Monthly Market Commentary with Portfolio Manager, Andrea Ciaccio

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Market Review

On August 23rd, Jerome Powell took the stage at the annual economic policy symposium in Jackson Hole to provide his much-awaited remarks. Market participants were expecting him to ratify the central bank's shift in focus from inflation to the labour market, and to officially announce the start of the rate-cutting cycle. The FED Chairman did not disappoint. His 16-minute speech delivered a clear, dovish message that, by his own admission, was diametrically opposed to the hawkish communication he conveyed from the same podium two years before. Back then, he had expressed his "unconditional commitment to fully restoring price stability and to keeping at it until the job is done", that is, to continuing to hike rates, even at the cost of bringing "some pain in the form of higher unemployment and slower growth", that is, triggering a recession. Fast forward to today, he has made a complete U-turn by using the past tense when speaking about inflation, stating that the "restrictive monetary policy helped restore balance between aggregate supply and demand, easing inflationary pressures and ensuring that inflation expectations remained well anchored". Then, in his characteristic terse, no-nonsense style, he proceeded to unequivocally declare that the central bank does not "seek or welcome further cooling in labour market conditions" and that "we will do everything we can to support a strong labour market as we make further progress toward price stability". In plain English, the FED is ready to cut rates to stimulate the economy and prevent a recession.

Powell's address was described by James Bullard, the former President of the Federal Reserve Bank of St. Louis, as "not quite a victory lap". However, as pointed out by several commentators, it was a close one. According to the FED Chairman, the burst of high inflation experienced in the past few years was largely the result of "pandemic-related distortions", that is, of "an extraordinary collision between overheated and temporarily distorted demand and constrained supply". Initially, the central bank deemed that price pressures were going to prove "transitory" given their concentration in goods. However, when inflation broadened from the latter to services, the FED responded forcefully by raising the target rate by 425 Bps in 2022 and by another 100 Bps in 2023. Eventually, inflation fell without a sharp rise in unemployment, "a welcome and historically unusual result", and with the economy continuing to "grow at a solid pace". In short, despite never uttering the words "soft landing", Powell indicated that one had been achieved. Moreover, he made sure that the institution he presides over takes much of the credit for it. In fact, in his final analysis, achieving "disinflation while preserving labour market strength is only possible with anchored inflation expectations". Crucially, the latter "reflects the public's confidence that the central bank will bring about 2% inflation over time", a confidence that "has been built over decades" and that was indeed reinforced by the strong policy response on the part of the FED since its first hike in March 2022.

The sense of accomplishment in Powell's speech was palpable, as was a certain sense of urgency. The state of the labour market was dissected to such an extent that economist Adam Posen, President of the Peterson Institute for International Economics (PIIE), felt the remarks were "narrow", as if employment was the only factor that will matter in the near term. In that context, the FED Chairman noted that "the unemployment rate began to rise over a year ago and is now at 4.3%, still low by historical standards, but almost a full percentage point above its level in early 2023". He stressed that "most of that increase has come over the past six months" and that "the cooling in labour market conditions is unmistakable". His conclusion was that, as "the downside risks to employment have increased", "the time has come for policy to adjust". In contrast with the more circumspect language he often utilized when hikes were on the table, Powell paved the way for rate cuts without hinting that the central bank may follow a gradualistic approach. Instead, he affirmed 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". He spoke about "an appropriate dialling back of policy restraint" and noted that "the current level of our policy rate gives us ample room to respond to any risks we may face, including the risk of unwelcome further weakening in labour market conditions".

In the summary of economic projections it released on June 12th, the FED was forecasting the unemployment rate to reach 4.0% at the end of 2024 and the target rate to decline to a range of 5.00%-5.25% (one cut). Based on the figures that it itself provided, the central bank may argue that it has fallen behind the curve and feel the need to front-load cuts. For that reason, while 25 Bps had become a certainty, at the end of August, futures markets were pricing a 50 Bps cut to be delivered at the FOMC meeting scheduled for September 17-18 with a 35% probability. The bar remains high for such a move. Historically, it has been unusual for the FED to inaugurate an easing cycle with larger reductions outside of a recession, as was the case in March 2001 and in September 2007.

