The Time Has Come for Policy To Adjust

Lawrence Gillum | Chief Fixed Income Strategist
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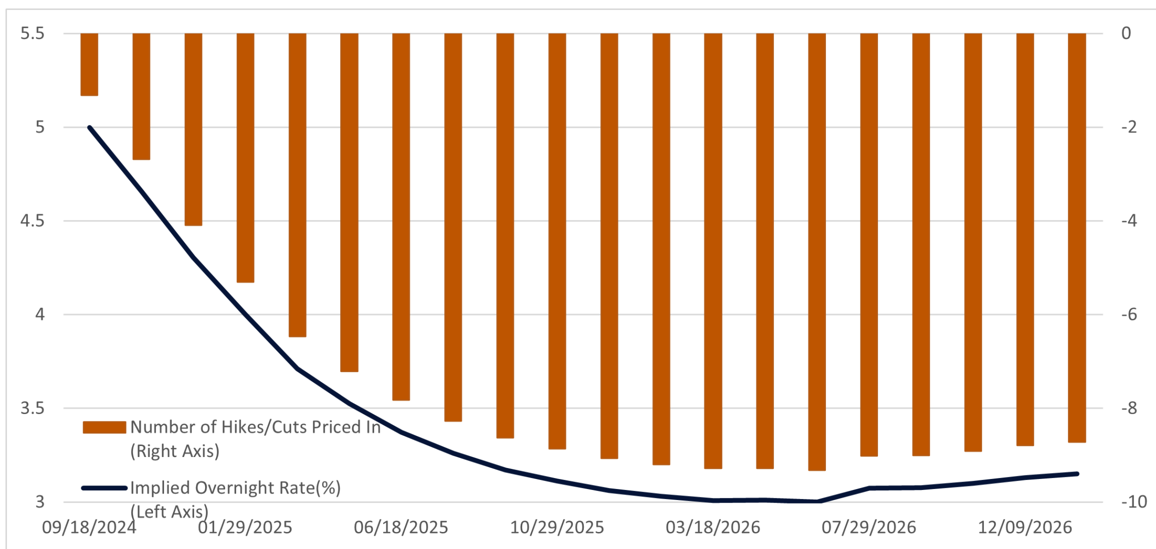
Additional content provided by Colby Hesson, Analyst, Research.

Federal Reserve (Fed) Chair Jerome Powell headlined last week's Jackson Hole Economic Symposium, titled "Reassessing the Effectiveness and Transmission of Monetary Policy." In his speech, he could not have been more clear: "The time has come for policy to adjust." The fed funds futures market expects a rate drop next month. Implied probabilities for a 0.25% reduction in the target rate remain at 100%, while the odds for a 0.50% rate cut are currently at 35%. Powell has stated the Fed's future decisions will be data-driven, and thus it may be too early to say. Next month's employment report will likely reveal whether we will get a 0.25% or 0.50% cut.

After Powell's speech last Friday, markets are likely to start expecting rate cuts beginning at the September Fed meeting. However, markets have priced in a pretty aggressive rate cutting cycle, with over 1.0% of cuts this year and another 1.0% by next summer. While the 2% in cuts is less than what the Fed typically cuts during recessionary periods, it's aggressive for an economy that is still growing. The 1994/1995 period is used as an analog of the current period because markets are mostly expecting a soft landing. However, the Fed only cut rates by 0.75% in 1995 before raising rates by 0.25% a year later, with core Personal Consumption Expenditures (PCE) levels lower than current readings. Could the markets be right? Of course. But that means further declines in intermediate rates are probably limited unless the economic data deteriorate significantly from current levels. This week's personal income and spending data could be more important than the PCE data, as the Fed's mandate has shifted from inflation to economic growth and employment.

Are Too Many Cuts Priced Into Markets



Source: LPL Research, Bloomberg 08/26/24
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Amid elevated debt and deficits, we expect more market volatility ahead, as financial markets become more sensitive to fiscal and political shocks. With the Fed set to cut interest rates this year and into 2025, we are likely going to notice shorter-maturity Treasury yields fall more than longer-maturity yields. The Treasury yield curve is still inverted, so until the curve "rights itself" longer-maturity yields are likely stuck at or around current levels. This limits the potential for price appreciation, but income opportunities are more enduring.

Summary

Fed rate cut expectations in September continue to directionally drive Treasury yields despite the expected increase in Treasury supply. From a fundamental perspective, we think Treasury yields are likely range-bound at these higher levels. Technically, 10-year yields remain in a downtrend and are now oversold near support from the December lows (3.78%). Watch for a potential short-term bounce near this area. Aside from preferred securities, valuations for riskier fixed income sectors remain rich relative to core sectors, in our view. And while price appreciation may be limited, until inflationary pressures abate, income levels remain attractive. As noted in our *Midyear Outlook 2024: Still Waiting for the Turn*, our year-end 2024 target for the 10-year Treasury yield remains at 3.75% to 4.25%, and we expect fixed income to outperform cash in 2024.

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Lawrence Gillum

Lawrence Gillum, CFA, guides the fixed income view for LPL Financial Research and has over 20 years of investing experience.

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