GLOBAL FIXED INCOME & CURRENCY STRATEGY

September 20, 2024

Fed Be Quick

- The Fed kicked off the easing cycle with a 50bps cut. The updated projections show that monetary policy will gradually return to neutral by the end of 2026.
- The risks to the Fed's dual mandate are skewed to the downside. Inflation could fall below the 2% target, while the labor market falls short of maximum employment.
- The Fed would need to get the policy rate down to neutral (or lower) quickly if the dual mandate is at risk.
- A back-up in 10-year Treasury yields to 4% should be seen as an opportunity to increase duration in fixed income portfolios.
- The U.S. dollar is likely to soften as its yield advantage shrinks. We favor being long the Japanese yen and the British pound.
- The combination of declining interest rates and a weaker U.S. dollar should be bullish for gold.

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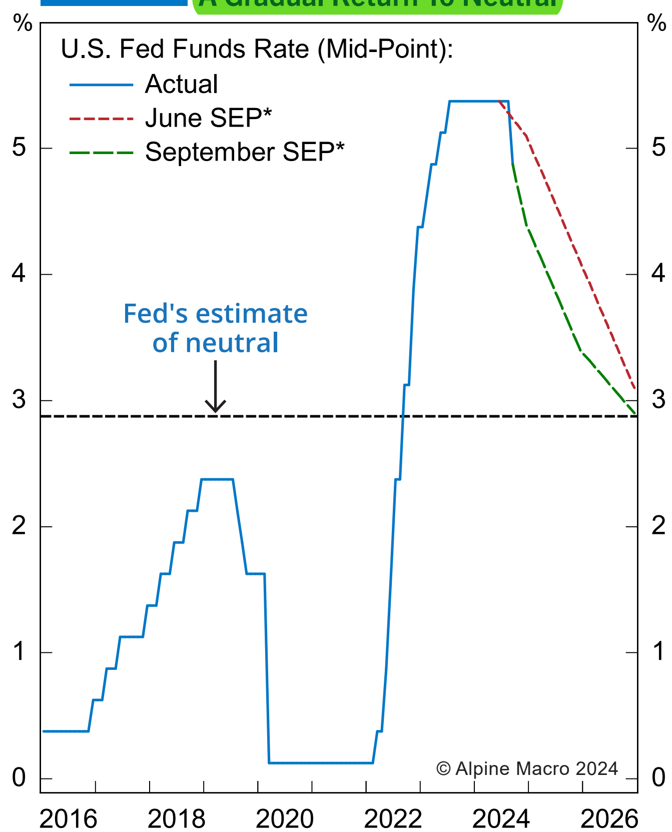
"The Committee would be prepared to adjust the stance of monetary policy as appropriate if risks emerge that could impede the attainment of the Committee's goals [of 2% inflation and maximum employment]."

- FOMC statement, September 2024

Although the Fed was late to join most of the other G10 central banks in lowering interest rates, it started with an outsized 50bps cut this week. While interest rate futures were close to evenly divided on

Chart 1 FOMC Members See A Gradual Return To Neutral



*Summary of Economic Projections

Table 1 The Fed's Economic Projections

	2024	2025	2026	Longer Run
PCE Inflation	2.3	2.1	2.0	2.0
Unemployment Rate	4.4	4.4	4.3	4.2
Federal Funds Rate	4.4	3.4	2.9	2.9

Source: Summary of Economic Projections, September 18, 2024

whether the Fed would deliver a 25 or 50bps cut, there was only one dissenting FOMC member voting in favor of a smaller move.

Chairman Powell made it clear that investors should not extrapolate what this week's decision means for future FOMC meetings. During the press conference, Powell emphasized that decisions will be made on a meeting-by-meeting basis. Relative to the path laid out in the updated projections, the Fed could cut faster or slower depending on the incoming economic data (**Chart 1**).

The new forecasts from FOMC members indicate that the policy rate will gradually return to neutral by the end of 2026. This path for interest rates is contingent on the Fed's economic outlook. The dual mandate will dictate the Fed's reaction function. **Table 1** shows the latest projections for inflation and the unemployment rate relative to the Fed's longer run objectives.

