

ECONOMIC OUTLOOK

Summary

The Federal Reserve's decision to initiate its rate-cutting cycle with a 50 basis points (bps) reduction in the overnight rate, rather than the conventional 25 bps adjustment, was among the notable economic surprises during September. This outsized rate cut didn't completely blindside market participants, but many were caught off guard since the possibility had only been 50% priced into markets. Additionally, the Fed indicated the potential for six more 25 bps rate cuts before the end of 2025 in its Summary of Economic Projections.

The Fed justified this aggressive action by citing improved balance in economic risks – its increased confidence in inflation returning to the 2% target in conjunction with a cooling labor market. In other words, the growing unemployment rate, albeit from all-time low levels, had become equally as important as inflation to the Fed. By starting the rate cutting cycle with 50 bps, the Fed is thought to have frontloaded to preempt potential economic headwinds due to the lagged effects of monetary policy. Still, they made it clear these actions do not determine the size or pace of any future rate cuts.

Recent labor market data has presented a slightly confusing picture. Payroll reports, unemployment rates and substantial downward revisions certainly have disappointed in recent months. Yet one of the drivers of the increase in the unemployment rate has been re-entry into the workforce, rather than significant layoffs or job scarcity. This made September's nonfarm payrolls report, released in early October, a welcome surprise. Job gains for the month exceeded expectations by more than 100,000 with a 254,000 increase. Perhaps more importantly, revisions to August and July added an additional 72,000 jobs – a noteworthy shift from the significant downward revisions observed since early spring.

Economic momentum appears to be solid, with the Atlanta Fed projecting continued above-trend growth for the third quarter. The lower overnight rate will only help to further stimulate economic activity, which should build on the trend of above-average growth seen since mid-2022. While the full impact of the Fed's rate-cutting cycle will take time to materialize, the current trajectory suggests progress towards a successful soft landing, provided inflation remains at or below current levels.

Positives

The unemployment rate continued to decline for the third consecutive month (4.1%)

Year-over-year Headline CPI has reached its lowest level since March 2021 (2.5%)

Retail sales remained positive for the month, despite expectations (0.1% vs. -0.2% est.)

Negatives

ISM manufacturing PMIs remained in contractionary territory for the sixth straight month

Existing home sales were more negative than expectations (-2.5% vs. -1.3% est.)

The Conference Board Consumer Confidence Index dropped to its lowest level in three months (98.7)

EQUITY OUTLOOK

Summary

Despite its reputation as being volatile and the worst performing months for stocks, September 2024 ended up being a decent month for equity investors. The opening days of trading in the month were weak but the S&P 500 Index ultimately pushed higher by 2.1%. The index rose 5.9% in the third quarter and capped off its fourth consecutive quarter of positive returns. Equity markets were broadly higher by style, size and geography.

Perhaps the biggest story for equity markets in September was the anticipation and delivery of the Federal Reserve's first rate cut of this cycle. Consensus expects this step to be followed by additional cuts for the remainder of 2024 and further action next year. Those moves are likely to create a favorable tailwind for risk assets and in particular equity markets, especially if this dovish Fed pivot doesn't cause inflation to reaccelerate or isn't too late to avoid significant economic deterioration. At this point, the stock market is suggesting policy makers have threaded the needle well.

There has been discussion in the media of an October surprise. The race for the presidential election remains extraordinarily tight with just a handful of weeks remaining in the campaign. Any scandal (true or fabricated) or gaffe by either candidate could shift the balance and have an impact on capital markets. The recent port worker's strike has no immediately clear resolution. An extended strike could hamper growth prospects, disrupt supply chains and lead to higher inflation. The Middle East conflict between Israel and the Iran-backed terror groups Hamas and Hezbollah has shown few signs of winding down. These are among a number of October surprises that could cause some near-term dislocation in equity markets.

As we consider these near-term risks, it is important to note the momentum has clearly been positive for stocks. The Goldilocks (not too hot or too cold) setup is advantageous for corporations. With earning season kicking off later this month, analysts expect solid earnings growth. Equity market performance has historically shown a significantly high correlation to earnings growth. This all bodes well as investors move into the final quarter of 2024.

Positives

Federal Reserve bank has begun easing with more rate cuts expected

Artificial intelligence and other innovations ushering in a new wave of improved productivity

The election and the noise that accompanies it will soon be over

Negatives

Geopolitical tensions remain elevated

Many retailers have acknowledged cautious consumer behavior

Unknowns

With the race so tight, the election outcome may create a knee-jerk reaction

FIXED INCOME OUTLOOK

Summary

Following months of anticipation, on September 18 the Federal Reserve (Fed) cut the Federal Funds rate for the first time since the momentous rate-hiking cycle began in March 2022. While the action was widely expected, an outsized rate cut of 50 basis points (bps) typically signals distress. However, this cut was not due to an economic emergency, but rather an acknowledgement policy was overly restrictive given the significant moderation in inflation and their confidence in its continued decline. The 50 bp rate cut was akin to purchasing an insurance policy against further material labor market weakness.

Since the end of April, yields across the curve have declined significantly as investors gained confidence in the outlook for multiple Fed rate cuts in the second half of this year. This continued with a sharp drop prior to the mid-September Fed rate cut. The 2-year Treasury note reached a low of 3.54% after ending August at 3.92%. This was about 150 bps lower than the late April peak. Starting the month at 3.90%, the 10-year hit 3.62% a few days before the rate cut. This was about 110 bps lower than the April high. Following the Fed announcement, short rates chopped sideways and longer-maturity yields ground slightly upward. For the month, the 2-year declined 28 bps to end at 3.64% while the 10-year declined a more modest 12 bps to end at 3.78%. After a rough first four months of the year, yields have now declined across the curve for five consecutive months. Notably, with the sizable drop in short yields, the 2 to 10-year curve has finally “un-inverted” after more than two years with the unusual situation of shorter-maturity yields being above those of longer-maturity bonds.

The Fed anticipates two additional 25 bp rate reductions in 2024, followed by another 100 bps of reductions in 2025 before reaching its long-run neutral rate target of 2.9% sometime in 2026. They believe they have plenty of flexibility to reduce rates faster or slower as needed to address unexpected economic vulnerabilities and extend the current economic cycle. At month’s end, the market was pricing for

another 75 bps of cuts this year followed by another 100 or 125 bps in 2025. Investors may be set up for disappointment if the economic data does not force the Fed to bring forward rate cuts sooner than their recent communication indicates. And as of now, there is little evidence to suggest the economy is stalling and forecasters expect Q3 GDP was about 3%, similar to the prior quarter. While shorter-maturity yields might not change much, longer yields could be under pressure and move somewhat higher as investors adjust to the Fed’s timing and cadence of rate cuts. We still recommend maintaining a portfolio duration similar to that of the benchmarks with a higher allocation to corporate bonds.

Positives

Labor market is in better equilibrium

Fed confidence that inflation continues to trend towards 2% target

Fed Chairman has begun to lower overnight borrowing rates

Negatives

No political will to lower the Federal budget deficit

The markets are anticipating a faster pace of rate cuts than the Fed

Yields have already moved sharply lower

Unknowns

The market’s ability to digest sizable Treasury issuance due to deficits

Risk of a broader Middle East conflict. Russia/Ukraine war