SouthState WEALTH

September 2024

On Point

INVESTMENT STRATEGY STATEMENT

The progress made over the past two years in cooling inflationary pressures and the previously hot jobs market point to the economy no longer requiring a policy rate above 5%. There are also indications that the current moderate pace of forward momentum in the economy will be difficult to maintain with a policy rate above 5%. As such, the markets and the officials at the Federal Reserve have concluded that the central bank needs to adjust the federal funds rate to be in line with the current dynamics of the economy to avoid tipping into an unnecessary recession.

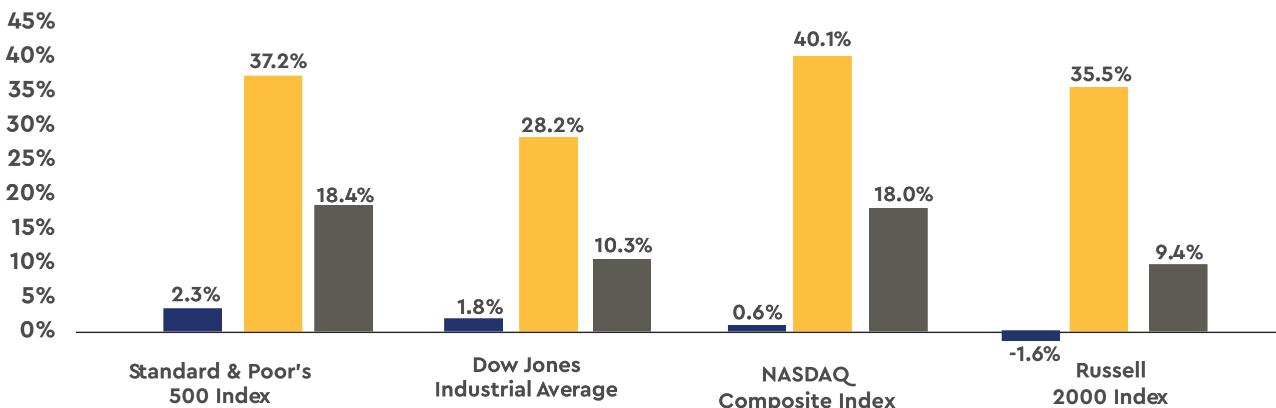
Equity Markets

Stocks Rebound from Early August Swoon.

Investors were hit with a one-two punch in early August in the form of a growth scare and a stampede by leveraged investors to exit an investment strategy that borrowed cheap Japanese yen to buy risk assets, notably common stocks. Following the Federal Reserve leaving rates unchanged at the July 30–31 FOMC meeting, but strongly leading investors to expect the start of the rate cutting cycle at the September 17–18 FOMC meeting, the DJIA slid more than -1100 points over the first two days of August. The decline in stock prices was widespread with large technology stocks weighing on the NASDAQ Composite – which hit correction territory with a drop of more than -10% from its recent high on July 10 – and small company stocks also falling nearly -7% from July 15.

The selloff in stocks followed a key gauge of manufacturing activity falling deeper into contraction territory, construction spending

Major Stock Market Indices – Price Change Only



declining in June for the second straight month, and an unexpected rise in weekly initial jobless claims to an eleven month high. These signs of a weakening economy were followed by the Labor Department reporting that the economy added an underwhelming 114,000 jobs in July with the unemployment rate rising to 4.3%, its highest level in nearly three years. The disappointing data fed fears that a soft landing for the economy could be elusive and the economy could tip into a recession.

That two day drawdown in stock prices was followed by U.S. stock market indexes opening sharply lower on Monday, August 5, with the DJIA dropping another -1000 points as an aggressive unwinding of the "yen-carry trade" took place globally. The three day decline in the S&P 500 came within a whisker of a -10% correction and Wall Street's fear gauge, the VIX index of volatility, shot up more than 50% to its highest level since the dark pandemic days of 2020.

How does the "yen-carry trade" work? With inflation benign in Japan over the past couple years compared to other developed nations and policymakers long struggling to jumpstart economic growth, interest rates in Japan remained near zero. This offered hedge funds and other leveraged investors the opportunity to borrow yen cheaply and then buy financial assets around the globe.

