EASING INTO FALL

Two years after raising interest rates at a near-record pace, to more than 5%, the Federal Reserve is finally poised to begin to ease policy. Fed Chair Jerome Powell could not have been clearer in his major speech at Jackson Hole last week. Moving away from the all out fight against inflation that he outlined at the same venue in 2022, Chair Powell declared "the time has come for policy to adjust." The question for investors is no longer when the Fed will begin to cut policy rates, but by how much and how quickly.

Unsurprisingly, financial markets responded with enthusiasm to the easing signal, which was reinforced by other central bank speakers and by the newly released minutes from the last Fed meeting in July. Bond markets raised the odds of a 50 – rather than 25 – basis point cut when the Fed next meets in mid-September and priced in a full percentage point move by the end of this year.

Markets are likely moving ahead of where the central bank is likely to go, in a pattern that has become familiar in the post-pandemic recovery. As long as the economy continues to add jobs and unemployment is contained, the Fed is likely to remain cautious as it guides rates down.

A LONG TIME COMING

Markets have been anticipating a shift in Fed policy for much of this year, only to be disappointed as the Fed continued to put the inflation fight ahead of concerns about growth and employment. As RockCreek has pointed out, the delay in the Fed's move to cut rates put it in the unusual position of being behind other major central banks as the global monetary cycle finally began to turn this summer. The European Central Bank (ECB), Bank of Canada and the Bank of England, among others, have all embarked on rate cuts in recent months, and signaled more to come.

Divergent economic fundamentals explain the different policy paths. Despite warnings from some that US spending and job creation could suddenly slow down – a "hard landing" scenario – the American economy has continued to show robust growth so far this year. Official data suggest that GDP grew above potential in the first half of 2024, and is now more than fully recovered from the pandemic shock. In Europe, by contrast, GDP growth has remained sluggish. Even now, output is still below the pre-pandemic trend, held down in particular by weakness in the core German and French economies. Canada is also projected to grow more slowly this year, by less than 1%. Contrast that with the latest GDP numbers released for the US this week, showing growth in Q2 at an annualized rate of as much as 3%.

Price performance also diverged earlier this year. In Europe, clear signs that underlying inflation was getting close to target emerged. But in the US, higher than expected inflation in the early months of 2024 worried Fed policymakers. Despite monetary policy that the Fed viewed as clearly restrictive, there were doubts that this would be sufficient to achieve the desired "credible and sustainable" path towards price stability, measured as 2% inflation. In response, the central bank signaled that policy would have to remain tight. Rates were set to be "higher for longer" to keep up the pressure on inflation. Talk resumed among

some analysts that a hard landing would be needed or inevitable to reach price stability, driving up unemployment to drive down wage and price inflation.

A string of better price news over the summer has changed the inflation narrative. At the same time, worries about the real economy spread. An initially gradual and welcome easing of labor market pressures showed signs of accelerating in July – just after the Fed's last pre-summer meeting. Credit card debt has also risen. And housing remains moribund, with August data showing a drop in permits, housing starts and completions from a year earlier.

A cut in interest rates is now duly baked in for the Federal Reserve's mid-September policy meeting, barring extraordinarily bad news on inflation in the next three weeks. Such news is unlikely. Disappointing jobs numbers for August are a more likely risk. If next week's labor report shows a further rise in unemployment or drop off in job growth, the Fed could move by 50 basis points. But with much of the data still showing US strength, it is more likely that in the US as elsewhere the easing cycle will begin with a 25 basis point cut in the Fed Funds policy rate.

CHINA AND GERMANY: ELEMENTS OF A SHARED FISCAL IDEOLOGY HOBBLING GROWTH?

China's post-pandemic economy continues to disappoint. Rather than snapping back once draconian Covid-related controls were lifted in early 2023, domestic consumption has remained sluggish. Latest data suggest that growth continues to underperform. At first glance, the state-dominated Chinese economy has little in common with Germany, Europe's economic powerhouse. But as leaders of both countries struggle to stimulate domestic growth, there is a similar ideology about debt and fiscal policy that is complicating their efforts. Both countries are overly reliant on exports for growth and, for important historical reasons, unwilling to use fiscal policy flexibly to stimulate private demand and consumption.

Germany, with a fractured coalition government, is moving to consolidate its fiscal position despite continued economic weakness. Many economists believe that austerity moves are mistaken at this juncture. The latest survey of business conditions by the German IFO Institute showed a further deterioration in August. "The German economy is increasingly falling into crisis" concluded the influential institute. But the government's room to maneuver is limited by the difficulty in winning support to change the "debt brake" built into the constitution after the 2008 financial crisis.

In China, the central government, which controls most of the revenues of the state, is traditionally loath to take on debt in order to fund local governments. But it is local governments that are responsible for most spending that supports household needs, from social services to education. Until recently, the circle was squared by a property boom that both boosted local government finances and raised household wealth, as Chinese families ploughed savings into real estate.