International Equities

It was a rollercoaster August for US equities. In the first three trading days, the S&P 500 (+2.28%) and the Nasdaq 100 (+1.10%) fell -8.03% and -10.77% in USD terms top to bottom, only to rebound +10.39% and +12.31% respectively. The two averages closed the month above their prices at the end of July, but below their peaks. Both the S&P 500 Equal Weight Index (+2.30%) and the "Old economy" heavy Dow Jones Industrial (+1.76%) ended August on a high note, hitting new all-time highs on the very last session. Conversely, the Russell 2000 (-1.63%), the popular benchmark for smaller companies, bucked the trend, giving back almost half of the outperformance it had generated vis-à-vis the Russell 1000 in July. The "Magnificent Seven" declined modestly for the second month in a row, as Microsoft, Amazon, Alphabet and Tesla fell, while Apple, Nvidia and Meta rose. As a result, the Bloomberg Magnificent 7 Index underperformed the Bloomberg US Large Cap ex. Magnificent 7 Index by the most since December 2022. Semiconductor stocks were dragged lower by Intel which, on August 2nd, had its worst day in 50 years, dropping to its lowest level since 2013, as its revenues and earnings missed expectations. In addition, AI darling Super Micro Computer Inc. (SMCI), whose performance for the first 7 months of the year was superior even to that generated by Nvidia, crashed -37.62% in August as the company became the target of a well-known short seller over accusations of accounting manipulation and sanctions evasion. After having reached the largest weight a company had ever had in the Russell 2000 index at the end of February on the back of a tenfold return in just over the year, the stock entered the S&P 500 on March 18th; since then, it has halved.

Consumer staples and healthcare shone in August as investors snapped up defensive and high dividend stocks. Real estate, utilities, financials and industrials continued their winning streak, while consumer discretionary, technology and communication services lagged. Energy was the worst performing sector, as it tracked oil prices lower. US equities underperformed the rest of the world (as exemplified by the MSCI AC World Index ex USA TR Index) in August. Europe was the best performing region on the back of improving growth and lower than expected inflation. Japan underperformed as positive news on the economic front, with domestic GDP expanding +0.8% in Q2 over Q1, were more than compensated by the disorderly unwind of the carry trade. Index heavyweights China and South Korea weighed on emerging markets, offsetting the strong gains posted by South East Asia and Latin America. All in all, the MSCI AC World Daily TR was up +2.54% in USD terms but down -0.90% in AUD terms.

Australian Equities

Australian equities outperformed their international peers in August in AUD terms. After falling -6.39% top to bottom during the first week of the month, the S&P/ASX 200 rallied smartly to notch a record-high monthly closure. The S&P/ASX 300 added +0.44%, with positive contributions coming, once again, from industrials, telecom and, within financials, banks and A-REITs. Technology was the standout performer on the back of the strong financial results for FY 2024 reported by index heavyweight WiseTech. The company experienced significant growth in total revenues and EBITDA and reiterated a positive earnings guidance for FY 2025. Conversely, resources were down sharply as pledges to spur consumer spending on the part of the Chinese government underwhelmed investors. Utilities, healthcare and consumer discretionary ended the month in the red as well. Mid-caps strongly outperformed the Top 20, while smaller companies fell. Finally, value stocks bested growth stocks for the seventh consecutive month.

International Fixed Income

Of the 4 major global central banks that met during the month, only the Norges Bank, Norway's central bank, left interest rates unchanged. On August 1st, the Bank of England (BOE) kicked off its easing cycle by reducing its official bank rate by 25 Bps to 5.00%, its first cut since March 2020. Its decision was followed by the Reserve Bank of New Zealand (RBNZ) on August 14th. The central bank cut the cash rate by 25 Bps to 5.25%, delivering its first reduction in 4 years and projected a path that takes it below 4% by the end of 2025. On August 20th, the Riksbank, Sweden's central bank, lowered its key policy rate for the second time this year, from 3.75% to 3.50%, and guided for "two or three" additional cuts in the remainder of 2024, one more than it had proposed in June.