This trade worked as long as the borrowing rate set by the Bank of Japan – Japan's central bank – stayed low and the yen traded cheap against other currencies such as the dollar. The trade paid off until late July when the Bank of Japan hiked its policy rate and said it would ease off on its bond buying program. That policy combination boosted the value of the previously stable yen and sparked the violent unwinding of the so-called carry trades with the Nikkei 225 stock index plunging -12.4% on August 5, the index's largest one day point decline, larger even than the plunge on the day following the Black Monday crash in the U.S. in October 1987. U.S. stocks also fell sharply on August 5, on the order of -2.6% to -3.4% across the major stock market measures.

While recession risks may have risen a touch with the economy's forward momentum slowing, a close look at the data suggests the economy is not in one now. That distinction is important because it means it is not too late for the Federal Reserve to cut rates and support the economy.

Treasury yields plummeted, with two-year Treasury yields hitting an intra-day low on August 5 of 3.66% compared to 4.26% at the end of July, before ending the day at 3.96%. Fears that the risk of recession could be growing and that forced liquidations could lead to a liquidity squeeze in the global financial markets led to many calls for the Federal Reserve to lower the federal funds rate before the next scheduled policy meeting in September. Over the next couple days cooler heads prevailed, however, with the rapid repricing of rate cut expectations reversing. Let's take a deeper dive into the concerns that investors had.

First on the economy, jobs continue to grow, just at a slower pace than earlier in the year, which should be expected with the Federal Reserve keeping rates high for longer specifically to cool what was an overheated jobs market. Also, the higher unemployment rate is largely a function of more people entering the labor force, which increased by 420,000 in July and by more than 1.15 million since January, much of which resulted from a rise in immigration, both legal and illegal. By comparison, household employment – used to calculate the unemployment rate – is only higher by 114,000 since January, resulting in the rise in the unemployment rate.

▲ **S&P 500 18.4%**	▲ **NASDAQ 18.0%**
▲ **DJIA 10.3%**	▲ **Russell 2000 9.4%**

YTD Index Performance as of 8/30/24

Over the remainder of August, the economic data pointed to inflationary pressures continuing to moderate with the consumer price index rising at only a 0.4% three-month annualized rate of change through July, while the CPI less food and energy rose at a 1.6% annualized rate over the past three months, comfortably inside the Federal Reserve's 2% inflation target.

While recession risks may have risen a touch with the economy's forward momentum slowing, a close look at the data suggests the economy is not in one now. That distinction is important because it means it is not too late for the Federal Reserve to cut rates and support the economy. With the jobs market relatively healthy, household incomes are growing, providing support to the largest segment of the economy. Taken with moderate gains in business capital spending and the housing market soon to receive a boost from the drop in mortgage rates, we look for the current business expansion to continue.

With the earnings reporting season in its later stages, investors took comfort in 2Q 2024 operating earnings on the S&P 500 looking to advance 6.9% year-over-year with company guidance on earnings over the second half of the year pointing to earnings growth of 10% or more in both 3Q and 4Q 2024. Companies that are growing earnings are not under pressure to cut jobs and are typically looking to add workers, invest in productivity enhancing equipment, and expand capacity to pursue additional profit opportunities. An expanding economy supports earnings growth, which in turn, provides a positive backdrop for common stock prices.

Additionally, the panic attack of the carry trade unwinding took place in relatively short order, without a deterioration in market functioning which would have called for emergency policy actions such as emergency rate cuts and liquidity infusions into the financial markets. We look at the drop in stock prices on August 5 as the unwinding of leveraged bets by a handful of hedge funds when the underlying supports gave way, rather than the start of a recessionary bear market in stocks.

While traders burdened by a short-term focus on market movements were alarmed by the three day selloff, investors with a long-term focus understood that no serious deterioration in the economy's fundamentals had occurred and that at least one 10%+ drawdown during a calendar year is a historically routine occurrence, even in the context of an otherwise healthy bull market. In fact, these pullbacks help to correct overly optimistic investor sentiment, providing a necessary reset of expectations that typically allows common stocks to return to a healthy advance if the fundamentals remain solid.

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More encouraging news on inflation was found in the report on the Federal Reserve's preferred measure of inflation, the core personal consumption expenditures price index. Core consumer prices rose 0.2% in July and are higher by 2.6% year-over-year, a big improvement from the 4.2% reading for the twelve months ending July 2023.

Although the financial markets were notably volatile early in the month, the economic data released over the back half of the month boosted confidence in the health of the economy, keeping the soft landing scenario very much alive.