The failure of property companies from Evergrande to Country Garden triggered by tougher regulations has been managed so as not to cause a collapse in the financial system. But the continued crisis has dealt a direct blow to consumer confidence and Chinese household wealth, as well as to the ability of local governments to raise revenue through land sales to fund social spending. The result is that domestic consumption is flagging.

Foreign investors have soured on China – influenced in part by geopolitical tensions that have continued to rise. This week brought welcome news on that front. High level talks in Beijing between President Biden's key foreign policy aide, Jake Sullivan, and China foreign minister Wang Yi resulted in agreement that Presidents Biden and Xi

should speak soon. Direct military-to-military dialogue will also restart. The first China trip in 8 years by a US National Security Adviser followed earlier secret meetings between the two diplomats. However, there are limits to how far either side is willing to go at a time of fierce economic and technological competition.

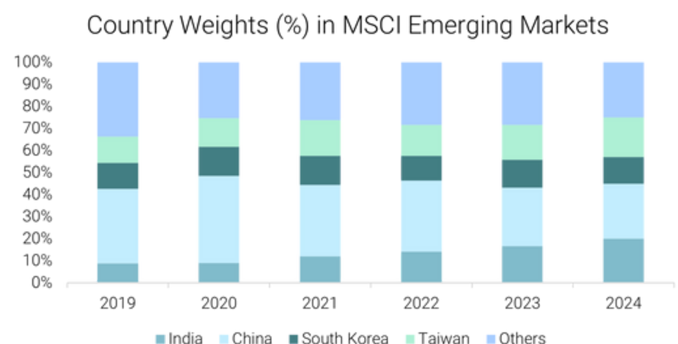
EQUITIES KEEP THE FAITH

Even as bond markets gave up over the summer on hopes that the Fed would cut rates early and often, US stock markets continued to reach new heights. While positive equity performance is nothing new in 2024, what has been interesting post-central bank and economic data releases since the end of July (detailed above) has been the broadening out/rotation of performance in certain segments of the market.

International equity markets are positive in dollar terms despite falling locally in many instances due to a weakening dollar (a weaker dollar brought on by an easing Fed is a repeated theme both directly and indirectly throughout the remainder of the letter). MSCI ACWI is up 1.7% (ex-US it is up 2.5%) for the month vs. up 1.3% for the S&P 500. The Nikkei is up 2.0% and the Stoxx 600 in Europe is up 4.0%. MSCI Emerging Markets ex-China is up 2.1%. What has pushed the S&P 500 higher all year is now weighing on performance with the "Magnificent 7" down 1.9% so far this month. Despite recovering a significant amount of their losses on the initial growth scare in early August, small cap equities are underperforming the broader equity markets.

While interest rates and currencies will continue to impact equity market returns, arguably what investors are most concerned about going forward is the earnings outlook. As the current earnings season comes to a close, markets received the most anticipated release on Wednesday of this week: Nvidia released its earnings on August 28 after the close, and the market reception was not as ebullient as in quarters past. Shares traded down more than 6% after the initial release and ended the following trading day down 4% from its prior close. The market's shunning of the tech behemoth's results demonstrates what can happen with a high growth company. Nvidia beat earnings, revenue, and other metrics and its forward guidance for revenue was even above the median sell-side estimate, but it wasn't better than the highest sell-side estimates for future revenue. In addition, the company disclosed production issues with its newest Blackwell chip. When the market is accustomed to great, it seems that good just might not cut it. This could very well end up true for the remaining Magnificent 7 and explain their recent underperformance. While earnings are expected to grow by 15 percentage points more than the rest of the S&P 500, they trade at more than a 50% premium.

A part of the market that has traditionally benefited from easier Fed policy and a weaker dollar could be poised for strong performance: emerging market equities. Yes, emerging markets are cheap – trading at 15x trailing earnings vs. the S&P 500's 25x – but critically, earnings growth is expected to be approximately 25% over the next 12 months according to data from Bloomberg. The earnings growth will be led by countries such as India, Korea, and Taiwan, which have risen in prominence in the index in recent years.



The IMF expects emerging economies to outgrow the US over the next five years to a degree not seen since 2005-2009. The divergence is in large part driven by the expectations for India, but other economies from all regions are forecast to grow above the US and broader developed market rate. Ruchir Sharma in a recent editorial eloquently builds the case for EM, citing these economic growth statistics as well as emerging market countries' robust earnings potential and a weaker dollar as supportive for the asset.

