# FED: CAUTIOUS OR BOLD?

The Federal Reserve is set to cut interest rates next week, kicking off a long-awaiting easing cycle. The only question is whether the initial cut will be a cautious 25 basis points or whether the Fed will go big with a 50 bp cut. Renewed hopes of a bigger cut pushed equity markets higher to end the week, but most major indices remain in the red so far in September. The European Central Bank (ECB) cut policy rates by 25 bp for the second time this week. President Christine Lagarde said data would determine whether the next cut is in October or December.

The odds for the size of the Fed cut may seem to favor going small. Market hopes for a bigger move dimmed last week after a labor report showed the jobs market in August was still expanding. They were almost extinguished by this week's slightly hotter-than-expected core consumer prices, pushed up in particular by stubbornly high housing and shelter costs.

But indications that the Fed's decision is not yet set in stone lifted spirits on Friday. Arguments in the press for starting with a bigger move suggested continuing internal debate. Indeed a small move risks disappointment unless such public comments are quickly tamped down. Investors should be ready for either move. Attention will also be on the Fed's "dot plot" indicating central bankers' expectations for where rates will move for the rest of this year, and in 2025.

## ELECTION WORRIES

Finally, we are getting close to the biggest political event of the year. Early voting has already begun in the US Presidential election. With the November 5 election day not far off, analysts are turning attention to what the outcome will mean for the economy, globally and here in the US, and for investors. But the election remains on a knife-edge. Polling carried out before this week's debate showed the two candidates neck and neck, both overall and in the few swing states that will determine who wins the Electoral College. With the two candidates offering very different economic policies, it is no wonder that market volatility is up.

Former President Trump is promising sharply increased tariffs on a wide range of imports – potentially from many countries – that would put renewed pressure on inflation and could lead to retaliation. Mass deportation of illegal immigrants would disrupt the economy, as well as many communities. But while businesses may worry about tariffs and losing immigrant labor, they are more supportive of the further cuts in taxes and regulations that former President Trump favors. Vice President Kamala Harris, by contrast, has said she would like to raise taxes on capital gains and for the better off, while keeping whole households earning less than $400,000, boosting federal help for families with children and on low incomes and taking steps to resolve America's growing housing problems and support innovation.

The ability of either candidate to carry out their plans will depend importantly on Congress. Here too, uncertainty rules. Both House and Senate are

up for grabs, with the House leaning to Democrats and the Senate likely to end with a very small Republican majority. Democrats are defending vulnerable Senate seats in states such as Montana and Ohio that heavily favor former President Trump while in the House, Republicans fear that they may lose the narrow majority that they have had since 2022.

Setting aside questions of policy direction, there are real concerns that a close election result will lead to contentious challenges. This would further prolong uncertainty.

## BALANCING RISKS

Until very recently, Fed Chair Jerome Powell and colleagues have been careful to emphasize the importance of establishing a credible path to a return to price stability, or 2% inflation. Over the cycle, the central bank has consistently taken a tougher stance than markets have expected. It raised rates more quickly and to a higher level – 5.25 to 5.5 – in 2021/2022. And the Fed has held off from lowering rates for two years, as inflation numbers stayed higher than desired and jobs remained plentiful.

Now the risks have shifted. Unemployment has crept up over the past six months, triggering the "Sahm rule" in July before slipping back to 4.2% in August. Former Fed economist Claudia Sahm has said that in today's circumstances her rule linking rises in the jobless rate to recession risk may not operate as before. But it is clear that the labor market is no longer "very tight." Revisions released at the end of August to earlier payroll data show less buoyancy in the job market than initially reported in the year from April 2023 to March 2024 as payrolls were revised lower by more than 800K jobs over that period. Labor market indicators lag changes in the underlying economy, leading some analysts to worry that a sharper slowdown is already underway.

In his keynote speech at Jackson Hole two weeks ago, Fed Chair Jerome seemed to agree that there was no time to lose. He indicated more worry about the risks of economic slowdown than a rebound in inflation. If the "direction of travel" for rates is clear, as he said, and the policy rate is well above a neutral level, then he may argue for taking a bigger upfront cut than usual.

## BANKS GET A BREATHER

This week brought good news for the largest financial institutions, or Global Systemically Important Banks (GSIBs), such as JP Morgan Chase and Goldman Sachs, as the Federal Reserve's supervisory leader, Vice Chair Michael Barr, rowed back stringent proposals for capital increases. Initial proposals for implementing the so-called "Basel III Endgame" were put forward in the aftermath of the 2023 unraveling of Silicon Valley Bank and other large regional lenders and would have represented an extensive effort to tighten banking regulations and strengthen the financial system. Banks and lawmakers pushed back hard on the suggestions from the regulators both in the US and the UK.

## GLOBAL DIVERGENCE: EUROPE SLUGGISH, CHINA FLAILING, AND WHAT NEXT WITH JAPAN?

Whatever the concerns that the US soft landing may be harder or bumpier than hoped for, the American economy continues to outstrip performance elsewhere. In Europe, the European Central Bank has already shifted to easing, with a second 25 bp rate cut this week.

