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November 2024 Crescent Commentary

How could the election results impact interest rates?

In our last Commentary, we talked about how the recent election results could impact your taxes. In this Commentary, we'll look at how the elections could impact interest rates. Interest rates impact almost every corner of finance, from the cost of consumer and corporate loans, to the interest you earn in your bank accounts. Interest rates also impact all major financial asset values, including real estate, stocks, and bonds. And interest rates basically act like gravity on asset values: higher interest rates lower the value of all financial assets, and lower interest rates increase the value of all financial assets. For these reasons, what happens with interest rates over the next several years will matter for your financial future.(1)

Recently, the key focus with interest rates has been what impact Trump's proposed policies will have. While it's true that Congress must approve these policies, Republican control of both the House and Senate greatly increases the chance of approval. Most of the news headlines following the elections have focused on the inflationary impact of some of Trump's proposed policies. For example, tariffs and tax cuts, which are viewed as inflationary. Yet some of Trump's other policy proposals are viewed as deflationary – namely deregulation and a push for lower energy prices. Obviously, these policies are far from settled. In fact, detailed proposals have not been put forth yet. And once they are put forth, there's likely to be some level of negotiation to work through Congressional approval.(2)

A final key impact that Trump could have on interest rates would come from pressuring the Federal Reserve to lower rates. Trump did this during his first term as President. In 2018, Federal Reserve Chair Jerome Powell publicly stated that interest rates were well below the level needed to maintain a stable economy. And the Fed started increasing interest rates. Then towards the end of the year, Trump began making public statements against Powell's view, pressuring Powell to lower rates. The pressure worked, and the Fed reversed course in early 2019. After increasing interest rates for several months, the Fed began lowering interest rates. Given that Trump pressured the Fed to lower rates during his first term, we think there's a significant chance he'll apply similar pressure during his second term.(2)

If we look at the combination of the different policy proposals, as well as Trump's tactic of applying pressure to the Fed, it's hard to know at this time what will happen. If we were forced to make a guess, we'd put a higher chance of seeing rates decline rather than rise over the next several years. And while we expect the above factors to impact interest rates, economic factors also matter: namely the unemployment rate, economic growth (or contraction), and inflation. The unemployment rate currently sits about 20% higher than it did in summer of last year. Economic growth has slowed. And inflation has declined towards the Fed's stated target of 2%. All of those factors point towards falling interest rates. But if those factors were to reverse, it could mean higher rates. One key difference now versus 2018 is the elevated inflation we've experienced.(3)

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In 2018, inflation was low and the Fed didn't see immediate consequences to lowering interest rates. Today, inflation was elevated the past two years and the Fed worries that lowering rates could spawn another increase in inflation. For this reason, the Fed may not give in to political pressure as readily as it did in 2018.

Given the different puts and takes and uncertainty with interest rates and the recent signs of economic slowing, we recommend that investors position themselves in a diversified manner, and only take as much risk as needed to achieve their financial goals. There are currently some cautionary signs with the U.S. economy. We already mentioned increased unemployment and slowing economic growth. Additionally, our government borrowed trillions of dollars and distributed the funds as covid-19 stimulus. Corporations and consumers received that stimulus, and many borrowed large amounts at interest rates near zero. Some of those loans have started resetting at higher rates. For example, recent financial news articles have highlighted rising loan defaults by consumers and businesses. The fact that businesses, consumers, and the government borrowed large amounts at interest rates near zero means that our economy doesn't have much of a cushion when the economy weakens.[4]

The recent news headlines about loan defaults help explain why we don't yet know the full economic impact of higher interest rates. Higher interest rates have always had a time lag in terms of their impact on the economy. And this time will be no different. For example, we can look at the Fed rate increases that preceded the Financial Crisis. The Fed stopped increasing interest rates in June 2006. But we didn't see the full economic impact until over two years later when Lehman Brothers failed in September 2008. What would a similar timeline look like today? The Fed stopped raising rates in November 2023, so a similar timeline means we wouldn't see the full economic impact until early 2026. It's also important to point out that the full economic impact this time around consists of a wide range of possibilities. We have seen our economy slow and unemployment increase this year, so we've seen some impact from higher interest rates. But we don't yet know whether our economy will simply settle into a slow and steady period of growth, similar to what we experienced prior to 2020. Or if the economy will actually enter a recession.[5]

Given the uncertainty with interest rates and the economy, how should you position your investments? As we mentioned above, we recommend a conservative and diversified approach to investing. This means having discipline, and only taking as much risk as needed to achieve your financial goals. While we've seen some signs of economic weakening over the past year, we've seen an intensification of investor exuberance – two factors which appear to contradict one another. The most successful living investor, Warren Buffett, has said that investors should "be greedy when others are fearful, and be fearful when others are greedy". Given that we currently see more greed than fear in investor sentiment, we're more inclined towards caution at this time. It's particularly important to diversify well beyond currently popular investments, since those investments encompass the most exuberance. The U.S. stock market is currently the most concentrated in 50 years, with the top ten companies making up 35% of the stock market. In the past, this led to decades of no return for investors. For example, the Dow Jones index was flat for seventeen years from 1964 to 1981. Diversifying beyond popular investments will help protect you from a scenario like this.[6][7][8]

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Forbes Best-In-State Wealth Management Team 2024

Sources:
(1) Harvard Business Review (2) CNBC (3) U.S. News (4) The Wall Street Journal (5) CNN (6) New York Times (7) MarketWatch (8) Hartford Funds