Morgan Stanley

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The Heartland Group at Morgan Stanley Investment Insights

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Recalibration

We are writing this the day after the Fed Reserve Chairman has spoken and the committee decided to lower the Fed Funds rate by a 50 bps (half a percent cut) on Sept 18th. During his speech, he used the word "recalibration" multiple times. He discussed the dual mandate that the Fed has: to create stable prices (fight inflation) and maximum employment (keep unemployment in check). The word "recalibration" was used to emphasize that the committee is transitioning from a primary focus on inflation to a balanced level of risk between employment and inflation.

What is interesting is what happened in the stock and bond markets directly after the 1 PM CST announcement of the 50 bps rate cut. At 12:59 pm, the S&P 500 was more or less flat for the day at 5636, in anticipation of the announcement.[1] One might expect the stock market to rally after the first rate cut, especially if it was larger than expected. Within the first 30 minutes, the S&P 500 did spike as high as 5674[1], which again approached the 5700 mark that we have previously mentioned as a potential resistance level.[2] However, over the next hour and a half, the market reversed course and gave up the gains for the day, closing at 5618.[1] As predicted, 5700 has proven to be a strong resistance level for the S&P 500, coming within 50 points now three times in the last three months. But we are hoping we can burst thru it today as the stock market is making another run at it. But it's hard to feel confident about sustaining this trajectory near term as we are in the middle of the historically 2 most difficult months for a market, September and October, leading up to an election year.

The 2-year Treasury bond also moved from 3.69% prior to 3.54% and eventually finished the day at 3.63%.[1] While a 15 bps swing may not seem significant, the reversal is noteworthy. Even more importantly, the 10-year Treasury was almost at the same rate of 3.69% prior to the move, dropped to 3.63%, but then rallied to 3.71% to finish the day.[1] What happened was that the 10-year Treasury spread versus the 2-year gapped to about 8 basis points by the end of the day, all during a 50 bps move lower on Fed rates.[3] It was only a few days ago that the 10-year vs. 2-year spread became positively sloped and was no longer inverted, most likely due to the expectation of this rate cut.[3] Originally, the plan was to write about inflation and employment data. However, it may be better to focus this newsletter on what Fed Chairman Powell said and how that translates into managing your portfolios, considering this cut is a historic and highly anticipated change of direction for the Federal Reserve. To be clear, a rate cut was expected, and the CME tracker indicated that the probability of a 25 bps or the unusual 50 bps cut was nearly even.[4]

Here are some important points from Chairman Powell's press conference: The committee sees the Fed rate at 4.4% by year-end, with a neutral or terminal rate of 2.9% by 2026. This means that the Fed Funds rate now sits at 4.75-5%, and another 50 bps cut is expected by year-end over the next three months (or two meetings).[5] The committee believes the economy is growing at a solid rate and that they see no increased likelihood of a strong downturn. However, the employment numbers bear watching, echoing our previous newsletter's advice to keep an eye on employment data.[2]

1 Dow Jones/ Reuters news and Thompson One
2 Aug 24 Heartland Group Newsletter(morganstanley.com)
3 10-Year Treasury Constant Maturity Minus 2-Year Treasury Constant Maturity (T10Y2Y) | FRED | St. Louis Fed (stlouisfed.org)
4 CME FedWatch Tool - CME Group
5 Fed meeting recap: Chair Powell defends central bank's decision to go big with first cut (cnbc.com)
6 News Release (dol.gov)
7 ICE BofA US High Yield Index Option-Adjusted Spread (BAMLH0A0HYM2) | FRED | St. Louis Fed (stlouisfed.org)

The first employment data after the Fed rate cut arrived yesterday. Jobless claims were lower than expected, down 12,000 month-over-month to 219,000 this morning.[6] Seeing fewer people claiming unemployment right after a significant rate cut, which some interpreted as the Fed's concern over unemployment, is encouraging, as the initial figures show a positive surprise in the job market.

What should we watch for now? Clearly, employment data and consumer spending are essential. However, high-yield bond spreads over Treasury yields may better indicate whether the bond market is worried about an economic downturn. U.S. high-yield spreads versus Treasury widened in early August to 3.93% when the stock market experienced heightened volatility. Since then, they have narrowed, but the medium-term trend appears to be moving upward, from 3% to 3.25% over the last three months.[7] If spreads approach 4% again, it could be a data point worth taking seriously. We still don't believe a recession is likely or any downturn, for that matter, but considering the high market valuations, any data hinting at the "R" word could trigger a market correction.

Continue monitoring the 5700 mark for the S&P 500, as higher volatility is typical in the months leading up to a presidential election. If we break thru and close above the 5700 mark for a few Friday closes in a row, it could be our new support level for 2025. Often a strong resistance levels that are broken become support levels in the future. But for now, until year end, since market valuations are high, our team is also recalibrating our outlook to a slightly more neutral stance on equities, at least until the 5700 mark can be proven a support level. After today's rally, we recommend adhering to your strategic allocation and avoiding tactical bullish overweights. Expect modest market returns from now until year-end and use cash reserves to add to investments if any corrections or downward moves occur.

The greatest compliment one can give us is a referral to their friends and family.
As always, please call or email us with any questions or concerns about the management of your family's wealth.

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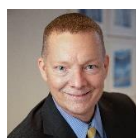

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For index, indicator and survey definitions referenced in this content please visit the following:
https://www.morganstanley.com/wealth-investmentsolutions/wmir-definitions
An investment cannot be made directly in a market index.

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The value of fixed income securities will fluctuate and, upon a sale, may be worth more or less than their original cost or maturity value. Bonds are subject to interest rate risk, call risk, reinvestment risk, liquidity risk, and credit risk of the issuer.

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Duration, the most commonly used measure of bond risk, quantifies the effect of changes in interest rates on the price of a bond or bond portfolio. The longer the duration, the more sensitive the bond or portfolio would be to changes in interest rates. Generally, if interest rates rise, bond prices fall and vice versa. Longer-term bonds carry a longer or higher duration than shorter-term bonds; as such they, they would be affected by changing interest rates for a greater period of time if interest rates were to increase. Consequently, the price of a long-term bond would drop significantly as compared to the price of a short-term bond.

The value of fixed income securities will fluctuate and, upon a sale, may be worth more or less than their original cost or maturity value. Bonds are subject to interest rate risk, call risk, reinvestment risk, liquidity risk, and credit risk of the issuer. High yield bonds are subject to additional risks such as increased risk of default and greater volatility because of the lower credit quality of the issues.

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