Fed Initiates Easing Cycle, Supporting Fixed Income

Jefferies

MANAGED FIXED INCOME

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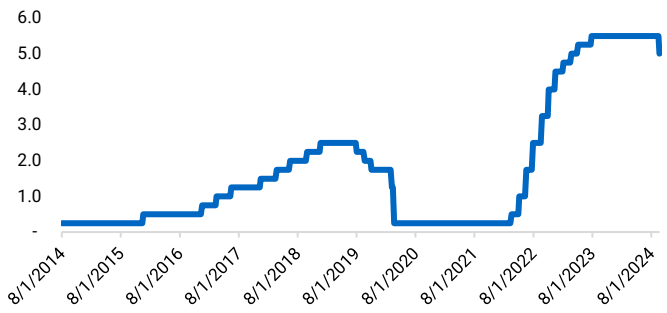
KEY POINTS

- After a 14-month pause, the Fed started its easing cycle by cutting the overnight Fed Funds rate by 50bps on September 18
- The Fed's *Summary of Economic Projections*[1] points to little expectation of a recession and a slower pace of accommodation than the market has been discounting
- Shorter rates immediately fell in response, but longer rates moved higher
- We remain very constructive on fixed income assets

50bps Cut and a Nod to a Stable Economy

The Federal Reserve confidently started the easing cycle by lowering the Fed Funds rate by 50bps last week (see chart 1). All FOMC members supported the cut with only one preferring 25bps rather than 50bps. Importantly for investors, Chair Powell was upbeat during the press conference, indicating that he didn't see an economic downturn as imminent, nor did he see a recession on the horizon (recall how many experts predicted recession last year). In fact, one of our favorite quotes by Powell was "The US economy is in a good place and our decision today is designed to keep it there"[2]. **This outlook fits well with our previously expressed view that the growth slowdown is more about post-pandemic normalization rather than a typical cyclical downturn.** Also notable was a shift by the Fed from inflation being the primary concern to the labor market - the other side of their dual mandate. Chairman Powell even acknowledged that if he had the July labor report at the last FOMC meeting he might have started cuts then. **This suggests that the magnitude of this cut was in large part catch-up rather than an emergency cut in the face of recession risk.** Finally, he reiterated that the pace and magnitude of further cuts will remain data dependent.

Chart 1 | Fed Funds Rate (Upper Bound)



Source: Bloomberg, Jefferies Investment Advisers. As of 9/20/24.

Market Reaction: A Slower Pace of Rates, Longer Market Yields Move Higher

The market was already leaning toward the 50bps cut prior to the meeting, so the initial rate reaction was subdued. As Jefferies' Chief Strategist David Zervos pointed out[3], the dovish cut was met with a more hawkish forecast that

1 https://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20240918.pdf
2 Federal Reserve Chair Jerome Powell, press conference September 18, 2024. https://www.cbsnews.com/news/federal-reserve-rate-cut-5-takeaways-mortgages-economy-unemployment-jobs
3 Interview, CNBC Closing Bell Overtime. https://www.cnbc.com/video/2024/09/18/the-market-did-not-like-this-move-fed-gave-really-weird-message-says-jefferies-david-zervos.html

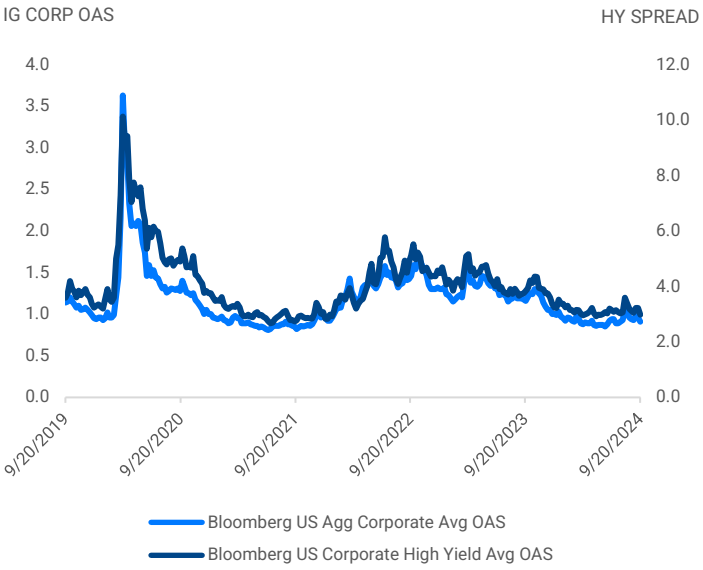
caused confusion in the immediate aftermath. After the market had time to digest the forecast – which reflected a slower pace of rates cuts in 2025 and 2026 – longer market yields moved higher, starting around the 5-year maturity point on the yield curve. Follow-on action reflected a risk-on bias with credit spreads firming and risk assets rallying (the S&P 500 hit its all-time high the day after the FOMC).

What This Means for Investors

From an asset allocation perspective, we remain very constructive on fixed income assets broadly as the rate cycle continues as expected. Investors who have enjoyed high cash yields, but now find themselves with too much liquidity or with income needs, should bring their fixed income allocations to at least a target weight.

In the wake of the Fed meeting, we welcome the increase in long yields and view it as a chance to buy or extend before the gravitational forces of the decelerating global economy pull the entire yield curve lower. In terms of credit exposure, the Fed's efforts to navigate the US economy to a soft landing will continue to keep credit spreads tight (see chart 2), but the additional yield accrual in a somewhat benign credit environment means that a full allocation remains appropriate in the near term. That said, we are increasingly cautious on longer-duration corporate credit since the opportunity for risk-adjusted excess returns has become more limited. Sector and security selection will continue to be important as a differentiator in total return.

Chart 2 | Corporate Credit Spreads Remain Tight

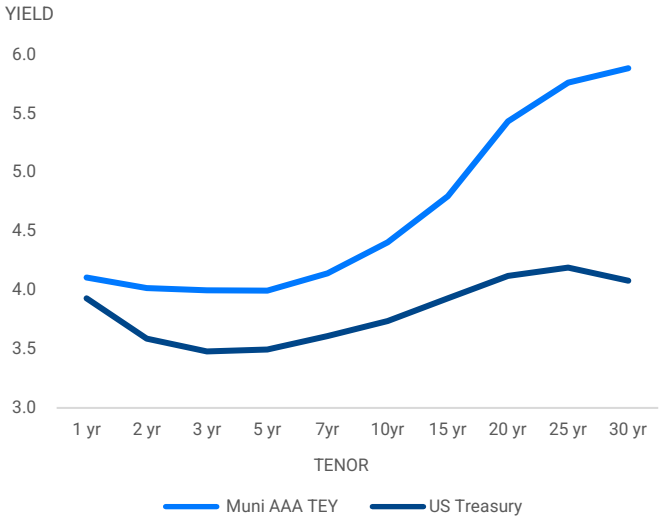


Source: Bloomberg, Jefferies Investment Advisers. As of 9/20/24.

We remain very constructive on municipal bonds, which offer attractive taxable-equivalent yields and strong credit fundamentals. Unlike the treasury "rates" curve, the municipal yield curve is positively sloped and rewards investors for moving out in duration (see chart 3). Thus we are somewhat long duration and are favoring lower coupons and single-A rated names, both of which should outperform during the ensuing Fed easing cycle.

In short, we expect both the Fed and the macro economic data to continue supporting fixed income assets across the curve.

Chart 3 | Municipal Yield Curve is Steep



Source: Bloomberg, Jefferies Investment Advisers. As of 9/20/24.

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