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# Investment Insights Monthly

From the Desk of Bill Hornbarger, Chief Investment Officer

August 2024


## The Fed Signals a Pivot

The Federal Open Market Committee (FOMC) first lowered interest rates to 0% on December 16, 2008, and since then, very little has been "normal" about monetary policy. Rates stayed at the zero-bound for seven years, with the U.S. Federal Reserve (Fed) embarking on a path to slowly increase them back above the rate of inflation in 2015—only to be faced with the sharp Covid-19 recession in early 2020. Rates again were lowered to zero, ultimately contributing to a reignition of inflation to the point where the Fed had to aggressively raise rates a total of 5.50% over an 18-month period, beginning in March 2022.

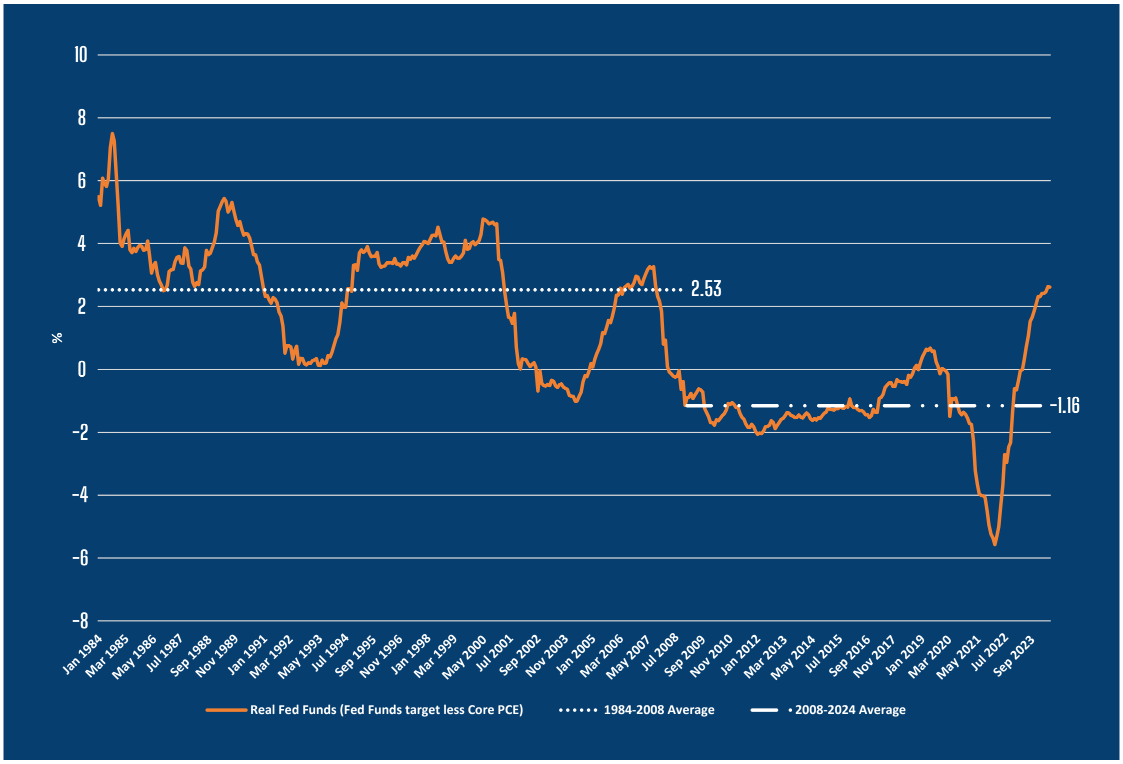
The markets entered this year forecasting that the Fed would cut rates potentially as many as six times (25 basis points each), but soon learned that the Fed meant what it said, that policy would be data-dependent, and it needed more signs that inflation was convincingly on a path towards the 2% target rate (as measured by core personal consumption expenditures, or PCE) before cutting rates.

Futures markets have priced and repriced not only when the Fed will cut rates for the first time but also how many in total can be expected in calendar-year 2024. In his press conference after the July 30-31 FOMC meeting, Fed Chairman Jerome Powell signaled that a rate cut in September (the next Fed meeting) is clearly on the table. Interestingly, the official statement was a little less clear. It did acknowledge that the employment and inflation goals have moved into "better balance" and that job gains have moderated, but didn't go quite as far as Chairman Powell, indicating some skeptics on the committee remain. The next FOMC meeting is September 17-18, and the markets will see July and August inflation reports as well as the August employment report prior to then, which might explain some of the hesitancy surrounding overtly signaling rate cuts.

