has averaged positive returns looking out 12 months after an initial rate cut as bond math dictates that the prices of these securities rise as interest rates drop.

Interest Rates and Money Market Funds

A byproduct of interest rates spiking higher in recent years has been investors increasingly becoming comfortable in cash equivalents as part of their overall asset allocation structure. Mid-single digit interest rates on money market funds and Treasury Bills have been enticing after a long period of earning next to nothing on one's cash. We have noted in recent letters that these improved rates of interest could be *"here today, gone tomorrow"* when the Federal Reserve shifts course and recalibrates rates lower. This day has come and rates of return on cash equivalents are likely to continue to move lower in conjunction with rates coming down. Exhibit 2 depicts the recent flood of assets into money market funds. The total of $6.5 trillion is an all-time record.

Exhibit 2: Aggregate Money Market Fund Assets



Source: LSEG Datastream, Yardeni Research, and Investment Institute.

Reaching for Yield?

Even before the Fed started cutting rates, the allure of financial products that offer attractive and/or above average income has been tempting for investors especially when sold to them by Wall Street. Today, "Private Credit" (said differently, private loans) is the product du jour with

yields often substantially higher than traditional bonds. Heretofore, many of these loans existed within the public markets or the regulated banking system. But with banks retrenching due to tighter regulations, retail investors can now get access to these private loans and corresponding yields on a direct basis. *What could go wrong?*

Sophisticated institutions originally were the purchasers of private credit, but the audience for these products has widened considerably. There is no free lunch in investing and higher yields on loans are primarily a reflection of the credit quality of the asset. The potential for retail investors to be surprised by the lack of liquidity, inferior transparency, and possible credit losses from such products seems plausible and we would remind investors of the age-old investing axiom, "know what you own!"

Looking Ahead

The resiliency of the U.S. economy has been on full display over the past few years. We have experienced a pandemic, rising inflation, a significant increase in interest rates, heightened geopolitical tensions, and throughout this, corporate profits have expanded. Investors who have stayed the course have been rewarded. The Fed is in the midst of recalibrating interest rates which could set the stage for continued economic expansion and rising corporate profitability.

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