Seeking Alpha α

Home > Market Outlook > Today's Market

The Peak Fed Dovishness - That's Negative For The Stock Market

Mar. 27, 2024 5:44 AM ET | **S&P 500 Index (SP500)** | TLT, UUP, USO... | 21 Comments | 10 Likes

Damir Tokic
8.33K Followers

About this article

Ticker	Analyst rating	Price at publication	Last price	Change since publication
SP500	HOLD	$5,226.31	$5,254.35	0.54%

S&P 500 change since publication	Days since publication
0.54%	2

Summary

The Fed is likely at the peak dovishness given the expectations of three cuts in 2024, despite higher inflation and stronger growth.

The Fed will be forced to delay interest rate cuts until November, and by then, the economy is likely to be in a recession.

Alternatively, if the Fed cuts in June without support for "the inflation bump thesis", the bond market could sell off as inflation expectations de-anchor.

Either way, the S&P 500 is facing a major correction, and the recent weakening in the momentum could be in anticipation of the Fed's hawkish turn.

Chip Somodevilla

The dovish pivot in November

The Fed started to make a dovish turn in November 2023, when the Fed speakers suggested that the Fed could start cutting interest rates before inflation returns to the 2% target, as long as the disinflationary process continues.

Essentially, as inflation decreases the real Federal Funds rate increases and becomes more restrictive on the economy - which could trigger a recession.

The Fed confirmed at the December 2023 meeting its intention to cut interest rates three times in 2024 via the SEP dot-plot. This also confirmed the end of the "higher-for-longer" policy and introduced the "interest rate normalization" policy.

Thus, the Fed made a major dovish pivot in December, and in response, the stock market staged a vicious rally over the next 3-4 months.

The financial markets started to price even more cuts in 2024, and in late January the consensus expectation was that the Fed would cut interest rates 6-7 times in 2024.

The Fed rejected the calls for a very aggressive monetary policy easing at the January FOMC meeting, and signaled that there would not be an imminent interest rate cut. Thus, the market repriced the expectations to three cuts, consistent with the Fed's prediction.

The stock market ignored the monetary policy repricing and continued rising.

The peak dovishness

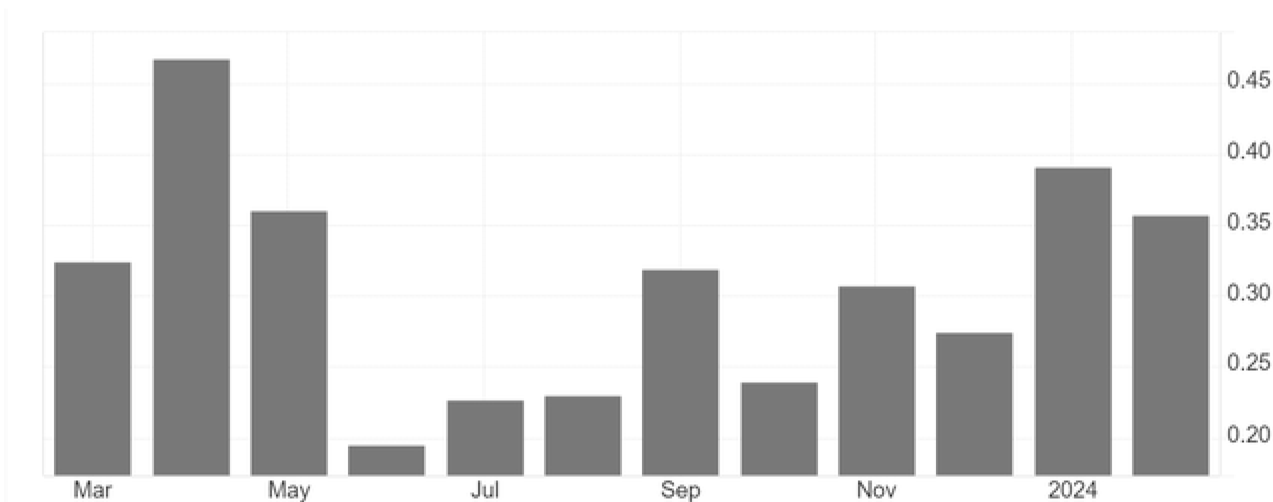
The Fed re-confirmed its intention to cut interest rates three times in 2024 at the March FOMC meeting, despite rising inflation expectations and boosting growth expectations.

Well - this moment could signal the Fed's peak dovishness. In other words, the Fed cannot possibly get more dovish than it already is, and this is usually a turning point for the stock market as well.

The "Fed's dovish pivot" stock market rally since November 2023 could end with the peak dovishness, as the Fed gets less dovish Fed or essentially more hawkish.

There are two key issues to consider:

First, there's inflation. The monthly core CPI increased well above expectations and above the Fed's target in January and February. The Fed views this increase as a "bump" and thus it does not want to "overreact". This is dovish.



