KKR

Flash Macro Update

U.S. FOMC | September 2024

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What You Need to Know

1 How are we thinking about the September FOMC meeting?

On Wednesday, the Fed cut rates by 50 basis points, while using its 'dot plot' to signal a more gradual pace of cuts going forward. Policymakers did not choose to end QT, underscoring that they will continue to allow bonds to roll off its balance sheet for now.

WHAT DO WE THINK YOU NEED TO KNOW:

1. **We agree with the Fed's base case for a soft landing. In the near term, however, we see more downside risks to growth versus upside risks to inflation.** Chair Powell expects the economy to remain at 'full employment' going forward, which would support the Fed's intention to cut rates only gradually in 2025-2026 after a further 50 basis points of cumulative rate cuts at the next two meetings. In reality, we think that the Fed's focus on 'risk management' – paired with a murky employment picture – will likely lead the Fed to cut a bit more aggressively than we previously thought.
2. **As such, we lower our 2024 fed funds forecast to 4.375% (in-line with the Fed's 'dot plot'), while maintaining our forecast of 3.125% for 2025 (25 basis points below the Fed's estimate).** NFPs are flirting with recession, so we still see flat-to-wider spreads and the potential for more easing at the front end of the curve in the near term.
3. **Bigger picture, however, we continue to see a higher resting heartrate for inflation leading to a higher 'neutral rate' this cycle, which is why we remain**

more hawkish than the Fed or markets on longer-term rates. Said differently, we expect some compensation for bigger deficits, heightened geopolitics, a messy energy transition, and higher services inflation. To this end, we stick to our bond yield forecast of 4.0% over the longer term (market is currently around 3.6-3.7%). Key to our thinking is that Fed easing will likely contribute to easier financial conditions at a time when fiscal stimulus is booming and protectionism is on the rise. As such, we think that the 'action' this cycle will be focused on the pace of rate cuts at the front of the curve – whereas we actually expect more steepening at the long end.

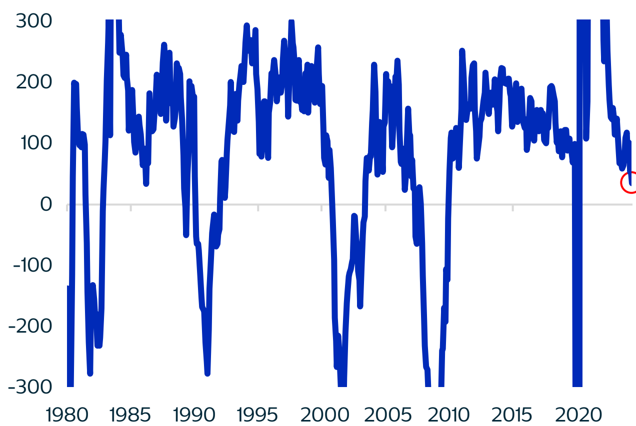
4. **Despite recent declines in rates across the yield curve, our message remains that this is still not the time to over hedge, or to place big bets on duration.** Current market pricing is not far off our forecasts, and we see two-sided risks to our base case for rates. As such, we would wait for a growth scare before aggressively locking in floating rate liabilities in the near term. At the same time, however, we also remain a bit more bearish on the potential for the 10-year to rally in response to weakness.

WHAT DOES THIS MEAN FOR MARKETS:

- **We do not view this 50-basis point cut as a euphoric pro-market cut**. Rather, it is an adjustment that signals two things. Specifically, it indicates that the Fed thinks the labor market is softer than expected (no surprise, given the 800k+ reduction in recent monthly payrolls, and it wants to buy some insurance), while the overall level of rates is too high relative to post-pandemic GDP growth. For what it is worth, we are more sympathetic to the latter argument than the former one.
- **The interesting wrinkle for us is that the Fed is cutting rates 50 basis points (quite accommodative), but still letting the balance sheet run-off, which is a restrictive action**. By comparison, it is actually the exact opposite of what it did post the demise of Silicon Valley Bank when it raised rates while also easing financial conditions with more favorable collateral posting (which we still view as another form of QE as the balance sheet increased). So, we view this announcement today not as an 'all-in.' Had it cut 50 basis points and stopped its balance sheet roll-off, the Fed would have delivered a more ominous tone about the direction of the economy, the labor market in particular.
- **In our humble opinion, we are not sure we agree with Powell's logic that a 50-basis point cut "was clearly the right call from an economic and risk-management perspective."** Credit spreads are tight, unemployment is still fairly low, and financial conditions are more favorable. As we have indicated in past communications, we were more in the camp of 25 basis points in September, alongside some positive commentary about the balance sheet being more accommodative. So, we were using a different approach to cuts and the balance sheet to end up in a similarly accommodative spot.
- **Decomposing our outlook: Moving Pieces**. While we would have started with 25 rather than 50 basis points, our 2024-2025 forecast is actually more dovish than the Fed about the pace of cuts and skew of risk for short rates. This contrast is point one. Point two is that we think credit spreads are going to widen a little from their current tight levels. Point three, however, is that today's big bang makes us want to have some additional term/risk premium in the back end of the curve, given services inflation is still five percent and the Fed is cutting like there is an emergency if we are using historical precedents.
- **What else does this mean for markets**? The yen should continue to rally relative to the USD. Overall, we view this as positive for Small Cap Equities and Private Credit, but we also think Wednesday's move runs the risk of the long-end of the curve getting nervous/unsettled about big deficits, 50-basis point cuts, and higher tariffs on the horizon. Against this backdrop, it puts significant pressure on U.S. productivity to remain outsized. Otherwise, the risk of modern-day stagflation could be higher than we would like.

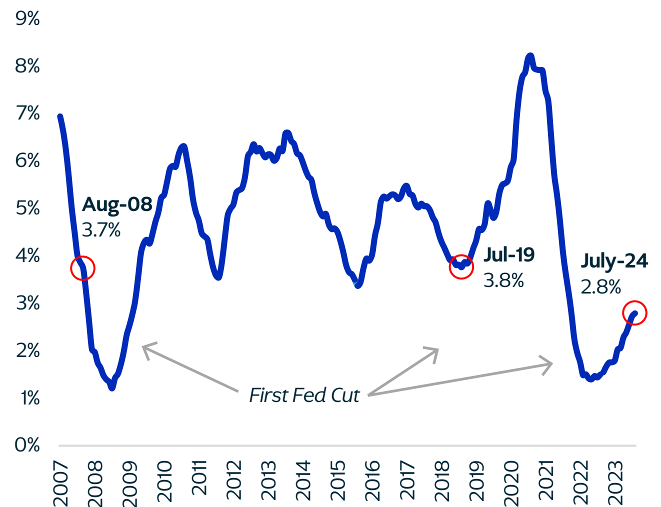
All told, we continue to ascribe to our asynchronous cycle amidst a *Regime Change*, which contains both rolling recoveries and rolling recessions. Therein lies the opportunity, we believe. As Powell indicated, the neutral rate is now elevated relative to the past decade. At its peak there were $17.8 trillion in negative yielding bonds. Today that number is zero. Against this backdrop, dislocations should be bought, investors should tilt to own more collateral-based cash flows, and we favor complexity over simplicity, including an increased focus on corporate carve-outs, public-to-private transactions, and buying down multiples of existing portfolio companies.

Exhibit 1: Our Rolling Recession and Rolling Recovery Thesis Remains Intact, with Slower Jobs Growth...



Data as at August 31, 2024. Source: Bloomberg.

Exhibit 2: ...But Recovering Liquidity



Data as at July 31, 2024. Source: Pitchbook, ICE-BofAML Bond Indices, Bloomberg.

We agree with the Fed's base case for a soft landing. In the near term, however, we see more downside risks to growth versus upside risks to inflation.

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