If the economy evolves differently from the Fed's baseline forecast, so will short-term interest rates. The key question that investors need to answer is whether the risks to the Fed's dual mandate are skewed to the upside or the downside. We believe that it is the latter.

Outside of shelter, U.S. inflation is already running below the Fed's 2% target. **Charts 2** & **3** show an update of our favored breakdown of the CPI data following last week's report for August. The former depicts the annual inflation rates, while the latter shows the faster and more volatile 3-month annualized rates of change. Excluding shelter, core inflation has slowed to just 1.7% y/y and on a 3-month annualized basis it is hovering close to zero.

Shelter accounts for a significant share of households' spending and it should not be dismissed lightly. The reason we are singling it out is that shelter CPI does not reflect what is actually happening in the housing market.

During the press conference, Powell was asked about elevated shelter inflation. He acknowledged that it is proving stickier than expected, but it should head lower. The lags from market rents to the shelter component of CPI are proving to be longer than usual in this cycle, but the fundamental relationship has not broken.

The shelter component of CPI measures changes in consumer spending on the entire stock of housing. This means that changes in market rents get incorporated into CPI gradually as households move to new locations and landlords update existing leases when they expire.

Chart 4 shows that renters have been moving less frequently. This could be the reason why it is taking longer for new rents to filter into the shelter CPI. While the lags are longer, an expected slowdown in shelter inflation should still pull overall inflation lower.

Moreover, owners' equivalent rent (OER), which accounts for 74% of shelter CPI, is not a cash outlay

