August 2024

The Market's Great Expectations

"Take nothing on its looks; take everything on evidence. There's no better rule."
– Charles Dickens, *Great Expectations*

Financial markets have been impatiently awaiting the Federal Reserve's (Fed's) next move since its last interest rate hike over a year ago. While the markets' hopes for rate cuts were dashed repeatedly over the last 12 months, it appears "the time has come" for the Fed to embrace policy easing. Bond investors would be wise to heed the call of coming yield curve normalization.

After having suffered a vicious one-two punch of volatility in early August, markets appear to be back on their front foot. First, on July 31, the Bank of Japan announced a new round of policy tightening, in a continued decoupling of policy actions among major central banks. This move catalyzed a rapid unwind of leveraged yen carry trades, pressuring an already strained market. Two days later, a weaker-than-expected July U.S. nonfarm payrolls report prompted worries that the Fed had overshot its target and U.S. economic growth was on course to slow too rapidly, potentially leading to recession. Skittish investors were quick to react; on August 5, the 2-year U.S. Treasury (UST) note yield briefly touched 3.7%, while the CBOE Volatility Index spiked above 60, indicating considerable market stress.

Then, over the ensuing days, howling for an emergency rate cut by the Federal Open Market Committee (FOMC) abated and the market's sudden consternation evaporated almost as quickly as it materialized. Risk assets have since recovered, as credit spreads in both investment grade and high yield are virtually unchanged, while the S&P 500® is almost 2% higher (**Figure 1**). However, this recent bout of extreme volatility made one enduring impact: both spot and forward U.S. interest rates have materially evolved. The inversion of the UST

Figure 1. Comparison of Recent Market Data
The market's sudden consternation evaporated almost as quickly as it materialized

	Respective YTD high/low close *before* market selloff	7/31/2024	Respective high/low close *during* market selloff	8/23/2024
Bloomberg U.S. Credit Index OAS*	80	88	104	89
Bloomberg U.S. Corporate High Yield Index OAS*	289	314	380	312
CBOE Volatility Index	11.9	16.4	38.6	16.0
ICE BofAML MOVE Index	82.5	99.4	121.2	105.6
UST 2/10-yr yield slope	(49.5)	(22.7)	(1.9)	(11.6)
Number of market-implied Fed rate cuts by 12/31/2024	6.3	2.9	4.6	4.1
S&P 500	5,667	5,522	5,186	5,634

**Option-adjusted spread, measured in basis points. As of 8/23/2024. Source: Bloomberg L.P.*

yield curve between 2 and 10 years has narrowed to around 12 basis points (bps), while the forward curve is pricing in an aggressive policy adjustment by the Fed over the next 12 months. Although the odds of a 50 bps cut in September have diminished, fed funds futures are priced for four cuts by the end of 2024 and almost eight cuts by mid-2025. Once again, market expectations for Fed policy have deviated considerably from both the most recent dot plot and guidance from Chair Jerome Powell following the July 31 FOMC meeting.

Has *Sahm-thing* Changed?

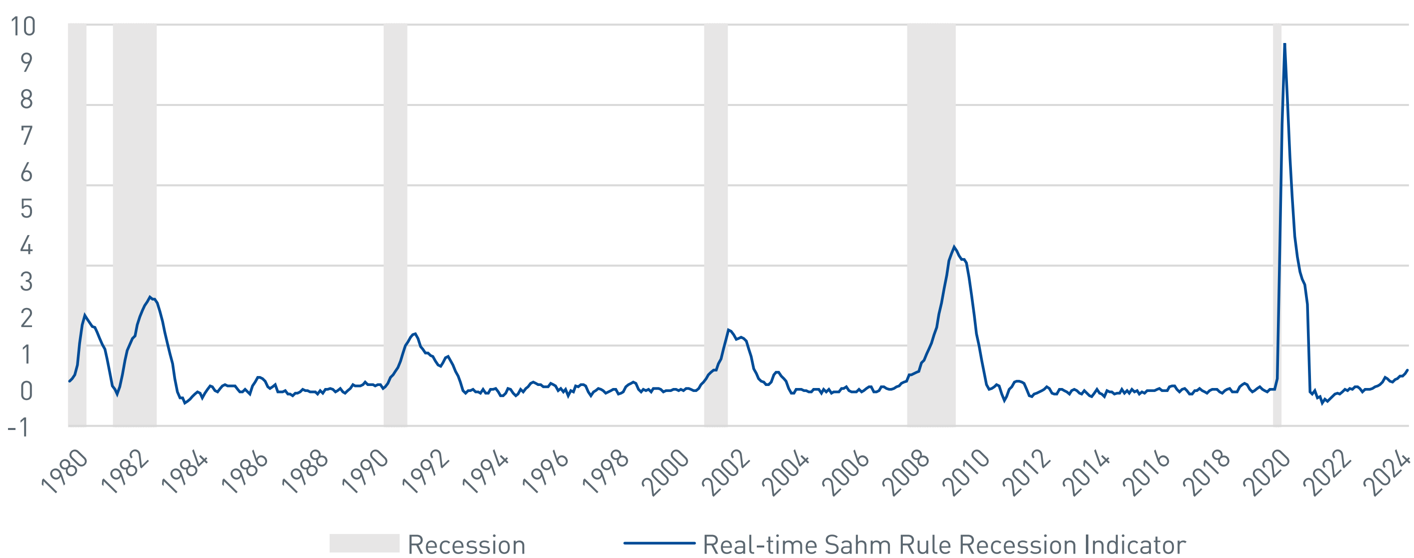
Given the long and variable lags of monetary policy, eventual economic softening has been expected — so why were markets so spooked by the August 2 jobs report? Notably, the 3-month change in the headline unemployment rate of 0.5% to 4.3% triggered what is known as the "Sahm rule," thought to be a harbinger of recession (**Figure 2**). The indicator suggests a recession has begun when the 3-month average unemployment rate increases by 0.5% or more from its 12-month low.

