Your Weekly Investment
Insights
August 26, 2024

VERDENCE CAPITAL ADVISORS

Key Takeaways:

- Powell confirms what the market has already priced in.
- Service inflation remains biggest risk to Fed declaring victory on inflation.
- The Fed is walking a fine line.
- Soft landing not guaranteed.
- Policy adjustment is warranted but market may be too optimistic on Fed's ability.

Fed Pivot is Here...Now What?

Last week, Fed Reserve Chairman, Jerome Powell pivoted on monetary policy by suggesting the risks have shifted from inflation to the labor market. Therefore, a "policy shift" is warranted so they do not fail on their dual mandate of maximum employment and price stability. As a result, the Fed is likely to cut interest rates at their September 17/18th meeting. Now that the much anticipated pivot is here, in this weekly we want to address the questions about whether or not inflation is officially behind us? How aggressive can or does the Fed need to be with rate cuts? Lastly, has the Fed orchestrated a soft landing?

- **Is inflation officially behind us?** The Fed's aggressive tightening cycle has been one factor to why headline CPI has dropped from 9.1% to 2.9% (YoY) and core PCE inflation has dropped from 5.6% to 2.6% (YoY). However, fixing the pandemic related supply chain disruptions has also brought goods prices down. The problem remains on the service side of the economy. Service prices are still growing at uncomfortably high levels. While we agree some policy adjustment may be warranted to avoid a major slowdown in employment, we are less confident that the Fed can deliver on the aggressive rate cuts that are priced into the market. The futures market is currently looking for over 200 bps of rate cuts between now and August 2025.
- **How aggressive can or does the Fed need to be with rate cuts?** To answer this question, it is important to look at the Fed's dual mandate. Regarding the labor market, the unemployment rate remains below the level seen at the first rate cut of every easing cycle since 1966. Since 1966, the average trailing six-month unemployment rate has been 5.2%. However, they typically cut when it has risen over the prior six months by at least 0.1%, given the unemployment rate has increased 0.6% over the past six months, it warrants an adjustment to policy. Regarding price stability, while inflation is progressing towards their target, in all the rate cutting cycles since 1966, the average real Fed funds rate (the Fed funds rate minus core inflation (PCE) year over year) has been 3.3%. With the real Fed funds rate at 2.9% using the most recent PCE reading, it is still not as restrictive as we have seen in the past. Therefore, the Fed is walking a fine line with rate cuts, especially with a money supply that has started to move higher again.
- **Has the Fed orchestrated a soft landing?** Not so fast. In fact, the Fed is typically late cutting rates and does so when the economy is already headed towards recession. The consumer is our biggest concern. Debt levels are high, and years of inflation have strained consumers. In addition, nearly every historical recession indicator has been flashing red signals for many months if not a year.

The Bottom Line:

We agree a policy adjustment is necessary but think with equity valuations elevated, markets are too optimistic about the pace of rate cuts. The amount at their September meeting (25 or 50 bps) completely hinges on the August employment report next week. A surprise to the upside on employment or inflation could unravel the optimism and result in volatility in equities.

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Weekly Economic Recap –

Fed Assures that Rate Cuts are Likely Soon

The Leading Indicator Index for July (which is a leading recession indicator) showed that leading indicators fell for the 27th out of the past 28 months. This is the longest streak of declines in history. The weakness was led by manufacturing new orders, the yield curve inversion, consumer confidence, and the average workweek.

The Philadelphia Fed Services Index plummeted to the lowest level since December 2020. The weakness was led by employment and capital expenditure plans.

The preliminary annual payroll benchmark revision showed the the U.S. economy added 818K less jobs in the year through March 2024 than expected. This equates to ~68K jobs less each month. According to the Bureau of Labor Statistics, this is the largest annual revision downward since 2009. One of the factors around the revision was accounting for unauthorized immigrant workers.

The Minutes from the Federal Reserve meeting on July 31st showed that several committee members wanted to cut rates at the July meeting. In addition, the “vast majority” said a rate cut at the next meeting (September) would be warranted if “data continued to come in as expected.”

Existing home sales rose in July after declining for the past four consecutive months. The rise was driven by an increase in single family homes as multi family home sales were flat. The median home price of an existing home declined for the first time in six months.

Fed Chairman Jerome Powell spoke at the annual Jackson Hole symposium and suggested that rate cuts will begin in September. He noted, the “time has come for policy to adjust,” but will be determined “on incoming data,” and the “balance of risks.”

Key Takeaways:

- Leading indicators continue to slide.
- U.S. economy lost over 800K jobs.
- Fed confirms rate cuts are on the way.
- Global equities jump on Fed pivot.
- Bond yields fall as rate cuts in September priced in.
- Commodities rally led by oil.