Chart 2 Annual U.S. Inflation Rates

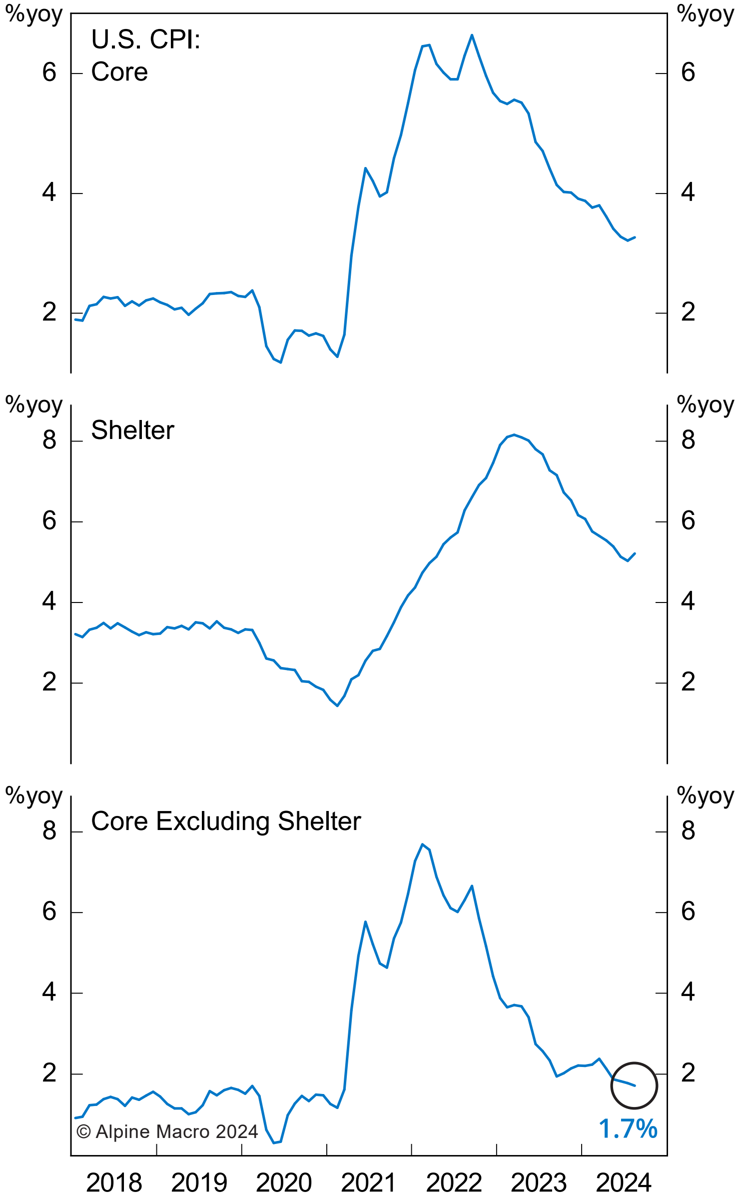
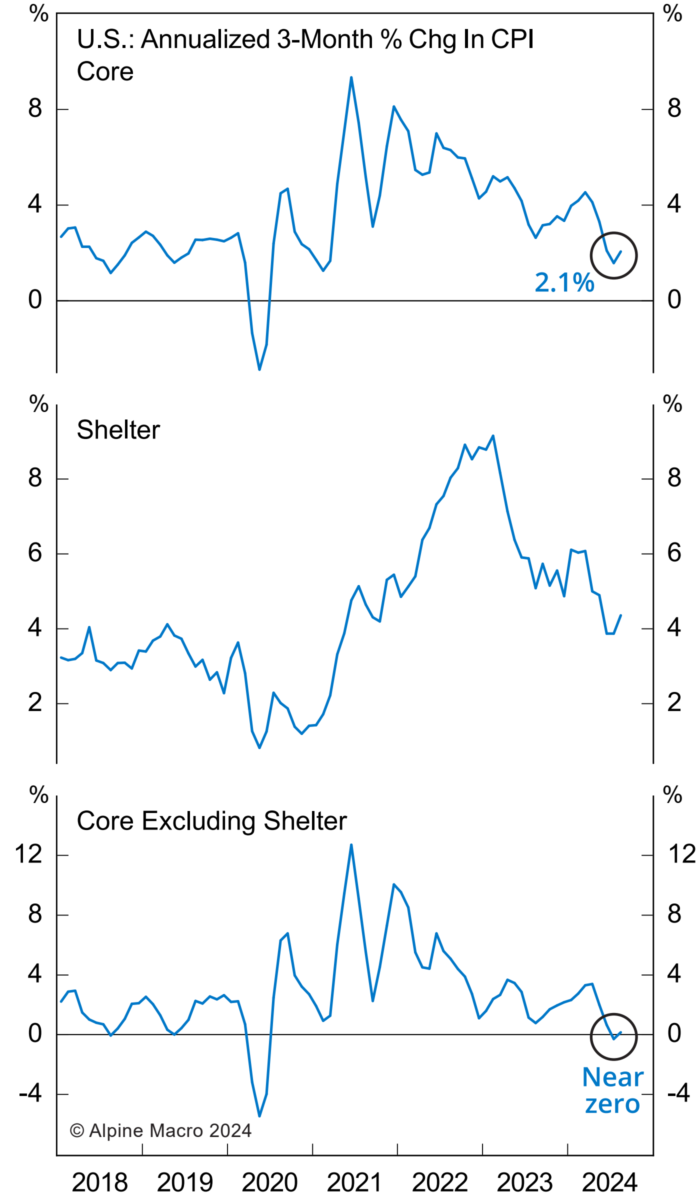


