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Markets Are Betting That Good Things Come in Threes—Especially Rate Cuts

By Erik Sherman   October 29, 2019

Is three the magic number?

Celebrity deaths occur in threes, so people say, and comedy depends on trios. In journalism there's a well-worn saying that 'three makes a trend.' But how about when it comes to interest rate cuts?

Since the mid 1990s, the Federal Reserve has depended on its own rule of three: when changing interest rates, that is, they have preferred a run of at least three increases or decreases. It's a practice that seems to have come about from experience: Better a number of small changes to rates to coax the economy to where the Fed wanted it to be rather than bigger changes that could overshoot the market, causing too much inflation or the opposite, deflation.

Markets are betting the trend will continue tomorrow, with the Federal funds futures market—financial contracts investors use to bet on where interest rates will be—predicting a 98% chance that the Federal Reserve will cut rates for the third time this year. That would bring the target Fed funds rate range to between 1.5% and 1.75%.

"In the mid-1990s, you did see a small number of steps one way and then a step back," says Gary Richardson, a professor of economics at the University of California at Irvine. But since about 1994, "usually you'll see a series of changes in the same direction."

A series of small changes lets the Fed nudge the economy without overdoing it.

Interestingly, while the S&P 500 hit an all time high Monday, it's the bond market that has been pressing the Fed for further cuts. Short-term Treasurys like the 1-month, 2-month, and 3-month ordinarily track the Fed funds rate. When they sit near or below the bottom end of the Fed's target range, which started in October, it's taken as a sign that bond investors think the Fed funds rate range is too high.

"The bond market that has demanded these rate cuts and the Fed has been more than happy to oblige," says Bill Zox, chief investment officer of fixed income at Diamond Hill Capital Management.

And there is no question that certain indicators are showing that growth is slowing. For example, GDP growth has slowed to 2% while manufacturing is contracting and the Treasury yield curve, which is no longer in a state of strong inversion, has remained somewhat flat.

"We saw a couple of weaker economic numbers in September and October," Kevin Heal, senior analyst at Argus Research. "We're basically down to one cut and take a breather for the rest of the year and see how things shake out." That still would leave room for a cut in early 2020, if necessary.

Certainly the Fed is will be looking to avoid spooking the markets as it did last December.

"The Fed was asserting itself last year until December 19 in the last Fed meeting [of that year]." At the time, the Fed was reducing its balance sheet that years of quantitative easing—purchasing bonds and other assets from banks to inject liquidity into the economy—had built up by trillions of dollars.

During the meeting, Chairman Jerome Powell said the Fed would "have the balance sheet runoff on automatic pilot and use monetary policy, rate policy, to adjust to incoming data." In other words, he was suggesting that the economy was returning to normal and that the Fed would continue to sell off bonds, tightening the money supply. All parts of the markets freaked out because investors didn't think the world was all that stable yet.

Two days before the meeting, markets hit a 14-month low. By Friday, Dec. 21, the Dow had its worst week in 10 years. Then the Federal government shut down over funding for Donald Trump's border wall and the 24th marked the worst Christmas Eve for the Dow on record.

One worry is that the Fed might be trying to appease the markets or the current administration, which becomes a problem as the Fed has a job defined by Congress, for which it works. What pleases investors or politicians at a given time may not be the best thing for the economy.

"There's a lot of speculation that the Fed's resolve to not worry about equity markets or what the executive branch has said has weakened," Prof. Richardson says. "I would guess that in ten years when we know the full story, it's likely to be untrue."

Others think that the concern may be overblown and that cooperation between the Fed and markets is positive. "If anything, the Fed's accommodating stance is a major reason—if not the major reason—for the stock market rally this year," says Jill Fopiano, CEO of O'Brien Wealth Partners.

The likelihood of a rate cut this Wednesday seems particularly high because of the way the Fed has approached the meeting. "The Federal Reserve has had plenty of opportunities to talk the market out of an interest rate cuts this past month but have not," says Charles Self, chief investment officer at iSectors. "Not cutting rates this week will lead the market to not trusting the Fed's rhetoric."

"Doing 'whatever it takes' seems like a noble endeavor right now, but it also raises future risks of financial instability," says Joe Arena, managing principal and chief investment officer at Quartz Partners Investment Management. Especially as lower rates reduce the tools the Fed has to address an eventual downturn. "The Fed is riding on the hope that one more rate cut, expected to happen this week, will be enough to wrap up what they are calling its mid-cycle adjustment," notes Arena.

After all, nobody says good things come in fours.