Weekly Market Recap –

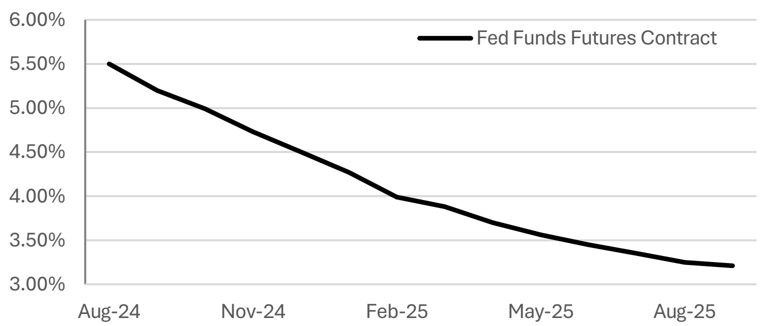
Global Equities Rally on Fed Rate Cut Optimism

Equities: The MSCI AC World Index rallied for the third consecutive week with all major equity regions moving higher for the week. The rally was driven by the much anticipated Fed pivot where they all but assured that rate cuts will begin in September. Developed international equities modestly outperformed U.S. equities led by gains in Europe (excluding the UK). Within the U.S., small and midcap stocks outperformed large cap stocks. Within the large cap space, value outperformed growth sectors as the real estate sector jumped on hopes for lower rates.

Fixed Income: The Bloomberg Barclays Aggregate Index rallied for the second consecutive week on hopes for rate cuts next month. All the major fixed income sectors rallied for the week but it was led by investment grade credit. The laggards were floating rate bonds and leveraged loans.

Commodities/FX: The Bloomberg Commodity Index rallied for the third consecutive week led by gains in crude oil. Crude oil rose on hopes that U.S. rate cuts will fuel demand. Gold prices also resumed their upward trend as the anticipation of lower yields fueled demand for precious metals. Copper also gained on hopes for better demand with lower rates.

Futures Market is Pricing in Aggressive Rate Cuts



Footnotes: Data is as of August 26, 2024.
Source: Bloomberg Finance LP, Verdence Capital Advisors.

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Global Equities Rise on Fed Rate Cut Hopes

U.S. Equities	Current	1WK	1MO	3MO	1YR	YTD
Dow Jones Industrial Average	41,175	1.3%	2.2%	5.9%	21.8%	10.6%
S&P 500	5,635	1.5%	1.5%	7.3%	28.9%	19.2%
Russell 1000 Growth	3,705	1.3%	0.1%	7.5%	34.7%	22.0%
Russell 1000 Value	1,825	1.9%	3.2%	6.3%	20.9%	13.6%
Russell Midcap	3,444	2.4%	2.7%	6.0%	21.8%	11.8%
Russell 2000	2,219	3.6%	-1.0%	8.7%	20.4%	10.4%
Nasdaq	17,878	1.4%	-0.6%	7.0%	31.3%	19.7%

International Equities	Current	1WK	1MO	3MO	1YR	YTD
MSCI AC World (USD)	831	1.7%	2.0%	5.8%	25.1%	15.6%
MSCI EAFE (USD)	2,439	2.8%	3.2%	3.6%	20.4%	11.3%
MSCI Europe ex UK (USD)	2,739	3.2%	3.5%	2.6%	19.8%	11.1%
MSCI Japan (USD)	4,109	2.1%	1.7%	5.2%	21.0%	12.2%
MSCI UK (USD)	1,309	2.4%	5.0%	4.7%	23.6%	14.7%
MSCI EM (USD)	1,101	0.7%	1.5%	1.9%	16.4%	9.6%
MSCI Asia ex Japan (USD)	703	0.8%	1.4%	1.8%	17.5%	11.4%

Fixed Income	Current Yield	1WK	1MO	3MO	1YR	YTD
U.S. Aggregate	4.3%	0.7%	3.1%	5.4%	8.6%	3.6%
U.S. Govt/Credit	4.2%	0.6%	3.1%	5.2%	8.5%	3.5%
U.S. 10 Year Treasury	3.8%	0.7%	3.9%	6.6%	7.2%	3.0%
U.S. TIPS (1-10YR)	3.9%	0.7%	1.8%	3.6%	6.9%	3.8%
U.S. High Yield	7.3%	0.7%	1.7%	4.3%	13.3%	6.1%
EM Bonds (USD)	6.7%	0.7%	2.7%	4.6%	13.1%	6.3%
Municipal Bonds	3.4%	0.1%	0.9%	2.8%	6.5%	1.3%

Commodities	Current	1WK	1MO	3MO	1YR	YTD
Bloomberg Commodity Index	229	0.9%	-0.6%	-7.0%	-2.7%	1.2%
Crude Oil (USD/bbl)	$76.9	3.5%	-0.2%	-0.8%	-2.9%	5.3%
Gold ($/oz)	$2,512.6	0.8%	5.8%	8.2%	31.9%	22.4%
Copper	$420.1	0.9%	2.8%	-11.7%	12.1%	8.4%
Wheat	$528.0	-5.2%	-4.5%	-29.2%	-24.6%	-21.7%
U.S. Dollar	101	-1.0%	-3.3%	-3.7%	-3.1%	-0.5%
VIX Index	15.9	7.2%	7.7%	24.2%	-0.8%	27.4%

Footnotes: Data is as of August 23, 2024.
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