Chart 3 3-Month Annualized U.S. Inflation Rates

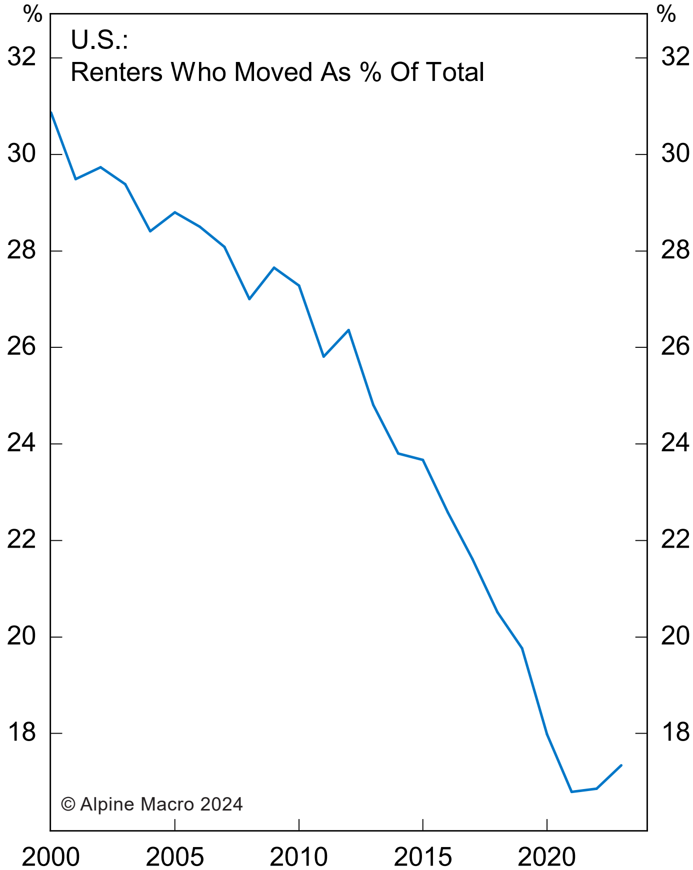


and it biases inflation higher. According to the BLS, OER is the *"implicit rent that owner occupants would have to pay if they were renting their homes."*

Consider a homeowner who has lived in the same house for five years and has a fixed 30-year mortgage or no mortgage at all. This person's monthly payments have not increased over the last five years. Yet according to the OER, this homeowner is now spending 25% more than five years ago to live in the same house (**Chart 5**).

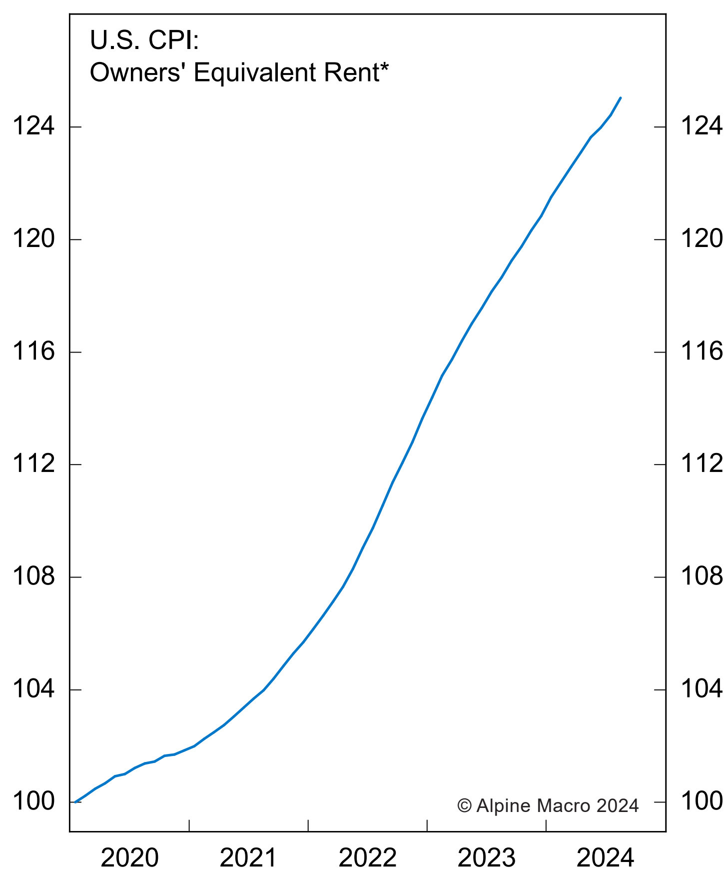
If the U.S. labor market weakens further, not only would the Fed miss its mandate of "maximum employment", but it would also increase the odds of inflation falling below the 2% target. As Powell

Chart 4 It Takes Longer For New Rents To Filter Into CPI



Source: Harvard Joint Center for Housing Studies

Chart 5 Homeowners Are Paying Themselves More!