Fed Chairman Powell, reading from a prepared script, did indicate that he had gained confidence that it would be "appropriate" to reduce rates as soon as September, and that the time for rate cuts is "approaching." Those comments, coupled with recent data, suggest to us that the Fed is predisposed to lower rates in September by a quarter-point, although it is still a close call.

While the timing of the first rate cut has preoccupied market participants, we believe that there is a possibility of "normalizing" rates after almost 16 years of what we think of as non-normal policy, as mentioned previously. What would normal policy look like? A few simple calculations show that prior to December 2008, the target federal funds rate averaged approximately 2.5% over core PCE; since that date, it has averaged 1.15% below that inflation measure. Since 1984, our analysis suggests that neutral policy (defined as when the Fed is holding rates relatively stable) has been core PCE plus approximately 1.5% to 1.75%.

**Inflation-Adjusted (Real) Fed Funds Rate**
*Target Fed Funds less Core Personal Consumption Expenditures*




*As of July 31, 2024*
*Source: Haver, BFE calculations*

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In the June materials, the Fed projected the longer-run range for fed funds between 2.4% and 3.8%, and inflation core PCE at 2%. If the Fed is successful in achieving a 2% inflation target, its projection of a neutral rate in the 3%-3.5% range is reasonable and consistent with what the futures markets are pricing. That would be higher than any time from January 2008 to December 2022 and does have ramifications for investors. Assuming a positively sloped yield curve, bonds become more attractive for asset allocators, particularly those who are income-oriented, which could potentially also have ramification for equities. There was an extended period where stocks were the "TINA" (there is no alternative) asset, but with yields above the rate of inflation, that calculus changes. Tech stocks in particular have benefitted from an extended period of low yields, and valuations remain elevated. That could continue based on the constant innovation in that sector, but does bear watching.

In closing, we are hopeful that we are nearing an end to the era of extraordinary monetary policy and that investors and savers will have additional and competitive fixed-rate options to augment their asset allocation models after the extended period of low rates and the whipsaw of aggressive Fed tightening and an inverted yield curve. While there is still work to be done, we will take the clues from the latest Fed statement that risks are better balanced; the unemployment rate has moved up but remains low, indicating a soft landing is still the base case; and the Fed will begin the process of moving towards neutral monetary policy (defined as something in excess of the 2% inflation target).

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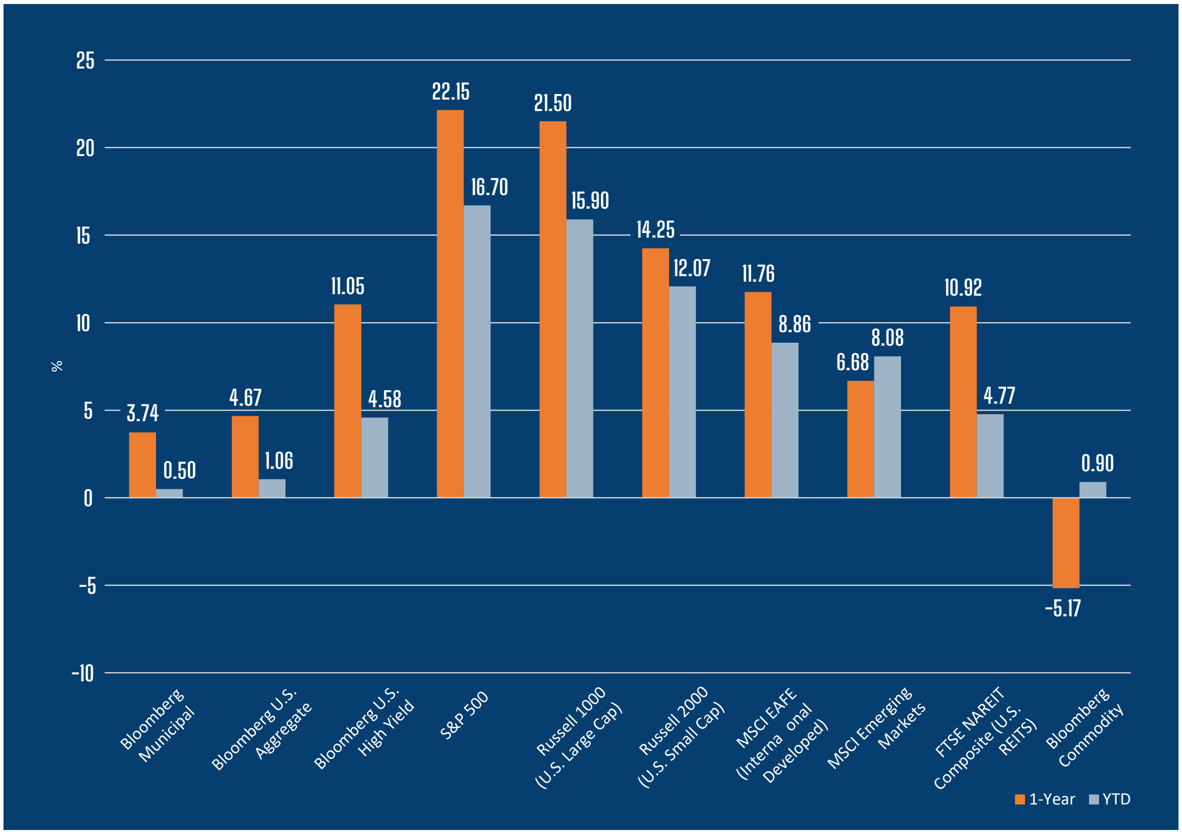
**Asset Class Returns**