FIXED INCOME

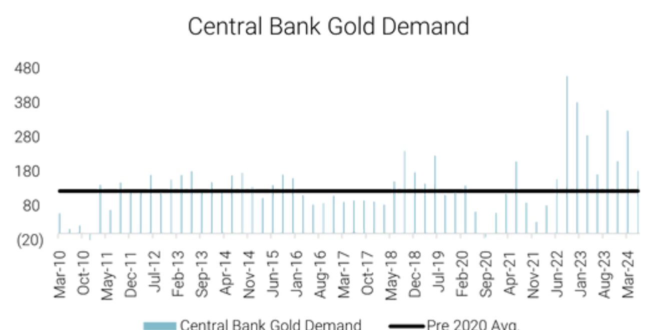
Fixed income markets continue to be dynamic in August. Following the Fed meeting on July 31 and the payroll announcement on August 2, short term interest rate markets went from pricing fewer than three interest rate cuts of 25 basis points each through the end of 2024 to pricing more than five in three trading sessions. As broader financial markets stabilized toward the end of August 5, that number moved closer to four expected cuts. Markets have stabilized around that mark despite some easing of immediate growth concerns. In addition, roughly two additional cuts were priced into year-end 2025, bringing the expected Fed Funds rate to approximately 3% by the end of 2025 – more than two percentage points lower than its current level.

Large moves in interest rates were not just isolated to the front part of the curve as US Treasuries rallied across the board. 2s10s bull steepened as 2-year yields fell by 46 basis points compared with a 24 basis points lower move in 10-year yields. Every key rate on the curve went lower as every point from one year out declined by at least 20 basis points. Real yields also fell with the 10-year real yield falling 10 basis points following the Fed meeting in July and another six after the weaker labor market data released in early August. This is a continuation of the downtrend in real rates that began at the end of April and has helped support asset prices over that period.

The fall in yields has been supportive for fixed income assets, including credit and emerging markets, despite some initial spread widening in the turbulent part of the month. The Bloomberg US Agg is up by 1.8% in August with mortgage-backed securities rising 2.0% and investment grade credit rising the same amount to slightly outpace the broader index. Local currency-denominated emerging market debt has performed particularly well, getting a boost from currency appreciation against the USD. Essentially all that outperformance against US fixed income has been driven by currencies (more on that below).

COMMODITIES

One commodity has caught plenty of headlines amid this recent fall in rates, particularly real rates: gold. While gold has been trading around a record high for this year, it has recently broken out well above $2,000/oz; it is trading just above $2,500 currently. In a falling real rate environment gold tends to do well as the opportunity cost to hold a no-yield asset lessens. Moreover, there is a general appeal to use gold as a dollar hedge, whether it is in terms of general depreciation, fears of debasement, or, in the case of other sovereigns and central banks, as a diversifier for currency reserves. Indeed, central banks continue to drive large amounts of demand for gold. In addition, speculative positioning in gold futures contracts is the highest it has been since 2020.

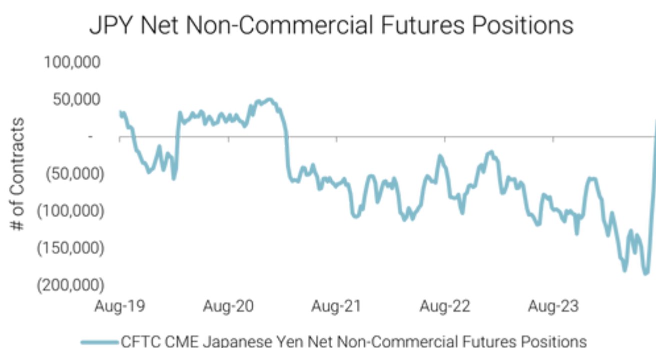


CURRENCIES

Once again, global currency markets were dominated by the activities of the Bank of Japan. On July 31, the Japanese central bank raised its policy rate to positive 25 basis points, the highest level since mid-2008. Prior to the meeting, interest rate traders were pricing in a 50% probability that the BOJ would go ahead with a hike. After the move, the yen rallied to 150 against the dollar.

The day following the BOJ decision proved to be equally impactful to the Yen. In the US, weaker-than-expected employment data and the shifting expectations for rate cuts over the course of the next two years (both described in more detail above) drove further buying of the Yen as a more aggressive cutting cycle from the Fed would narrow the real interest rate differential between the US and Japan.

However, by the time the employment numbers were released at 8:30 am Eastern time, Japanese markets were closed and traders were headed off for the weekend. When they returned on Monday, market participants had to play catch-up, spurring yet another flurry of Yen buying and further feeding on itself as many Western traders began rapidly unwinding existing currency shorts, as these traders hit risk limits and were forced buyers. As demonstrated by data from the CFTC, the rate of short covering was so aggressive that for the first time since early 2021 speculators ended up net long the Yen.



The Japanese Yen hasn't been the only currency to strengthen against the US Dollar in recent weeks. In fact, DXY – a general measure of dollar strength – is nearing its lowest point since June of 2023, down more than 10% from its five-year high reached in September 2022. DXY consists solely of developed market currencies, however, so it only tells part of the story. As alluded to above, emerging market currencies have also strengthened against the dollar, particularly this month. The MSCI Emerging Markets Currency index is up 2% in August, its best month since November of last year. Currencies of Malaysia, Indonesia, Thailand, Brazil, Chile, and across eastern Europe have all performed strongly against the dollar. Should this bout of dollar weakness continue, it should be supportive of international assets.