The Inflation bump thesis (Trading Economics)

Second, there's growth and the job market. The January and February jobs data showed that the new job creation also accelerated, which is likely to keep the GDP growth above potential - and inflation elevated and sticky as well. Accordingly, the Fed boosted the GDP prediction for 2024 from 1.4% to 2.1% and the core PCE inflation to 2.6% from 2.4% - and still signaled that it intends to cut interest rates three times. That's very dovish.

In fact, it would be hard to imagine how the Fed could get more dovish (other than sharply cut due to a recession). That's the peak dovishness.

What comes next?

Now, the Fed has to actually signal that first cut in June and then actually cut the Federal Funds rate in June.

In order to be able to cut in June, the Fed has to get enough evidence to support the January/February "inflation bump" thesis, which means that March core CPI has to come at 0.1-0.2% MoM range, and then it needs to be supported with equally tame inflation in April.

But even if this happens - it's already priced-in. The Fed would have to signal 4 cuts in 2024 at the June FOMC meeting to get "more dovish".

But what's more likely to happen is that the core CPI comes at 0.3% MoM either for March or April, which would invalidate the "inflation bump" thesis and further delay the first interest rate cut, possibly to November after the election.

In fact, the December 24 Federal Funds futures are already starting to price less than 3 cuts in 2024 after the FOMC repricing on March 20th (the implied rate is 4.65%, and it was 4.75% before the Fed meeting, the Fed's target is 4.6%).

Dec FF futures (Barchart)

Huge problem for the stock market

However, the delayed normalization to November would be a huge problem for the stock market.

Specifically, the yield curve has been inverted now for the record time - and the inverted yield curve causes a recession with the lag. This means, the longer the yield curve stays inverted, the higher the probability of a recession. Thus, if the Fed is forced to delay the interest rate cuts to November, it is very likely that by that time the lagged effects of monetary policy easing will cause a recession.

More importantly, the market will get hit with the maturity wall in 2025, this is when leveraged loans and junk bonds will have to be refinanced - at a much higher rate. Thus, this will only accelerate a recession by possibly inducing a credit crunch.

The Fed can prevent the recession and a credit event if it aggressively cuts interest rates before 2025, which is what market priced-in earlier this year with expectations of 6-7 cuts. But the Fed might not be able to cut at all before November - due to still elevated and sticky inflation and the approaching election. Thus, the stock market could be facing a recessionary bear market in 2025.

Huge problem for the bond market

The Fed is aware of what happens if interest rates stay higher until November - a deep recession. So, the Fed is aware that it needs to lower interest rates in advance. But it needs to provide the supporting evidence for the "inflation bump thesis".

If the March and April core CPIs disprove the "inflation bump thesis", and the Fed still cuts in June, and signals more cuts in 2024, the market could interpret this as the signal that the Fed abandoned the 2% inflation target.

As a result, the inflation expectations could de-anchor which could result in sharply higher long-term interest rates, with the 10Y Treasury Bond (TLT) yields rising well above 5%.

In addition, the US Dollar (UUP) could start depreciating, boosting the price of oil (USO), gold (GLD), as well as other commodities, which would only add to the inflationary pressures, and further push interest rates higher.

This would be a disaster scenario for the bond market, especially in combination with the US debt issues. Obviously, this would also be a very bad scenario for the stock market as well.

Implications

The Fed understands that "excess dovishness" is dangerous. Thus, the Fed is unlikely to cut in June, unless there is sufficient evidence for the "inflation bump thesis."

Thus, we are likely past the peak dovishness, which means that the Fed will be forced to make a hawkish turn, and further delay the interest rate cuts - likely until a recession.

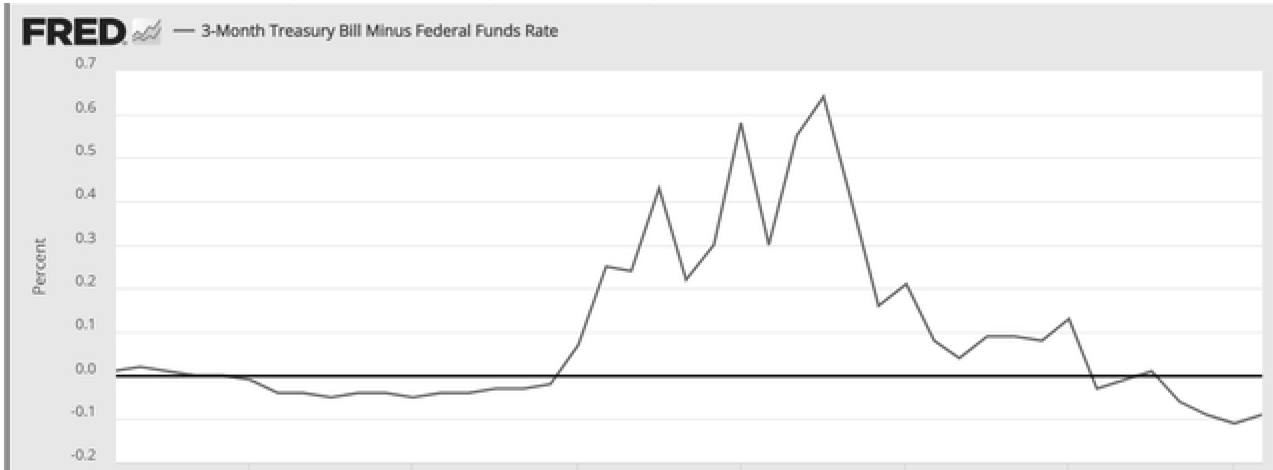
Obviously, this is a negative for the S&P 500 (SP500) as the delayed interest cuts imply a hard landing and a bear market, as previously discussed.

