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Investment Institute

Market Commentary

Weekly perspective on current market sentiment **October 2, 2024**

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Last week's S&P 500 Index: +0.6%

Bond prices and Fed rate cuts

Key takeaways

- While bond yields typically fall during easing cycles, the difference this time is that rates have come down in a non-recessionary economy.
- In our view, much of the fall in yields has already been priced in across the yield curve.

Financial markets often, if not most of the time, anticipate changes in Federal Reserve (Fed) monetary policy and move ahead of the actual announcement of interest-rate adjustments. Historically, stocks and bonds are good at discounting the likelihood of upcoming changes. Saying that, and in jest, it has also been stated that "the stock market has correctly predicted nine of the last five recessions." In other words, the markets are not always correct when anticipating Fed or economic outcomes.

But this time around, with at least a little bit of help from our central bankers in terms of "hints" (aka Fed speak), stock and bond prices moved well ahead of Fed rate reductions. The markets have been expecting the domestic economy to slow to a more modest pace (but avoiding a recession) and inflation to fall. So far, with inflation, that has been the case as the headline Consumer Price Index (CPI) has fallen from more than 9% in July 2022 to the latest August reading of 2.5%. But the economy keeps growing at a faster pace than many expected as with revised second-quarter growth of 3% and preliminary third-quarter estimates coming in well north of 2%. Our view is that growth will slow noticeably in the coming couple of quarters.

While bond yields typically fall (prices rise) during easing cycles, the difference this time is that rates have come down in a non-recessionary economy. Past easing cycles typically occurred in reaction to quickly slowing economic growth and a jump in unemployment. The Fed's historical track record shows that engineering a soft landing and avoiding economic contraction (recession) has occurred only a couple of times over the past 50 years. Success is much easier said than done.

Given that, much of the fall in yields has already been priced in across the yield curve. The 10-year Treasury yield has fallen from 4.7% in April of this year to less than 3.8% at the time of this writing. The yield on the 2-year Treasury security, which is more sensitive to Fed monetary-policy changes, has fallen from just above 5% in April to its current 3.65% yield as investors have anticipated rate cuts.

Our view is that as 2025 progresses, the rate cuts we anticipate will have a positive effect on the economy. Growth, and inflation, are likely to be higher in the second half of next year. If that is the case, longer-term yields are likely to climb meaningfully higher than current levels, which equates to negative price performance based on today's yield.

As a result, we continue to suggest that investors reduce exposure to long-term fixed income (unfavorable rating) with funds moving to the intermediate maturities (maturities in the range of three to seven years) where yields are attractive and less sensitive to underlying interest-rate movement. We also moved to an unfavorable rating on short-term fixed income and suggest moving those funds into large-cap (favorable) and small-cap (neutral) equities.

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Definitions

Consumer Price Index (CPI) produces monthly data on changes in the prices paid by urban consumers for a representative basket of goods and services.

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