*Rebased to Jan 2020 = 100

made clear at the Jackson Hole symposium last month, FOMC members *"do not seek or welcome further cooling in labor market conditions."*

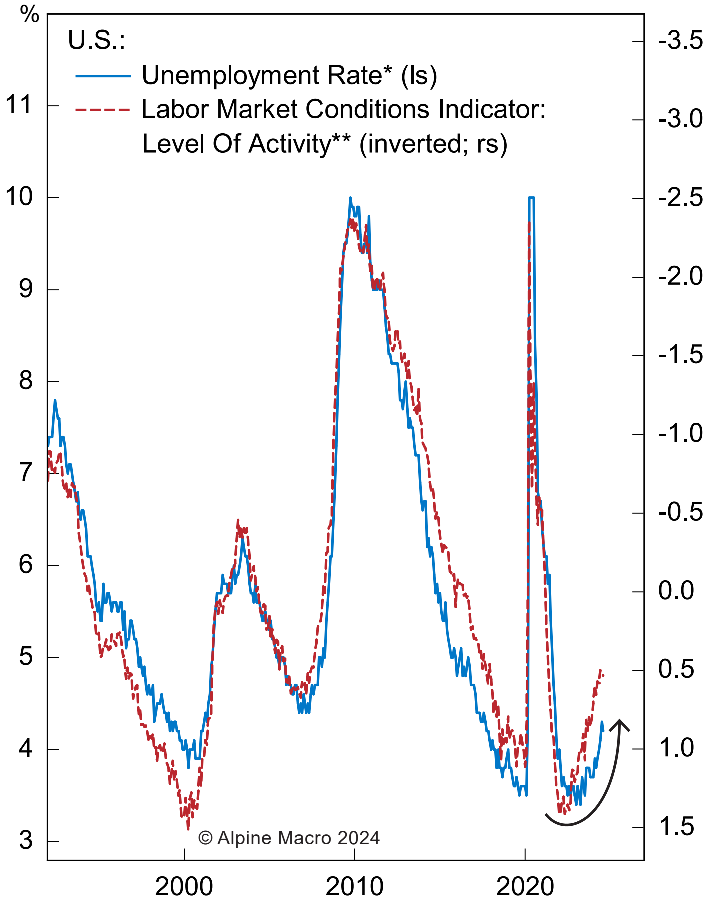
During Wednesday's press conference, Powell noted that the labor market is now softer than it was prior to the pandemic and it is not a source of elevated inflationary pressures. This is noteworthy as U.S. inflation was running below 2% in 2019 and the Fed was cutting interest rates (from a much lower level) and re-starting QE.

In contrast to the projections of FOMC participants, the evidence points to a further rise in the unemployment rate. This is best captured by the Kansas City Fed's Labor Market Conditions Indicator (LMCI). The LMCI is based on 24 variables and is a good summary statistic on the overall health of the labor market.

The KC Fed's LMCI suggests that the jobless rate could approach 5% over the coming months (**Chart 6**). This will be above the FOMC's 3.5-4.5% range for the long-term steady state unemployment rate. In other words, the Fed would be missing its goal of maximum employment.

Bottom Line: The risks are that U.S. inflation will fall below the Fed's 2% target and the labor market will fall short of full employment.