Retail sales posted a strong 1.0% gain in July after falling -0.2% in June. While much of the July gain reflected a rebound in auto sales following a cyberattack-related software outage in June which impacted the ability of auto dealerships to conduct business, retail sales excluding autos rose a solid 0.4% in July, led by broad-based gains in electronics and appliances (1.6%) building materials and garden equipment (0.9%), food and beverage (0.9%), and health and personal care (0.8%).

After the July employment report fueled recession concerns, initial unemployment claims returned to a downward trajectory during August after reaching a recent peak in late July, easing concerns about the health of the labor market. The recent easing in mortgage rates showed up in some signs of stabilization in the housing market with new home sales surging 10.6% during July, the largest monthly gain in nearly two years. The 739,000 annual sales pace is roughly the same pace from 2019 before COVID.

Although the financial markets were notably volatile early in the month, the economic data released over the back half of the month boosted confidence in the health of the economy, keeping the soft landing scenario very much alive. Taken with Chair Jerome Powell and other Federal Reserve officials pivoting toward supporting the labor market and the unwind of the yen-carry trade quickly fading in investors' memories, stock prices largely recovered their declines from the first three days of August over the rest of the month.

The S&P 500 led the way with a gain of 2.3% last month, with the DJIA and the NASDAQ Composite posting gains of 1.8% and 0.6%, respectively. While the Russell 2000 Index of small company stocks rebounded from its early August low, it still posted a decline of -1.6% for the full month of August. On a year-to-date basis, the S&P 500 and the NASDAQ Composite are higher by 18.4% and 18.0%, respectively, while the DJIA and the Russell 2000 still trail somewhat at 10.3% and 9.4%.

Finally, Mr. Powell delivered the money line, "The time has come for policy to adjust." The official pivot to a period of lower borrowing costs has arrived and the markets responded positively with stock prices rallying and Treasury yields easing a bit further.

"The Time Has Come for Policy to Adjust."

Speaking at the Federal Reserve's annual economic symposium at Jackson Hole, Wyoming on August 23, Federal Reserve Chair Jerome Powell delivered a landmark speech, offering up the three key statements the markets have been waiting on to signal that the rate cutting cycle was about to begin. First, Mr. Powell stated, "My confidence has grown that inflation is on a sustainable path to 2%." This statement met the necessary condition the FOMC Committee laid out at the March 19–20 FOMC meeting for rates to be lowered.

Consistent with the recent focus of Federal Reserve officials on the employment part of their dual mandate, Chair Powell stated that the members of the FOMC Committee "...do not seek or welcome further cooling in labor market conditions," adding that the slowdown in the labor market was "unmistakable." Finally, Mr. Powell delivered the money line, "The time has come for policy to adjust." The official pivot to a period of lower borrowing costs has arrived and the markets responded positively with stock prices rallying and Treasury yields easing a bit further.

There are three key reasons why we expected a rate cutting cycle to begin in short order and likely last at least through 2025. First, monetary policy is restrictive with a real, or inflation-adjusted, federal funds rate near 3% (5.4% less 2.6% year-over-year increase in the core PCE price index), a much higher inflation-adjusted policy rate than the historical average between zero and 1%.

Also, keep in mind that policy continues to tighten in a passive manner with the Federal Reserve holding the policy rate steady while actual and reported inflation continues to ease. Consider that when the Federal Reserve raised the federal funds rate to its current level in July 2023, the real federal funds rate was about 1.1%, but with the decline in inflation over the past 13 months, the real federal funds rate has risen to about 2.8% with no change in the nominal policy rate.

Second, the relationship between the yield on the two-year Treasury note and the federal funds rate points to the Treasury market looking for rate cuts. The yield on the two-year Treasury tends to sit right on top of the federal funds rate when policy is not being actively tightened or loosened. On the days prior to Mr. Powell's Jackson Hole presentation, the two-year Treasury yield averaged about 4%, 140 basis point below the federal funds rate at 5.4%.

As such, the Treasury market was looking for about five to six rate cuts into 2025. This is the exact opposite position that the Treasury market took in March of 2022 when the rate hiking cycle began. The two-year Treasury yield was about 160 basis points above the policy rate of 0.13%, calling for the Federal Reserve to start a rate hiking cycle. The futures market for the federal funds rate is currently looking for roughly eight rate cuts over the next year.

