AUGUST: FALLING YIELDS & VOLATILE STOCKS
FED EXPECTATIONS – AGGRESSIVE RATE CUTS AHEAD?

Figure 1: 8/31/2024 Returns (source: Bloomberg)
Conditional formatting: green (high) to red (low) for each time period

Bonds	ETF	Month	YTD	1YR	vs. 52-wk High	vs. 52-wk Low
US Aggregate Fixed Income	AGG	1.5%	3.2%	7.3%	-0.7%	9.5%
Investment Grade Corp Bonds	LQD	1.9%	3.1%	9.5%	-1.1%	13.2%
U.S. Treasury Bonds	GOVT	1.3%	2.7%	6.0%	-1.1%	7.6%
U.S. 20+ YR Treasuries	TLT	2.1%	-0.1%	3.8%	-4.1%	17.1%
Muni Bonds	MUB	0.2%	1.0%	5.1%	-1.1%	6.8%
US High Yield	HYG	1.5%	6.3%	12.0%	-0.1%	10.7%
Non-US Corp Bonds	IBND	2.6%	2.2%	8.7%	-1.9%	12.9%
Emerging Markets Bond LC	EMLC	2.9%	1.3%	4.9%	-3.2%	7.2%
Global Equity						
ACWI Global Equity	ACWI	2.5%	15.9%	23.4%	-0.1%	32.4%
ACWI Global Equity ex US	ACWX	2.7%	10.8%	17.8%	-0.4%	24.2%
International Developed	EFA	3.3%	12.1%	19.6%	-0.4%	26.3%
Emerging Markets	EEM	1.0%	8.6%	13.6%	-2.8%	19.2%
Global Equity by Region						
United States	VTI	2.1%	18.2%	26.2%	-0.3%	37.5%
Europe	IEUR	3.7%	12.3%	20.2%	-0.5%	28.5%
Asia ex-Japan	AAXJ	1.0%	10.1%	13.7%	-3.4%	19.9%
China	MCHI	0.7%	3.1%	-4.1%	-12.3%	17.6%
Japan	BBJP	1.3%	13.4%	19.5%	-0.5%	24.8%
Latin America	ILF	4.6%	-8.4%	5.1%	-13.1%	15.2%
US Equity						
US S&P 500	IVV	2.4%	19.4%	27.1%	-0.3%	37.9%
NASDAQ 100 QQQ	QQQ	1.1%	16.6%	26.9%	-5.4%	39.2%
US Large Growth	IWF	2.0%	20.8%	30.5%	-4.5%	42.8%
US Large Value	IWD	2.7%	14.9%	20.9%	-0.1%	31.4%
US Eqwt S&P 500	RSP	2.5%	12.4%	19.2%	0.0%	31.9%
US Mid Cap	IJH	-0.1%	12.3%	18.8%	-1.5%	33.7%
US Small Cap	VTWO	-1.8%	10.3%	18.5%	-3.7%	36.0%

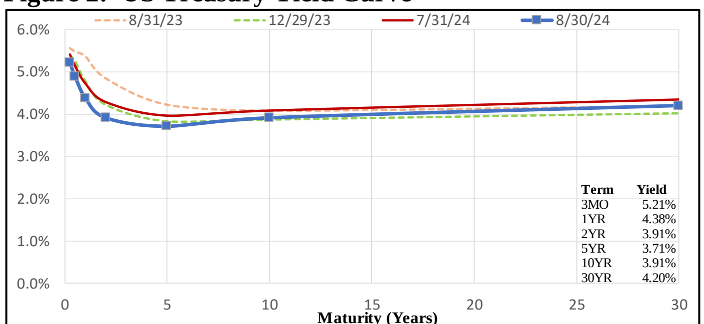
After a sharp plunge early in the month, global stocks recovered to finish August near all-time highs. Bond yields moved lower as weaker-than-expected employment data and moderating inflation fueled hopes for Federal Reserve (Fed) rate cuts. Performance highlights for the month and year-to-date (YTD) are below.

- Bonds: The US Aggregate index (AGG) rose 1.5% this month (+3.2% YTD) as yields fell. Long-term Treasuries (TLT), which are very sensitive to interest rates, gained 2.1% (-0.1% YTD). Corporate bonds (LQD) rose 1.9% (+3.1% YTD), and high yield bonds (HYG) rose 1.5% (+6.3% YTD). Non-US bonds outperformed this month as the US dollar weakened.
- Global equity (ACWI): +2.5% in August (+15.9% YTD).
- US Equity: The broad market (VTI) rose 2.1% (+18.2% YTD). The S&P 500 (IVV) gained 2.4% (+19.4% YTD). After a very strong July, small stocks (VTWO) were down 1.8% this month (+10.3% YTD). Returns were led by defensive and interest rate-sensitive sectors: Consumer Staples, Real Estate, Health Care were all up over 5%; Energy stocks fell 2.1% as oil prices declined below $74 per barrel on slowing global demand.
- Non-US Equity: Developed markets (EFA) gained 3.3% in August (+12.1% YTD), led by gains in Europe (IEUR +3.7%, +12.3% YTD); Japanese stocks (BBJP) were volatile but ended the month marginally higher. Emerging market stocks (EEM) rose 1.0% (+8.6% YTD) with a notable reversal in Brazil (EWZ +7.6%, -11.8% YTD); Mexican stocks continued to fall (EWW -6.2%, -21.1% YTD) after populist election results.