Chart 6 Upside Risks To The U.S. Jobless Rate



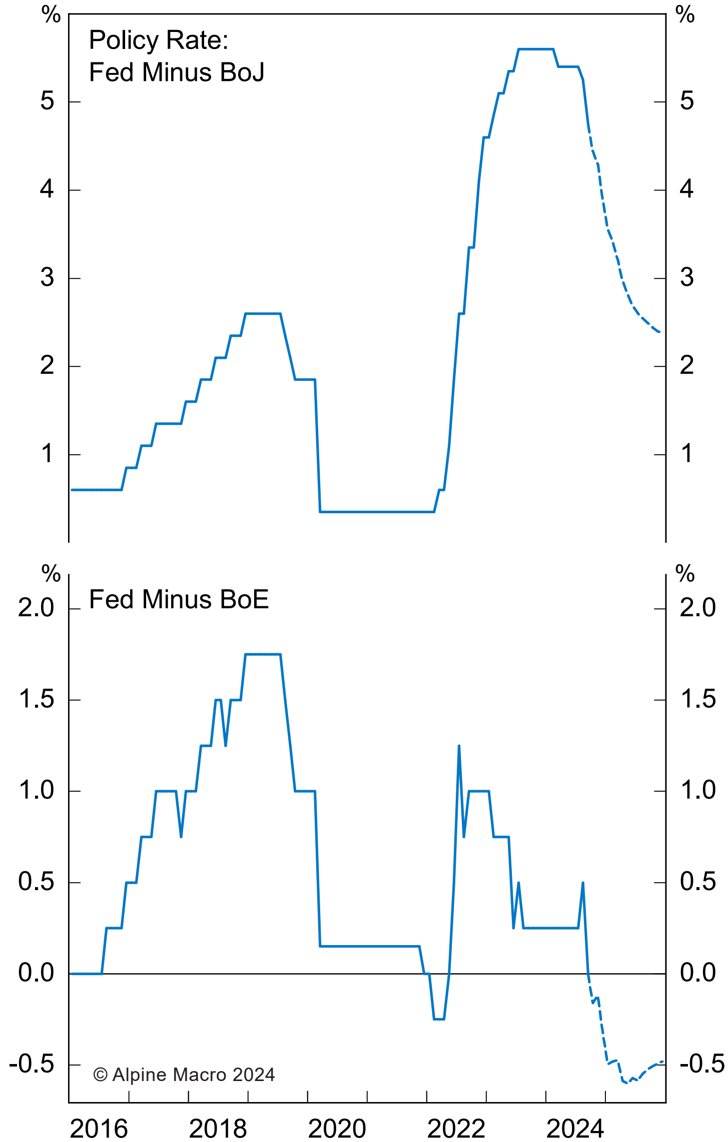
*Truncated at GFC high
**Source: Kansas City Fed

Investment Implications

Bond yields have moved higher after this week's FOMC meeting. It could be that investors believe that by front-loading the rate cuts, the Fed will have to ease less on a cumulative basis.

In our view, the Fed will need to get the policy rate down to neutral (or lower) quickly if the dual mandate is at risk. We recommended shifting duration to neutral in early August after the sharp pullback in global risk assets. A back-up in yields to 4% should be seen as an opportunity to increase duration again. Investors should also stay positioned for a steeper yield curve.

Chart 7 Favor The Yen & Sterling Versus The Dollar



Note: Dotted lines denote market expectations from OIS curves

The U.S. dollar is likely to soften as its yield advantage shrinks. The Japanese yen and the British pound are the two currencies that we favor the most (**Chart 7**):

- The BoJ is the sole G10 central bank that is raising interest rates. Consequently, the dollar's yield advantage is set to narrow the most against the

