October 2024

We're one month away from the election. It's hard to separate the facts from the less-than-objective information barraging us daily, whether it be via the TV, radio, internet, Facebook, Instagram, YouTube, etc. To this end, this month's update addresses some major issues surrounding the FED's recent interest rate decision.

This email letter is a little longer than usual… It's worth the read, however, as the FED's decision is going to have a <u>real impact on our personal cash flow</u>. As interest rates decrease, so does the amount of income we receive from bank accounts, CDs, and more. These rate changes also impact the interest rate/amount we pay in order to borrow money, such as via mortgages, auto loans, Home Equity Lines of Credit, and credit cards.

Let's get started. Recently, I spent some time with our partners at PIMCO, one of the world's largest managers of Fixed Income products, aka 'bonds'. They are a terrific partner and source of invaluable information. During the presentation, Dr. Ben Bernanke, former Federal Reserve chairman and member of the PIMCO Investment Advisory Committee, spoke about the FED's recent decision to cut the overnight rate by ½%, aka 50 basis points, or '50bps'. Below, I'll share and summarize his commentary. I'll also provide an update to Congress' recent budget decision. And, for client who are invested in them, I'll discuss notable changes made to our current model portfolios.

First, the proverbial low-hanging fruit. As expected, Congress ran out of time to agree upon a full-year 2025 fiscal budget. Or, perhaps they didn't want to put one in place prior to the election?? Rather than cause a government shut down, a short term 'extension' was put in place, through mid December. Doing this places the burden of creating the FY 2025 budget on the new/upcoming Congress. Stay focused on this issue, as our economy is dependent upon recent high levels of government spending.

Next, earlier in 2024, based upon our team's expectations for rate cuts, we made a notable shift in our fixed income (think bonds and CDs) portfolios by 'extending duration'. This essentially means that rather than continuing to invest in short term bonds (6 months to 1 year long), we shifted to fixed income investments in <u>intermediate-term bonds (4-6 years long)</u>. By doing this, we locked in the higher rates for longer periods of time. We made this move, within most of the model portfolios, several months ago. Last week we adjusted our model portfolios again. We shifted most of the remaining short-term-fixed-income positions to longer-term types of investments, thereby locking in those higher rates prior to any further rate cuts. We're already seeing the fruits of these decisions.

Tied to this, we also made adjustments to the stocks in the portfolios. As the United States' interest rates are declining, so does the US dollar also decline (because investors see the lower interest rates and move their funds to other areas/countries with higher interest rates). The declining US dollar helps international investments, and so we have taken advantage of this trend. (Just in case you're wondering, we're NOT investing in China directly, or in any notable way.)

Let's move on to Ben Bernanke's comments. Former Chair Bernanke started the discussion by reminding us that the FED's dual mandate focuses upon '<u>Inflation and unemployment'</u>. He stated that the FED will lean their policies *toward the one of the two that seems to be more of an issue*.

In this regard, Inflation is in much better shape that it has been over the past 18 months, which is to say that it's stable, currently. He provided some evidence of this claim, such as that wage-growth and rent-growth are slowing. To summarize, the FED is mostly comfortable with inflation, today.

That said, employment/jobs are still a puzzle. The US economy is chugging along. But, the labor rate is cooling and payroll-increases are slowing. The FED is concerned that 'risk of unemployment' is a self fulfilling problem. That is, the more unemployment there is, the worse the economy gets, and then unemployment gets worse as employers lay off workers, and so on. *So, the FED wants to stimulate job creation before unemployment gets out of control.*

Thus, the issue of 'Unemployment' is the FED's number one concern right now.

Next topic. When the FED recently cut rates by 50bps, you also heard about its *projections for further changes in rates*, affectionately called the DOT PLOT. The Market is currently pricing in lower rates than the FED's dot-plot suggests may occur. The same happened in late 2023 when the Market expected 7 rate cuts in 2024 (and it's only received 2 thus far and is unlikely to see 7 before the end of this year). It's normal for the Market to 'price in' opinions than are different than others'. As investors, we must watch these differences, closely.

Importantly, Dr. Bernanke reminded us that the FED's dot-plot is ***not*** an official committee decision. It's not a guarantee. It's guidance only. It's not a promise. Don't bank on it.

With this in mind, the FED is currently projecting a soft economic landing. It forecasts that unemployment will stabilize and inflation will moderate. This situation would be the best of all possible worlds, if it happens. But remember, things can change! Shocks do occur. The FED's outlook is a 'provisional' and optimistic view. A 'soft landing' is a rare event, but a positive one. *So, we, as investors, should price in the possibility of something worse occurring.*

So where are interest rates headed? There's tremendous and varied disagreement over this issue. But Dr. Bernanke's personal belief, currently, is that 3% might be the target overnight rate. It's just one opinion among many.