*Comparing Recent 1-Year and Year-to-Date Total Returns*




*As of July 31, 2024*
*Source: Conway Investment Research*

## Fixed Income

- It was a good month for fixed income overall with the decline in rates and modest spread tightening.
- Core fixed income and municipals posted strong gains in July, led by the fall in Treasury and other sovereign debt yields.
- Credit gained ground last month, led by some modest spread tightening and continued clipping of elevated coupons.
- U.S. dollar weakness was a tailwind for non-U.S. bonds.

## Equities

- U.S. equities broadly gained ground in July, led by the surge in small caps and value stocks.
- Value trounced growth last month and small caps sharply outperformed large caps.
- The S&P 500 has gained 16.7% year to date, and the Russell 2000 has risen 12.1%.
- Equities outside the United States generally gained ground last month, with mixed results relative to U.S. equities. U.S. dollar weakness provided a nice boost.
- Similar to what occurred in the United States, value outperformed growth, and small caps beat large caps.
- Emerging markets underperformed developed markets in July, primarily due to weakness in China and Eastern Europe.

## Alternatives

- REITs had outsized gains in July as previously shunned sectors drew interest.
- Commodity prices fell sharply.

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| July 31, 2024 | MTD | QTD | YTD | 1-Year | 3-Year | 5-Year | 10-Year |
|---|---|---|---|---|---|---|---|
| **Fixed Income Indices** | | | | | | | |
| Bloomberg U.S. Treasury Bill 1-3 Month | 0.45% | 0.45% | 3.14% | 5.51% | 3.26% | 2.22% | 1.54% |
| Bloomberg Municipal | 0.91% | 0.91% | 0.50% | 3.74% | -0.86% | 1.18% | 2.47% |
| Bloomberg US Govt/Credit Intermediate | 1.19% | 1.19% | 2.58% | 5.67% | 0.89% | 1.50% | 1.48% |
| Bloomberg U.S. Aggregate | 1.79% | 1.79% | 1.06% | 4.67% | -2.81% | 0.11% | 1.55% |
| Bloomberg U.S. High Yield | 1.94% | 1.94% | 4.58% | 11.05% | 2.17% | 4.20% | 4.65% |
| **U.S. Equity Indices** | | | | | | | |
| DJ Industrial Average | 4.51% | 4.51% | 9.52% | 17.22% | 7.52% | 11.06% | 11.96% |
| S&P 500 | 1.22% | 1.22% | 16.70% | 22.15% | 9.60% | 15.00% | 13.15% |
| NASDAQ Composite (Price) | -0.75% | -0.75% | 17.24% | 22.68% | 6.25% | 16.57% | 14.95% |
| Russell 1000 | 1.46% | 1.46% | 15.90% | 21.50% | 8.52% | 14.59% | 12.86% |
| Russell 1000 Growth | -1.70% | -1.70% | 18.65% | 26.94% | 9.46% | 18.41% | 16.31% |