Lastly, the markets are looking for inflationary pressures to be largely in line with the Federal Reserve's 2% target over the next one to ten years. The implied inflation outlook over the next 12 months embodied in the Treasury market

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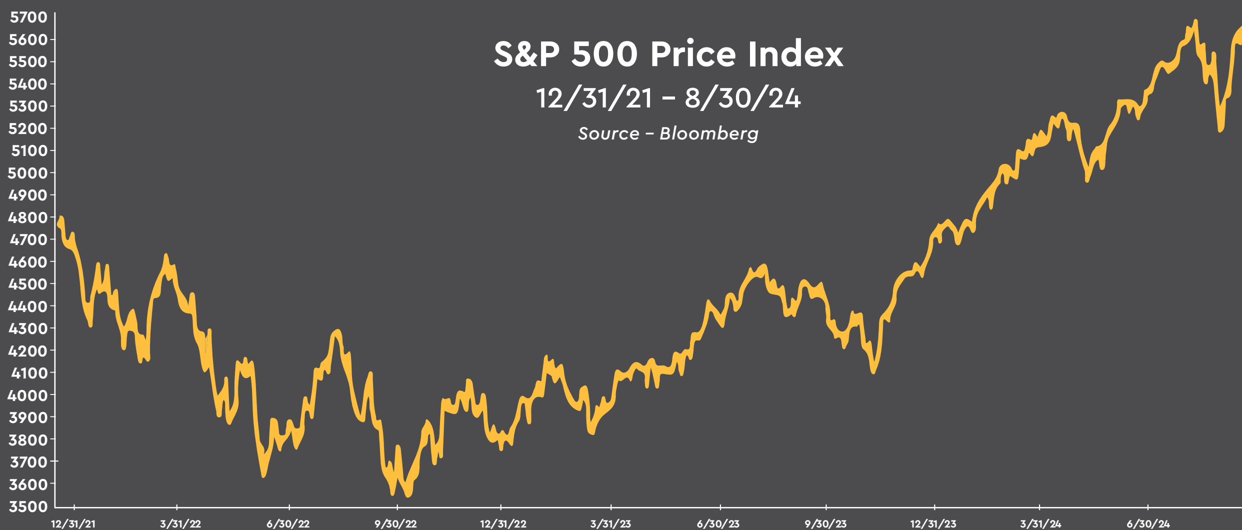
is currently 1.79%, significantly below the 4.18% implied one year inflation outlook on May 31 of 2022 just prior to the Federal Reserve shifting to a more aggressive tightening of policy by ramping the rate hikes to 75 basis points. Longer term inflation expectations have also moderated with two-year inflation expectations falling from 3.86% to 2.0%, five years from 2.96% to 2.01%, and ten years to 2.15% from 2.64%.

The bottom line is that the progress made over the past two years in cooling inflationary pressures and the previously hot jobs market point to the economy no longer requiring a policy rate above 5%. There are also indications that the current moderate pace of forward momentum in the economy will be difficult to maintain with a policy rate above 5%. As such, the markets and the officials at the Federal Reserve have concluded that the central bank needs to adjust the federal funds rate to be in line with the current dynamics of the economy to avoid tipping into an unnecessary recession.

How much and how quickly rates are going to be cut are the only questions on monetary policy remaining today. As such, the big questions the FOMC Committee will face in September is whether the economy is likely to remain on a glide path to a soft landing which will allow policy to move to a less restrictive posture in a steady and deliberate manner, or are the fundamentals deteriorating at a faster pace, requiring a more aggressive pace of rate cuts to keep the economy from slipping into recession, even a mild one. Labor market conditions will primarily determine the pace and extent of rate cuts through 2025.



Disinflation, Continued Growth in the Economy and Earnings, and Rate Cuts Ahead.

With the economy and earnings continuing to grow, Treasury yields falling sharply since late April, the disinflationary influences in the economy well entrenched, and the Federal Reserve about to start a rate cutting cycle, we think the backdrop for common stocks is positive. This is the same position we took as 2024 unfolded. The key dynamic has been the disinflationary influences in the economy taking hold without the economy falling into recession.

The cooling of inflation has taken place in stages. Price increases for consumer goods from electronics and building supplies to used cars were the first to slow, and eventually fall in some cases, as the stay at home, pandemic demand turned down and disrupted supply chains were repaired. Inflation in the service sector – everything from haircuts to car repairs and airline fares – took longer to moderate, but price gains have slowed, and, again, prices have actually reversed on some services. Disinflation in the service sector partly reflects a slowdown in wage growth as the labor market has cooled.