But over the near term, the peak dovishness also signals the end of "the dovish Fed" rally, and a sharper correction.

My rating for SP500 remains a Hold, until the March CPI data. However, I will also be monitoring the momentum for Nvidia (NVDA) and Semiconductors (SMH). It appears that the momentum is weakening which could be a signal that the GenAI-rally is fading, possibly in anticipation of the Fed's hawkish turn.

Note: How to track the Fed's dovish/hawkish expectations?

The spread between the 3-month yield and the Federal Funds rate signals the market expectations of an imminent Fed cut (if negative) or hike (if positive). Note in the chart below, the peak hawkishness was exactly at the bear market bottom in October 2022. Currently, the spread is negative, which signals the expectations of a June cut.



3m-FF spread (FRED)

This article was written by

Damir Tokic
8.33K Followers

Global-macro research. Proprietary trader. Holding a valid Series 3 license as a Commodity Trading Adviser, member of National Futures Association. Professor of Finance. Editor-in-Chief Journal of Corporate Accounting and Finar

Show More

Analyst’s Disclosure: I/we have no stock, option or similar derivative position in any of the companies mentioned, and no plans to initiate any such positions within the next 72 hours. I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it (other than from Seeking Alpha). I have no business relationship with any company whose stock is mentioned in this article.

Seeking Alpha's Disclosure: Past performance is no guarantee of future results. No recommendation or advice is being given as to whether any investment is suitable for a particular investor. Any views or opinions expressed above may not reflect those of Seeking Alpha as a whole. Seeking Alpha is not a licensed securities dealer, broker or US investment adviser or investment bank. Our analysts are third party authors that include both professional investors and individual investors who may not be licensed or certified by any institute or regulatory body.

ACCOUNT STOCK ANALYSIS ANALYSIS BY SECTOR MARKET OUTLOOK MARKET NEWS

Comments (21)

Sort by Oldest

Privacy
Alert Preferences
Downgrades
Editors' Picks
Real Estate
Consumer Staples
Metals
Commodities
Market Pulse
Global Markets

SUBSCRIPTIONS

Premium & Pro

Group Subscriptions

Alpha Picks

INVESTING GROUPS

Most Popular

Free Trials

Top Rated

Dividend Investing

Value Investing

Options Trading

Growth Stocks

Biotech Investing

Tech Stocks

Quantitative Investing

LEARN

Investing Resources

Investing Education

Investing Strategies

Retirement Investing

Stock Market Sectors

Stock Market Holidays & Hours

After Hours Trading

Portfolio Management

Cryptocurrency

Dividend Investing

Portfolio Strategy

Fixed Income

Retirement

IPO's

Quick Picks & Lists

Emerging Markets

STOCK SCREENER

Stocks by Quant

Top Stocks

Top Quant Dividend Stocks

High Dividend Yield Stocks

Top Dividend Stocks

ETFS & FUNDS

ETF Screener

ETF Analysis

ETF Guide

Mutual Funds

Closed End Funds

Editors' Picks

DIVIDENDS

Dividend Stock News

REITs

Dividend Ideas

Dividend Strategy

Dividend Quick Picks

Editors' Picks

Tech

Basic Materials

Healthcare

Consumer

Utilities

Financials

Industrials

STOCK COMPARISON TOOLS

FAANG Stocks

Gold ETFs

Cash Equivalents

Big Bank Stocks

Big Pharma Stocks

Retail Stocks

TOP INDEXES

Dow Jones

S&P 500

Nasdaq

Gold

Bitcoin

Forex

Editors' Picks

Cryptocurrency

MARKET DATA

Bond ETFs

Commodity ETFs

Country ETFs

Currency ETFs

Dividend ETFs

Emerging Market ETFs

Global and Regional ETFs

Growth vs. Value ETFs

Market Cap ETFs

Real Estate ETFs

Sector ETFs

ETF Strategies

Smart Beta

Themes & Subsectors ETFs

Cryptocurrency

Notable Calls

Buybacks

Commodities

Cryptocurrency

Debt/Share Issuance

Dividends - Stocks

Dividends - Funds

Guidance

IPOs

SPACs

Politics

M&A

US Economy

Wall Street Breakfast

NEWS BY SECTOR

Consumer

Energy

Financials

Healthcare

Tech

EARNINGS

Earnings Calendar

Earnings News

Earnings Analysis

Earnings Calls Transcripts

Podcasts

Editors' Picks

Terms Of Use Privacy Do Not Sell My Personal Information Market Data Sources © 2024 Seeking Alpha