| Russell 1000 Value | 5.11% | 5.11% | 12.08% | 14.80% | 7.01% | 9.92% | 8.96% |
| Russell Mid Cap | 4.71% | 4.71% | 9.91% | 13.69% | 3.69% | 10.16% | 9.88% |
| Russell 2500 | 7.43% | 7.43% | 9.95% | 13.06% | 2.72% | 9.65% | 9.31% |
| Russell 2000 | 10.16% | 10.16% | 12.07% | 14.25% | 1.85% | 8.91% | 8.72% |
| Russell 2000 Growth | 8.19% | 8.19% | 12.99% | 12.80% | -1.12% | 7.64% | 8.92% |
| Russell 2000 Value | 12.19% | 12.19% | 11.23% | 15.68% | 4.62% | 9.53% | 8.13% |
| **Non-U.S. Equity Indices** | | | | | | | |
| MSCI World | 1.78% | 1.78% | 14.03% | 18.89% | 7.37% | 12.60% | 10.10% |
| MSCI ACWI | 1.64% | 1.64% | 13.41% | 17.55% | 6.26% | 11.57% | 9.29% |
| MSCI ACWI Ex-U.S. | 2.35% | 2.35% | 8.53% | 10.28% | 2.31% | 6.80% | 4.68% |
| MSCI EAFE | 2.95% | 2.95% | 8.86% | 11.76% | 4.17% | 7.88% | 5.35% |
| MSCI EAFE Growth | 1.23% | 1.23% | 7.79% | 8.94% | 0.24% | 7.14% | 6.17% |
| MSCI EAFE Value | 4.71% | 4.71% | 10.02% | 14.70% | 8.04% | 8.23% | 4.30% |
| MSCI Europe | 2.16% | 2.16% | 8.66% | 11.36% | 4.65% | 8.66% | 5.41% |
| MSCI Japan | 5.80% | 5.80% | 12.63% | 16.60% | 5.06% | 8.19% | 6.45% |
| MSCI AC Asia | 2.07% | 2.07% | 10.91% | 10.27% | -0.10% | 5.64% | 5.02% |
| MSCI EAFE Small Cap | 5.72% | 5.72% | 6.61% | 9.62% | -1.64% | 5.95% | 5.54% |
| MSCI ACWI Ex-U.S. Small Cap | 3.84% | 3.84% | 7.04% | 10.44% | 0.01% | 7.54% | 5.45% |
| MSCI Emerging Markets | 0.37% | 0.37% | 8.08% | 6.68% | -2.34% | 3.80% | 3.01% |
| MSCI EM Asia | -0.19% | -0.19% | 11.02% | 8.41% | -2.45% | 5.22% | 4.52% |
| MSCI China | -1.23% | -1.23% | 3.53% | -12.18% | -13.70% | -4.26% | 0.64% |
| MSCI EM Eastern Europe | -2.20% | -2.20% | 6.75% | 17.84% | -34.14% | -19.73% | -7.99% |
| MSCI EM Latin America | 1.05% | 1.05% | -14.59% | -8.80% | 3.28% | 0.78% | 0.08% |
| MSCI EM Small Cap | 0.02% | 0.02% | 7.27% | 13.09% | 3.51% | 10.81% | 5.48% |
| MSCI Frontier Markets | 1.92% | 1.92% | 8.27% | 7.43% | -2.09% | 2.44% | 1.09% |
| **Real Assets Indices** | | | | | | | |
| FTSE NAREIT Composite | 7.13% | 7.13% | 4.77% | 10.92% | -0.93% | 4.17% | 6.61% |
| Alerian MLP | 0.62% | 0.62% | 18.44% | 28.96% | 25.69% | 12.36% | 2.46% |
| Bloomberg Commodity | -4.04% | -4.04% | 0.90% | -5.17% | 3.58% | 6.51% | -1.19% |
| S&P Global Infrastructure | 4.42% | 4.42% | 8.63% | 9.51% | 6.77% | 5.65% | 5.25% |

*Source: Morningstar*

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