While past cycles may not repeat but often rhyme, it is worth pointing out that both the Conference Board Leading Economic Indicator Index and the inverted UST yield curve have been signaling a recession for well over a year. It is clear labor markets have cooled given trends in both the Job Openings and Labor Turnover Survey and nonfarm payroll report. In fact, labor markets were an area of emphasis for Chair Powell's Jackson Hole Economic Symposium speech, during which he gave the clearest indication yet that rate cuts are on the horizon.

At best, economic indicators are sending mixed signals about the rate of slowing in U.S. economic growth. Like the Fed, our path forward continues to be data dependent as we believe the arguments are well balanced: at more than 2.5%, the real policy rate is restrictive (one of the highest in over 15 years) and should act to slow growth, but the dynamism of the U.S. economy should not be discounted. Continued progress on inflation is tantamount to the Fed gaining more confidence in aggressive policy easing. Although there is now a clearer line of sight to the Fed's 2% inflation target, it is far from assured.

Figure 2. Real-time Sahm Rule Recession Indicator

The August 2 jobs report triggered the Sahm rule



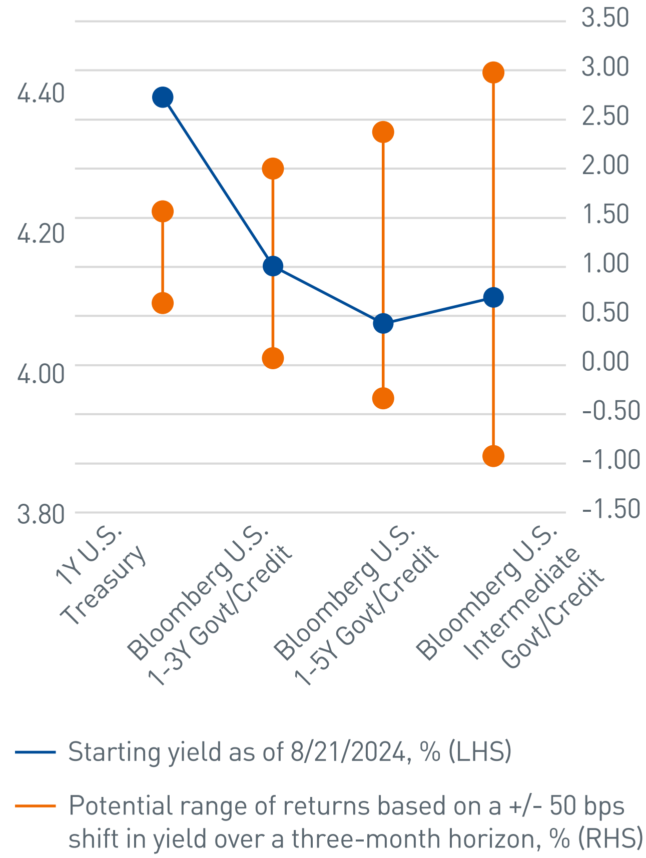
As of 7/31/2024. Source: Bloomberg L.P.

A Call to Action: All Aboard, not All Clear

Regular bouts of episodic volatility may continue for the foreseeable future as markets adjust to the withdrawals of extraordinary stimulus measures along with a coordinated tightening of the primary policy rate. Global central banks, in our view, have had a thumb on the scale since the global financial crisis. While the path of policy — and ultimately yields — remains largely uncertain, we believe the market has shifted into a paradigm of lower highs and lower lows. Even with the level of rates down significantly from the peak in late April, we continue to find the symmetry of yields further out the curve compelling (**Figure 3**). As such, we believe clients still have an opportunity to shift the duration posture of their portfolios to improve overall diversification and lock in higher yields. While the ship has not yet sailed, we've cast off the lines and call "All Aboard!" as the time has come for a Fed pivot.

Figure 3. Comparison of Potential Returns

Short/intermediate indices have more favorable ratios of upside to downside



As of 8/21/2024. Source: Bloomberg L.P., PNC Capital Advisors

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