But continued sluggish growth across the EU has deeper roots, according to a devastating report issued this week by former ECB President Mario Draghi. In addition to criticizing the conservative stance of overall macro policy favored by Germany and, often, Brussels, Draghi called out the lack of private investment and dynamism in European industry. A detailed sector by sector analysis showed European businesses hobbled by fragmentation in today's innovative sectors of telecoms and cloud computing. Although R&D

remains high in the automotive sector, the traditional sweet spot for European competitiveness, companies in this sector have been slow and less successful in moving from internal combustion engine vehicles to electric.

Although China has been remarkably successful in developing and exporting electric vehicles, its broader economic performance is also disappointing. The continued unwillingness of the administration to provide support to consumption means that growth remains dependent on investment and exports. A return to growing global imbalances – with rising Chinese surpluses and US deficits – is causing political reaction in China's export markets. As the International Monetary Fund points out in a timely blog, fears of a second China shock are encouraging its trading partners to consider active industrial policies and protection to ward off a flood of imports. A better response would be to press for a more effective shift to support consumption in China.

## FIXED INCOME

The onset of autumn has seen a renewed interest in safe-haven assets across the board. Economic data, as discussed above, has pointed toward a slowing economy. While the sky may not be falling, investors seem to think it is time for interest rates to do so. Short-term interest rate markets are now pricing a full percentage point cut in interest rates by year-end. With the 2-year and10-year points of the yield curve flirting with dis-inversion for the first time since mid-2022 also suggests traders are expecting imminent rate cuts. The most recent CPI print released on Wednesday has not done much to unwind those expectations. It does seem a possible stretch that a soft landing would be accompanied by so much easing. A single cut in September and December is a more modest expectation for a mid-cycle adjustment.

It is perhaps no surprise then that real rates and long-term inflation expectations continue to fall in September. Historically a fall in both has portended a macro environment in which safe-haven assets perform well. Developed market duration has the best nominal performance and rallies most consistently, but both gold and Japanese Yen have tended to do well in these periods as well (see more below on the currency and commodity moves). Consistent with historical precedent, fixed income markets have performed strongly over the past few weeks with the US Agg outperforming its Global Peer. Quality has done better with Mortgages, Treasuries, and US Investment Grade outperforming domestic high yield and emerging markets debt. Within investment grade, performance has been uniformly skewed to higher quality with triple-A outperforming double-A and on down the line. In high yield, the results are a bit different, with lowest rated triple-C's outperforming the broader market. These riskier credits had a bout of significant underperformance over the summer, and thus a tactical bounce back could at least partially explain the paradoxical outperformance. In addition, investors are finding it harder to find value in the better-quality high yield bonds and as such are moving out the risk spectrum.

Relatedly, another potential reason for the relative performance of these lowest rated credits in an otherwise risk-off environment could be the growing understanding of the shifting composition of this segment of the high yield market. There has been an increasing amount of analysis suggesting many of the lowest quality borrowers within the triple-C universe have turned to private markets for financing. If the credit quality has indeed improved, then perhaps one isn't moving as far out the risk curve for a pick-up in yield as was the case in the past. Like many things in financial markets, however, it will likely take a period of significant economic stress to determine if CCC rated securities have indeed gotten any safer.

## EQUITIES

September has earned a reputation for being a historically weak month for equities and this September has been no different with small-cap and cyclical stocks suffering the brunt of it. Small-

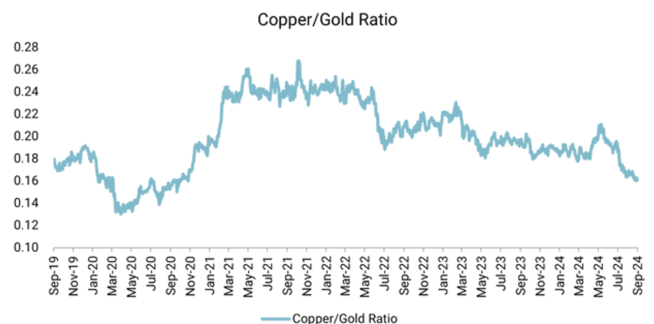
-cap underperformance has been particularly pronounced with the Russell 2000 underperforming the S&P 500 by roughly one percentage point month-to-date. Meanwhile, economic growth concerns have spurred a flight to defensives, helping large-cap tech earn back some of its momentum from earlier this year. Quality and Minimum Volatility factors have correspondingly been holding up as well. A similar dynamic is playing out in emerging markets. Some of the worst performers so far this month have been the most pro-cyclical economies in EM. Commodity producers such as Chile, Peru, Colombia, and South Africa have underperformed the broader market. Korea and Taiwan have also been hit hard, likely driven by their sensitivity to regional and global growth.