In the US, the yield curve transposed lower and briefly uninverted on August 5th, with the 2 year yield dropping below the 10 year yield for the first time since July 2022. After experiencing an initial bout of volatility, credit spreads recovered, tightening into month-end. Emerging markets in hard and local currencies were the best performing segments. The Bloomberg Barclays Global Aggregate Index hedged back to AUD rose +0.99% for the month.

Australian Fixed Income

On August 6th, the RBA held the cash rate at 4.35% for the sixth consecutive meeting. During her post-meeting press conference, Governor Bullock reaffirmed that the Board is "not ruling anything in or out" and added "but vigilance [is] to the upside". She also made clear that "near-term interest rate cuts are not on the agenda" as getting inflation back to its target range of 2-3% is taking longer than expected. Despite her comments, the Australian yield curve bull steepened as the 2 year fell 20 Bps to 3.67 and the 10 year declined 14 Bps to 3.97%. The Bloomberg AusBond Composite 0+ Yr was up +1.21% for the month, while the Australian Dollar appreciated vis-à-vis most major developed and emerging currencies.

Real Assets

Global property continued its ascent in August, rising +5.82% in USD terms and +2.27% in AUD terms. All regions gained, with Europe topping the list and Australia trailing the general index. The rate for a 30 year US home fixed mortgage dropped 24 Bps, from 7.04% to 6.80%, its lowest level since January 2024.

Global infrastructure rallied +4.12% in USD terms and +0.62% in AUD terms for the month Communications infrastructure was the best performing segment, while transportation stocks lagged. The S&P Global Infrastructure TR unperformed the FTSE EPRA Nareit Developed TR for the 3rd month in a row.

Alternatives

Alternatives (+0.32%) posted muted returns in August. Fixed income strategies led performance gains, while discretionary macro and CTA and managed futures extended losses.

Market Outlook

On September 18th, the FED decided that it was time to “go big or go home” and kickstarted its easing cycle with a 50 Bps reduction to a range of 4.75%-5.00%. The decision did not catch traders off guard, as in the two weeks ahead of the FOMC meeting futures markets had moved to price in a half point cut with a 66% probability. However, based on data collected by Bloomberg, it came as a surprise for 85%+ of economists and strategists. The consensus was expecting 25 Bps primarily for three reasons:

1) The FED does not want to be seen as political by cutting aggressively before the US presidential election;

2) The FED does not want to give the impression that something is wrong with the economy;

3) A larger cut may signal that the FED is behind the curve and that it should have started to ease in July, hence putting its credibility into question.

We have argued for some time that, if the central bank was to cut by 100 Bps before the end of the year to match what was already reflected in the yield curve, the FOMC meeting in September was the ideal time to ease by 50 Bps. In fact, barring an “emergency cut”, that is, a cut announced during an interim meeting, there are only two FOMC meetings left in 2024. The first is scheduled for November 6-7, that is, one day after the election and the second for December 17-18. We have always found it difficult to reconcile the idea that the FED would ramp up its easing should Trump, the (more) “inflationary” candidate, re-take the White House. As a result, rather than delivering a 25, a 25 and a 50, it was plausible that the central bank would have opted for “frontloading” the 50. That seems to be what has just transpired. The timing and the quantum of the cut, coupled with the upbeat tone of Chairman Powell during the press conference, are consistent with the concept of an “insurance cut”, that is, a larger reduction in the interest rate aimed at keeping the economy “in a good place”, and not at combating an entrenched slowdown. This leads us to the second point, the FED “knows something that we do not know”. We do not subscribe to that thesis. The jury is still out on whether the US economy has entered or is entering or will soon enter a recession. Also, the FED may well be or think that it is behind the curve. However, in our view, that was not the rationale for its decision.