Interest Rates and the Economy

The yield curve (Figure 2) plots the interest rates (vertical axis) for various US Treasury maturities (horizontal axis). Yields declined in August as weaker employment and inflation data fueled hopes that the Federal Reserve will cut interest rates aggressively starting in September. Headline CPI fell to 2.9% year-over-year, and the 2.6% reading on core Personal Consumption Expenditures, the Fed's favored inflation metric, hovers just above their 2% target. An inverted yield curve (short-term > long-term yields) is usually a recession warning, but a "soft landing" seems more likely. US 10-year Treasuries now yield 3.91%.

Figure 2: US Treasury Yield Curve

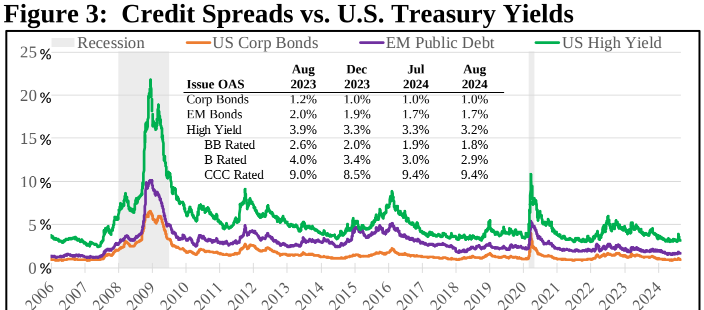


Source: Board of Governers of the Federal Reserve System via St. Louis Fed (FRED)

For bonds other than US Treasuries, we track the option-adjusted spread (OAS) between their yields and Treasuries of comparable maturities (Figure 3). Low or narrowing spreads signal optimism, while high or widening spreads signal fear. Spreads were volatile in August but ended the month relatively unchanged.

- Investment grade corporate bond spreads were unchanged at +1.0% this month, slightly tighter than +1.2% spreads last year.
- High yield (non-investment grade) spreads have narrowed to +3.2% from +3.9% a year ago. Spreads of the riskiest bonds (rated CCC & below) were unchanged at +9.5% but have widened this year and over the past twelve months.
- Emerging market spreads were narrowed to +1.6% and have tightened over the past year; investors see low risk in EM debt.

Figure 3: Credit Spreads vs. U.S. Treasury Yields

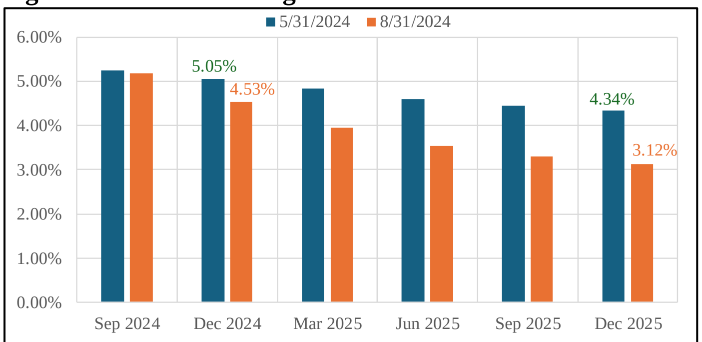


Source: Ice Data Indices, LLC via St. Louis Fed (FRED)

Fed Expectations: Inflation & Employment

Markets continue to be driven by changing expectations for the future path of interest rates. The Fed has held short-term rates steady in the 5.25-5.50% range since July 2023, but they have clearly signaled their intent to begin cutting rates soon, likely starting in their next meeting (September 17-18). Recent data indicating a softening labor market and moderating inflation has led market participants to price in much more aggressive rate cuts, driving bond yields down and stock prices higher. Figure 4 plots the significant shift in expectations for Fed interest rate cuts (via the CBOT Fed Funds Futures market) over the last three months.