Of course, we must remember that the FED controls ONLY the 'overnight' rate, which is the shortest interest rate. The FED doesn't control the rest of the Yield Curve, which are the interest rates for longer term bonds, such as 1 year, 5 year, 10 year, and so on. The Market controls these rates through normal supply and demand.

I'm going to share Dr. Bernanke's 'history lesson' in the next paragraphs.

The US is in a historically 'easy' period of financial conditions. That said, given that rates are relatively and historically 'easy', then where's the overheated labor market? He opined that 'Pandemics are bad for inflation' and that we're still feeling the effects. 2020 disruptions caused supply-side driven, energy, food, and supply chain issues. Over the past few years, as the supply-side improved, we saw lower inflation numbers and better economic output. The FED recognized this was occurring. But its mistake was in calling the inflation that was caused, 'transitory'. Now it appears that inflation may not be so 'transitory', and could stick around. So, the markets and the FED need to be flexible in their consideration of different possible scenarios.

A second lesson, in his opinion, was that the FED needed to be more pre-emptive. They raised rates 'too late'. Dr. Bernanke said that the FED wanted a strong labor market (at the expense of inflation), but inflation didn't help the labor market.

With regard to our nation's 33 Trillion dollar debt, he said that the FED is "not a 'household' that has to balance its budget". The Government can run a deficit, indefinitely. Social Security and Medicare are a spending-burden while income-taxes affect our nation's income and give us more monies that we can spend, or use to pay down National debts. For now, at our current debt levels, International investors are buying/holding US Treasury bonds at reasonable yields. So, that's a reason for the US Government to stay on a 'reasonable' trajectory with its debt. If investors lose faith in our ability to manage our finances, as a Nation, then we could have issues. However, so long as investors keep lending monies to the US, then the FED won't be motivated to change its policy.

With regard to the Election, Chair Jerome Powell explained that the FED IS a non-partisan organization. This independence is critical. Independence is needed in order for the FED to be able to focus on the economy and not on politics. Further, elections create uncertainty. Monetary policy is difficult to create when decision-paths are affected by 'who's in charge'.

The Presidential/Congressional transition time period is an issue too. Thinking back on history, in November of 1932, during the depression, Roosevelt not sworn in until Spring of the following year after the election, (by the way, this 'delay' caused Congress to move up the inauguration date to January). With a January inauguration, there was only a 2 month gap between outgoing and income politicians, rather than what had been 4+ months of delay. This may be part of the reason that Congress didn't agree upon the 2025 budget (yet). That is, they're leaving it for the new politicians to decide upon.

As I mentioned last month, we need to remember that the FED's rate cut also means that **CASH FLOW is going to decrease, as interest rates decrease**. Investors should expect that interest from bond funds, CDs, and other fixed income products are going to change dramatically. Further, the FED dot plot suggests that another 50 bps of rate cuts are possible before year end. These reductions in income directly tie into clients' portfolio construction and their need for cash/spending monies.

Tune into the monthly teleconferences to hear more, or give us a call to discuss your portfolios.

As always, please share this letter with your friends and family. We're also posting these letters on our website (The website link is available in the signature section of our email). If your friends and loved ones find that they need financial expertise, guidance, or a second opinion, our "20-Minute Ask Anything Sessions" are available to them. We're happy to share our professional expertise.

We want to sincerely thank you for your business as we continue through the end of 2024. We are committed to helping preserve, manage, and grow your net worth by addressing a comprehensive range of complex financial issues including those related to income-during-retirement, cash flow, investment goals, and insurance-related risks, all while remaining sensitive to your Business, Estate and Income Tax planning needs.

Sincerely,

Chris, Greg & Darcy

Christopher P. Yalanis, MBA
CERTIFIED FINANCIAL PLANNER™ Practitioner
Managing Director - Investments
Branch Manager
CA Insurance License Number: 0K42043
Senior PIM Portfolio Manager

7 Brown & Howard Wharf, Newport, RI 02840
Telephone: 401-848-9949, Direct: 401-848-3009, TEXT: 401-240-4740
Toll Free: 888-848-9738, Fax: 401-847-0329
Email: Christopher.yalanis@wfa.com
Email: Christopher.yalanis@wellsfargoadvisors.com

View our website:
www.yalanispwmg.com
http://fa.wellsfargoadvisors.com/yalanis-wealth-management-group/

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