The reality is that the FED wants and can have lower rates at the current juncture. We contend that it has reverted to its “asymmetrically dovish” reaction function of easing faster and aggressively to respond to risks to economic growth and to financial stability, while tightening measuredly and cautiously when dealing with price stability issues. 2022 was the proverbial exception to that rule as the central bank was confronted with an inflationary shock of a magnitude unseen in decades, and even then, the liftoff from the zero lower bound only happened after the US CPI had run above +5% YoY for 10 consecutive months. Fast forward to today, headline inflation has decelerated to +2.5% YoY, a level still above target, but that does not endanger the credibility of the FED. Moreover, before the FED decision, it was almost 300 Bps below the level of the target rate at 5.25%-5.50%, that is, the so-called “real rate” was (and still is) in highly restrictive territory. The real rate swung in the black for the first time in May 2023 and it has steadily increased since then. In fact, the FED paused its hiking cycle two months later, but by maintaining the target rate unchanged in the context of a cooling inflation, it de facto administered additional tightening. Following a realignment in its priorities, from lowering inflation to preserving and prolonging the economic expansion, it is understandable that the central bank may desire to “recalibrate” its policy stance and to “begin the process of moving towards a more neutral stance” at a quicker pace. The FED itself estimates the so-called, elusive “neutral rate”, that is, the rate at which monetary policy is not stimulating or restricting economic growth, to be at 2.90%. One or a series of deeper cuts may certainly assist in that regard. The flaw in this analysis is that it completely ignores two critical factors uniquely applicable to this cycle. First, the size of the FED balance sheet remains 3 Trillion USD larger than it was before the pandemic. Second, since Q4 2023 the US government has continued to expand its already bloated budget deficit, which at the end of August was equal to 7.2% of GDP. Moreover, in the first 11 months of the fiscal year 2024, that is, from October 2023 to August 2024, the US government has already spent 843 Bil USD in net interest, which equates to 13.5% of its total outlays and 44.5% of the budget deficit (1.9 Trillion USD) recorded over the same period of time. In short, the fiscal-monetary mix remains benign, if not outright stimulative, and real rates in highly restrictive territory may only tell part of the story. However, they do provide the perfect cover for the FED to pursue a looser policy.

The new Dot Plot released by the central bank projected an additional 50 Bps of easing in 2024, followed by 100 Bps in 2025 and by another 50 Bps in 2026, for a cumulative 250 Bps of cuts including the one already announced. Futures markets are pricing in the same amount of easing, but they expect the FED to get to a range of 2.75%-3.00% by the end of 2025, with no cuts for 2026. We think that bond markets are correct in anticipating that the rate-cutting cycle will progress faster than what the FED itself has indicated. We also note that, looking back at history, the US 10 year yield at around 3.50% appears to be fully pricing in the “soft landing” scenario. In other words, in the absence of a recession, long duration bonds do not seem to offer further upside from here. Whilst the prospects for capital gains appear to be limited only to one specific economic outcome and yields are less compelling than they were one year ago, the carry remains attractive. In addition, we think that, given how late cycle the US economy is, growth risks outweigh inflation risks, and that the probability of a recession remains elevated. Hence, we deem it prudent to maintain a fixed income exposure characterized by a duration comparable to that of the benchmark. With the US CPI running below +3% YoY on a stable basis, the hedging quality of bonds makes a comeback, as their correlation to equities flips to negative. That was indeed the case during the flash crash experienced by stock markets in the first week of August. In short, if the FED is really behind the curve, bonds will deliver. However, it is entirely possible that the economic softness we are currently going through won’t morph into a full-blown recession. Financial conditions remain loose, credit spreads tight, commodity prices contained, and mortgage rates are trending lower. On top of that, we suspect that a fair number of companies may have put new business on hold while waiting for the result of the election. We attach a lower probability to such a scenario, but if it turns out to be the correct one, in H1 2025 the environment may quickly evolve from one of a “growth scare” to that of a re-acceleration of the economy and, potentially, of inflation. Thus, the FED may be overreacting and, for that reason, we do not see particular reasons to reduce our exposure to growth assets too far ahead of time. The macroeconomic backdrop remains uncertain, but we are convinced that the inauguration of the easing cycle put the “soft landing” not on the horizon, but in the rearview mirror.

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