Figure 4: Fed Funds Target Rate Forecast

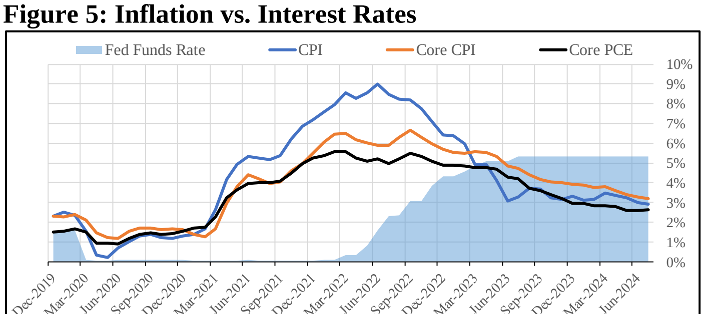


Source: CBOT via WSJ

- **2024:** Investors now expect the Fed to cut rates at least three times this year (0.25% each), starting in September; just three months ago, the markets had priced in only one cut in 2024.
- **2025:** Investors now expect aggressive rate cuts throughout 2025, with the futures market predicting six additional cuts (0.25% each) next year; this is a big change versus three months ago when just three additional cuts were priced in.
- **Summary:** Investors expect a total of nine Fed rate cuts (0.25% each) by the end of next year, bringing the Fed Funds Target Rate down from 5.25-5.50% currently to the much lower range of 3.00-3.25%; just three months ago, futures predicted a total of four rate cuts, ending 2025 at 4.25-4.50%.

The Fed's "dual mandate" is to promote price stability and maximum sustainable employment. Recent data on both fronts suggests that while the inflation fight is not yet won, the Fed has room to moderate their restrictive policy and begin moving rates lower. Figure 5 illustrates the progress made against inflation and the significantly positive real interest rates (net of inflation).

Figure 5: Inflation vs. Interest Rates

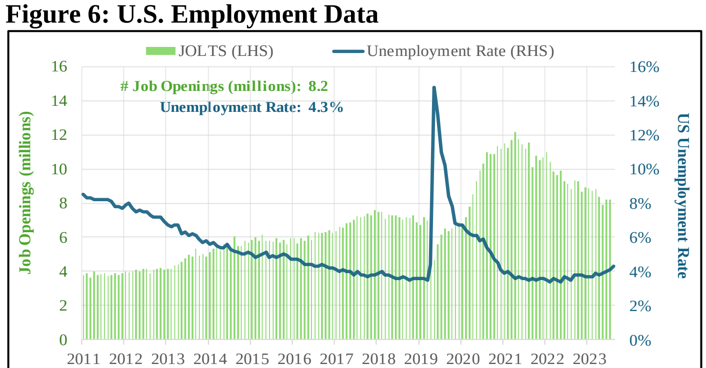


Source: U.S. Bureau of Labor Statistics, U.S. Bureau of Economic Analysis, Board of Governors of the Federal Reserve System

- CPI: Headline inflation peaked at 9.0% in June 2022 but has declined steadily to 2.9% as of July 2024.
- Core CPI: Excluding food and energy, the most volatile components of inflation, the so-called core CPI inflation has declined from a peak of 6.6% to 3.2% year-over-year.
- Core PCE: Personal Consumption Expenditures excluding food and energy (the Fed's preferred inflation metric), has fallen from 5.6% to 2.6%. Data over the last three months suggests an annual run rate of 1.7%, below the Fed's 2% target.

Despite the Fed's aggressive efforts to slow growth and inflation by raising interest rates, the economy has been resilient. Real GDP (Gross Domestic Product, the value of all final goods and services produced in the US, net of inflation) grew at an annual rate of 3.0% last quarter, well above the 2.4% average annual rate during the 2011-2019 economic expansion. Recession fears have subsided in recent months, but those fears were briefly reignited by softer employment data released in August. The latest monthly jobs report indicated that 114,000 jobs were created in July, much lower than the 175,000 jobs expected, and the unemployment rate ticked up to 4.3%, the highest since October 2021. Investors panicked for a couple of days, but markets recovered quickly. Figure 6 offers perspective on the current labor market, which appears to be softening modestly and coming into better balance (so far).

Figure 6: U.S. Employment Data



Source: US Bureau of Labor Statistics via FRED

- **Unemployment remains historically low:** During the Global Financial Crisis, unemployment peaked at 10%, then declined steadily to less than 4% just before the pandemic. Unemployment spiked to 15% in 2020 but declined rapidly back below 4% before rising modestly this year (watching this closely).
- **Job Openings have declined but are still historically high:** Unfilled job openings spiked to a record 12.2 million in the wake of the pandemic; openings have declined to 8.2 million today but are still well above pre-pandemic levels.

Bottom Line

Investors remain focused on interest rates, analyzing each new economic data point to assess when the Fed will begin cutting interest rates and by how much. Recent employment data (weaker-than-expected job creation, unemployment rising to 4.3%) and falling inflation have led markets to price in aggressive Fed interest rate cut expectations. Bond yields have moved lower (and stocks higher) as investors now expect at least three rate cuts (0.25% each) by year end and at least six more cuts next year, bringing the Fed Funds Target Rate down from the current range of 5.25-5.50% to 3.00-3.25% by the end of 2025. With money market rates expected to move commensurately lower, investors should consider reducing cash in favor of bonds to lock in yield.

Expectations regarding interest rates vary with every new economic data report. New employment data will be released this week, inflation data on September 11, and the Fed meets September 17-18. Market volatility is likely to continue, especially with U.S. elections looming. Diversification remains critical.

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