Corporate earnings have proven resilient with solid earnings beats across sectors, helping support equity pricing, but the market may at this point be capped into November. The Street is forecasting widespread earnings growth over the next 12 months, but this presents a downside risk with projections likely to be revised downward. Distinct pockets of cyclical weakness have clearly emerged in consumer discretionary, particularly with the low-end consumer. Banks and other financials are flashing warning signs as well. Just this week JPMorgan Chase cautioned on next year's expenses and net interest income, driving its shares to their largest single-day loss in over four years. Also, Ally Financial reported higher auto delinquencies and net charge-offs than anticipated and Goldman Sachs warned about its trading revenue this week. On Thursday, Wells Fargo was the subject of an enforcement action from the Office of the Comptroller of the Currency requiring it to take comprehensive corrective actions to shore up its financial crimes risk management practices and AML internal controls. Other major banks will want to re-examine their own policies to ensure they're in compliance. It's worth noting that banks are widely considered to be de-regulatory beneficiaries of a Republican-led administration and Congress. While it can be difficult to discern the extent of impact from the US election season, the results of Tuesday night's presidential debate certainly did nothing to advance this bull case.

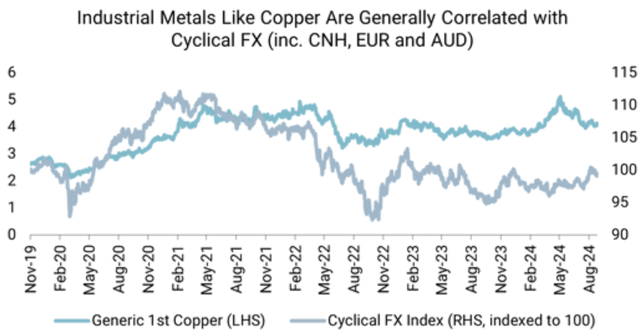
Between evidence of cyclical slowdown in key parts of the economy and uncertainty around the outcome of US elections, the market is likely to continue favoring high-quality companies delivering consistent earnings growth and excess free cash flow, i.e. Big Tech. The outlook for cyclicals largely hinges on the Federal Reserve's ability to stabilize the economy through interest rate cuts. Proof to the positive of that will be key to a broadening out of market strength into cyclicals and small-cap.

## COMMODITIES

Over the last several months, an interesting trend in a number of commodity markets has emerged. These trends may provide insight into how investors across asset classes are evaluating the probability of achieving a soft landing. Following a rapid selloff in copper prices in July, the copper/gold ratio has fallen to levels not seen since November 2020. A low reading on this ratio may be a harbinger of economic weakness, as copper prices are highly pro-cyclical and driven by industrial demand while gold is seen as a safe-haven that tends to benefit from economic weakness. This ratio in particular is highly correlated to prices of other key industrial commodities, such as crude oil and iron ore – both of which have declined in recent weeks. All of this in aggregate suggests that, whether knowingly or not, commodity market participants are pricing a much weaker global economy than certain other measures and polls.

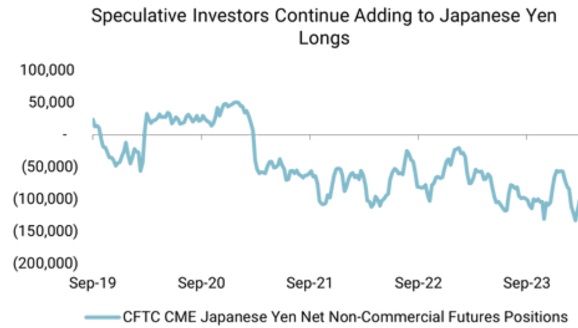


Much of the market action described above can be, at least partially, attributed to China. The much-covered slowdown in Chinese economic activity, particularly with regards to construction activity has dampened demand for various cyclical commodities, most notably iron ore and copper. A protracted slowdown in the Chinese economy may have a profound impact on the global economy writ-large, especially for developed economies that are particularly sensitive to Chinese growth, such as Australia. This could precipitate a rally in global bond prices and safe haven currencies, especially against more cyclically-driven FX, which has materialized over the past few weeks, which is covered in more detail below.




## CURRENCIES

As RockCreek has written in several recent newsletters, the Japanese Yen has proven to be one of the most important risk assets to the broader market in recent months. The Bank of Japan's second interest-rate-hike in late July alongside weaker-than-expected Non-Farm Payrolls prints in both August and September, has pushed the Yen stronger against the dollar – reaching levels last seen in late 2023. Given the ongoing series of domestic wage gains, inflation in Japan is likely to remain elevated, justifying continued tightening by the BOJ as the rest of the world moves to cut their policy rates. While much debate has taken place over the size and scope of the "carry trade" unwind in early August, positioning data from the CFTC indicates that speculators, including levered hedge funds, have continued to add to Yen longs, albeit at a considerably slower pace than before.




Perhaps even more notable is the recent bid for safe-haven currencies. In Asia, the Yen has strengthened considerably against most neighboring currencies, but in particular against the Australian dollar and Korean won. This is potentially attributable to Australia and Korea's greater reliance on China, which continues to slow, as well as Japan's shift towards hawkish monetary policy. In mainland Europe, the Swiss franc has appreciated against the euro, while further north in Scandinavia, the Swedish Krona has risen against its westerly neighbor, the oil-influenced Norwegian Krone. All of this suggests that while growth in the US has remained resilient and that a soft landing may be possible domestically, growth fears in the rest of the world remain a primary concern that has started to be reflected in asset prices.