As for the economy and earnings, at worst, we anticipate a somewhat bumpy, soft landing for the economy, which could include a quarter or two of small negative quarterly growth rates similar to the first two quarters of 2022 when inventory swings and a deterioration in the trade deficit pushed the quarterly growth rates into negative territory, although the overall economy did not slip into recession. A growing economy should support earnings growth for the foreseeable future.

Admittedly, the stock market faces a number of uncertainties over the next couple months, starting with the economy. As already mentioned, will the slowing economy continue the transition to a soft landing, or could a mild recession be ahead? The outlook for Federal Reserve policy is also a key consideration, along with the policy outcomes which will follow the upcoming presidential and congressional elections.

While Chair Powell all but promised that a rate cut is coming at this month's FOMC meeting, he did not offer much guidance on how quickly or to what extent the FOMC Committee intends to proceed in lowering rates over the next several months. Mr. Powell offered that, "The direction of travel is clear, and the timing and pace of rate cuts will depend on incoming data, the evolving outlook, and the balance of risks."

However, Chair Powell was careful to avoid using certain nuanced words such as "gradual," "measured," or "methodical" in portraying a potential roadmap for how fast or for how long monetary policy could be eased. In doing so, Mr. Powell's lack of guidance appears to have kept the door open to larger rate cuts if the labor market shows signs of more pronounced weakness in the weeks and months ahead.

As for the elections, the policy positions of the two parties continue to be far apart, but a key determinant will be whether the party in the White House has control of Congress. The economy and the markets typically operate better under divided government as extreme policy measures are more difficult to pass. Time will tell on the political scene, but our capitalistic economy tends to flourish over time no matter what the political environment turns out to be in Washington.

Treasury Market

A Surge in Volatility and Looming Rate Cuts Push Treasury Yields Lower.

Yields on Treasury securities have fallen at a fairly steady pace since recent peaks in late April as the economy's forward momentum continues to slow and disinflationary forces have taken root in the economy. These fundamental developments received an assist from a fairly significant flight to safety in early August as a violent unwind of the yen-carry trade led investors to fear a financial market accident which could have disrupted the normal functioning of the financial system. While those fears dissipated fairly quickly, Treasury yields fell across the yield curve during August.

Yields on ten-year Treasury securities fell another 13 basis points last month, while two-year Treasury yields fell 34 basis points. The larger decline in two-year Treasury yields is likely related to the Federal Reserve being poised to commence a rate cutting cycle later this month, which over time should restore a normal, positive slope to the Treasury yield curve.

Yields on ten-year Treasury securities have declined as growth has slowed and inflation expectations have fallen toward the Federal

We continue to expect the inversion of the Treasury yield curve to end in relatively short order with yields on shorter maturity Treasury securities mirroring the path of actual and expected rate cuts by the Federal Reserve. There remains a strong likelihood the yield curve will have a modest positive slope by year end, possibly even by the end of September.

Reserve's 2% target since their recent peak at the end of May 2022. Two-year Treasury yields have also fallen, but continue to be held hostage to a certain extent by the current 5.25% to 5.5% target range of the federal funds rate.

The inversion of the Treasury yield curve – shorter term yields above longer term yields – has declined to only -1 basis points compared to -38 basis points at the end of 2023 and the peak of -109 basis points back on March 7, 2023. The return of a positive slope to the yield curve will follow the Federal Reserve lowering the target range of the policy rate. In line with this view, we feel there are larger declines ahead for the yields on shorter and intermediate term Treasury securities than on longer dated Treasury securities.

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Treasury Market Talks to Federal Reserve

	Ten-Year Treasury Yield	(minus)	Two-Year Treasury Yield	(equals)	Yield Spread
9/30/21	1.49%		0.28%		121bp
3/07/23	3.98%		5.07%		-109bp
12/29/23	3.87%		4.25%		-38bp
4/30/24	4.68%		5.04%		-36bp
7/31/24	4.04%		4.26%		-22bp
8/30/24	3.91%		3.92%		-1bp

Source – Bloomberg

Given the significant decline in the yield on ten-year Treasury notes since late April and the outlook for a series of rate cuts to the end of 2025, investors should continue to be rewarded by embracing a barbell approach by taking advantage of still high yields on the short end of the yield curve while also modestly extending duration to lock in yields on intermediate term – two to five year – fixed income securities. Adding duration in that manner to fixed income portfolios is appropriate as the reported inflation data are moving closer to the Federal Reserve's target, the jobs market looks to be slowing, and real yields remain high.

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