Report

Thoughts from the Pricing Desk

Treasuries should benefit from highly probable September cuts

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Interest Rates Expected to Drop

As of the last policy decision in July 2024, the Federal Reserve maintained its interest rates at a high of 5.25% to 5.50%. However, it is expected that the U.S. Federal Reserve will lower interest rates by 25 basis points after each of its final three meetings in 2024, according to the majority of Reuters-surveyed economists who said a recession is unlikely. Inflation data (currently 2.9 %) and the August employment numbers (significantly weaker than initially estimated) will guide the Fed's hand in September. Chair Powell stressed in a 2023 speech that the Fed "is navigating by the stars under cloudy skies."

In the past, there has been a strong association between changes in Federal Reserve rates and the yield on 10-year Treasury bonds, which is the opposite of bond prices. This is so because the economy determines the long end of the yield curve, while the Fed controls the short end. Consequently, as the Fed lowers rates in reaction to a disinflationary event, longer-term yields react to the reality of the economy. With the yield gap at negative 22 basis points (bps), the extensively followed two-year/10-year yield curve has been inverted for the longest period of time in history—two years. According to Tony Farren, managing director of rates sales and trading at Mischler Financial Group, "the market is starting to think the Fed is too late in cutting rates." The current 2.9 % inflation, which the government said is the smallest 12-month increase since March 2021, is for sure good news. However, the actual numbers might be much higher. Shelter, services, and electricity prices are up 5%, transportation is up 9%, and car insurance premiums are up 26% (2023-2024). Rent, housing, and grocery prices have been the biggest drivers of inflation in the past year. The consumer price index revealed a surprising decrease in inflation in June, which was primarily caused by lower gas, airline tickets, and used car and truck prices. Everything else is up, and everyone is paying more.

Is the Fed ignoring the actual inflation numbers?

At a decline of 0.1% in the past year, it will take, in theory, 10 years to reach the target of 2%. At the Fed's last meeting, Chair Jerome Powell said officials are no longer laser-focused on inflation. "We think we don't need to be 100% focused on inflation because of the progress that we've made." Is the Fed ignoring the actual inflation numbers to prevent the economy from stagnating by decreasing the rates on September 18th? With the US national debt currently at $35 trillion, continued deficit spending will be extremely inflationary. The annual average CPI was 224.939 in 2011 and 304.702 in 2023. This represents an inflation rate of 35.5% over 12 years.

Two more important datasets will be examined before the meeting on September 17-18th in Washington, D.C.: the PCE index (Personal Consumption Expenditure) on August 30th, and the second is the jobs report from the Bureau of Labor Statistics on September 6th. The jobs data will likely determine the percentage cut. The markets are pricing a September cut. Therefore, we assume the Fed will cut the rates in order to avoid a market crash. 10-year Treasuries are back below 4% as markets are pricing 95bps of Fed rate cuts across the remaining three meetings this year and 200bps of easing by next October. At Capital Economics, Paul Ashworth said recent rata "should support a quarter-point cut in interest rates" but, "at the same time, doesn't suggest price pressures are collapsing in a way that could warrant a bigger 50 bsp reduction". There were concerns earlier this month that the economy might be slowing down faster than previously thought after last month's jobs report.

Bond yields and mortgage-backed securities

Bond yields would decline in response to lower interest rates, increasing the value of existing bonds acquired at a higher rate of return. Financial strategist JoAnne Bianco claims that corporate bonds provide profitable opportunities. She believes that the US economy will continue to be robust enough to sustain growth and maintain low default rates. She stated that higher-tier trash bonds (think BB-rated) and investment-grade corporate bonds (BBB and above) are equally appealing.

Mortgage-backed securities are also a favorite of Janney Montgomery Scott's top fixed-income strategist, Guy LeBas. While they might not be "a free lunch, they are at least a cheap snack," he told Barron's that their risks are similar to those of Treasuries and that bond investors could expect "more income and some price appreciation." Bond yields would decline in response to lower interest rates, increasing the value of existing bonds acquired at a higher rate of return. For those interested, duration opportunities can be found in investment-grade credit, municipal, and government bonds.

Money Market funds

Last week, investors poured $37 billion into cash-like money market funds (MMFs Bank of America said on August 23rd, 2024, as they braced for the U.S. Federal Reserve to cut interest rates in September. BofA said that investors put $20.4 billion into stocks, $15.1 billion into bonds, and $1.1 billion into gold. BofA and EPFR's data showed investment grade bonds drew their 43rd straight week of inflows at $8.1 billion. Treasury bonds profit from the flight to safety during deflationary events, economic recessions, and credit-related events, while corporate bonds are liquidated to reduce default risks.

Mirroring the US, the Bank of Canada is expected to cut its rates at the next meeting. Inflation decelerated in June to 2.7 percent annually, with the drop attributed to a slowdown in gasoline prices.

Bond investors are speculating that the U.S. Treasury yield curve will become less inverted and eventually return to a normal positive slope. As the first Fed rate cut in September draws near, it could be appropriate to consider lowering equities risk and raising exposure to Treasury bonds. Those purchasing longer-term bonds, like 30-year bonds, should keep in mind that a lot can happen during that time, including changes in interest rates, inflation, economic growth, exchange rates, geopolitics, and even the president.

10-Year US Treasury Rates

Figure 1 10-Year US Treasury Rates
Source: Confluence Data Services: STL

US Corporate Bond 6-Month Bid Yield

Figure 2: US Corporate bond, BBB+, Norfolk Southern Corp., 2024, 5.5% USD
Source: Confluence Data Services: STL

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