First Citizens Wealth™

Making Sense

## Basis Points | August 6, 2024

# Tougher Decisions

*Markets have reacted strongly over the last few trading days. We have organized a few points for your consideration.*

1. **Forceful reaction.**

Pessimism is on the rise, and financial markets have reacted forcefully. Over the last few days, US equity prices fell sharply across the size and style spectrum. The move in fixed income has been extreme: 2-year Treasury yields fell by ½ percentage point in just three days last week, a decline typically reserved for highly adverse macro events.

2. **What catalyst?**

Second-quarter earnings season has delivered some shaky guidance from a few of the biggest names, including in the technology sector where markets expect robust earnings growth to play out well into the future. Against this backdrop, **Friday's employment report for July was considerably weaker than expected, leading markets to question whether the economy can still withstand elevated interest rates.** International factors have also played a role, including turbulence in Japanese markets and heightened geopolitical uncertainty.

3. **Offsides.**

With inflation now very close to 2% – the Federal Reserve's stated target – the Fed's restrictive 5.5% interest rate appears increasingly offsides, risking impairing the labor market and leaving consumers exposed. Fed policymakers primed investors last week for a standard 0.25% rate cut in September, but markets are currently positioned for 1.00% to 1.25% of interest rate cuts by year-end. If current economic trends continue, **a 0.5% interest-rate cut at the September Federal Reserve meeting is likely warranted.**


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4. **(Over)-reaction?**

A large discrepancy between Fed policymaker guidance and market expectations has been a recurring feature this year. In Q1, markets expected substantial cuts to the policy rate only to see those expectations dashed after a few surprisingly firm inflation reports. If in coming weeks the growth and labor market picture appears even modestly more upbeat, recent market moves could likely prove excessive and subsequently unwind.

5. **Dry powder.**

But if economic conditions weaken substantially further, the Fed's fairly high policy rate of 5.5% leaves considerable room to cut. Recent monetary policy history shows that the Fed is inclined to use its dry powder to support the economy. The Federal Reserve may pivot hard in coming months to support the employment half of its dual mandate, especially if incoming price data shows inflation is stabilizing at roughly 2%. If economic fundamentals weaken materially or financial turbulence worsens, the Fed may even lower rates before its September 18 meeting.

**6. Volatility returns.**

Leading up to July 24th, the S&P 500 finished 356 trading days without declining more than 2% in a single day. This has now happened twice in nine trading days, and the index is down 8.5% through August 5, just shy of the conventional 10% "correction" level. However, by historical standards, the current sell-down is still modest. Since 1990, the S&P 500 has had an intra-year sell-down averaging 15%, even as most of these years saw positive calendar year return. **While we think this equity volatility will persist in the near term, we believe longer-term fundamentals remain in place and are optimistic. Our 12-month forward price target for the S&P 500 remains 5,900.**

**7. Briefly uninverted.**

The Treasury yield curve has re-steepened much faster than expected, reflecting markets' aggressive pricing for lower rates this year. High rates have left the curve inverted for two years, as shorter-term notes yielded more than those with longer duration. **The collapse in 2-year Treasury yields led the closely watched spread between the 10- and 2-year notes to briefly uninvert yesterday, but huge intraday swings brought the spread back to slight inversion. We expect uncertainty to persist and thus bond markets to remain relatively volatile.**

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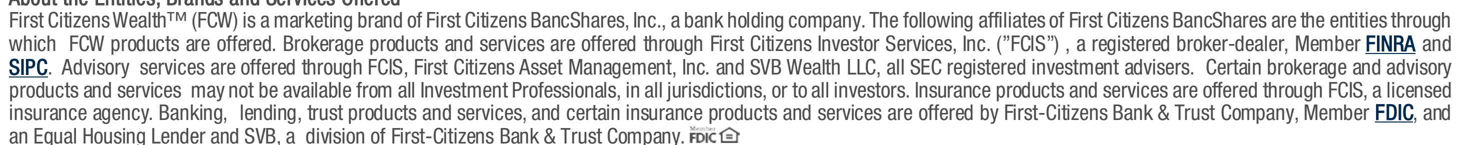

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