Chart 8 Japanese Investors Have Piled Into Foreign Bonds

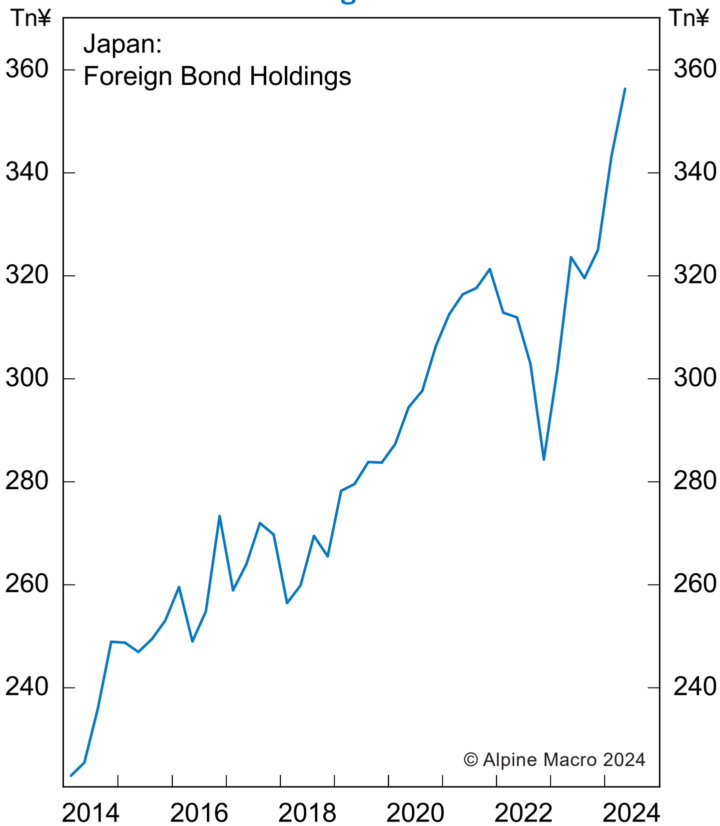
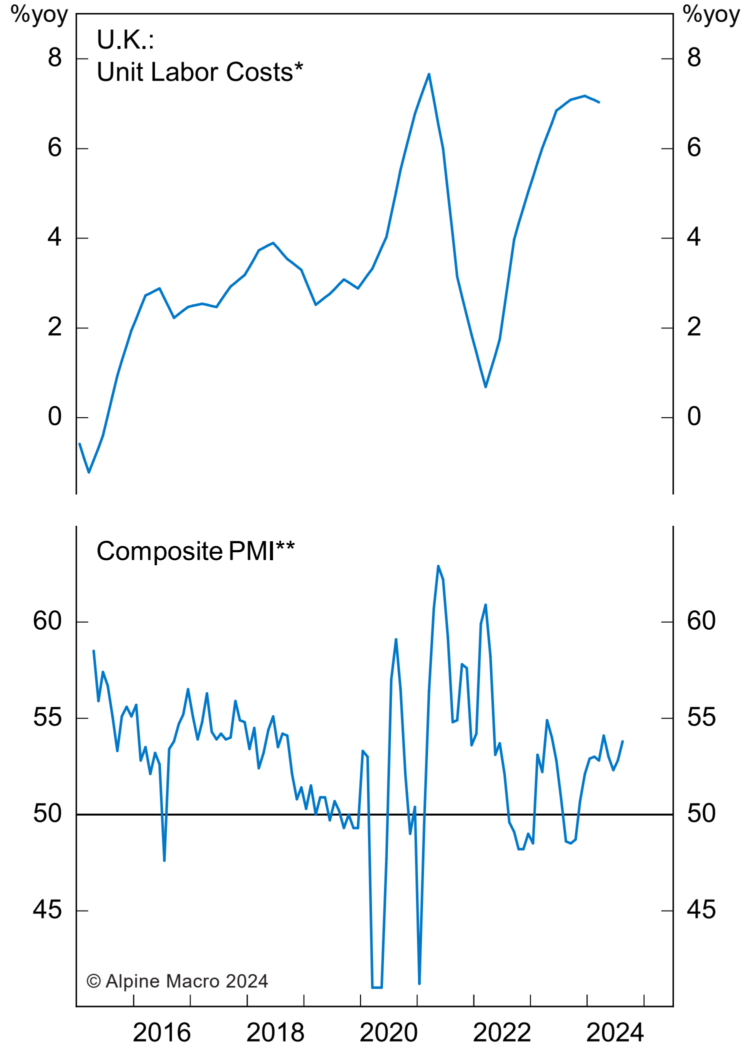


Chart 9 The BoE Will Be Slow To Cut Rates



*Shown as a 4-quarter moving average; source: ONS
**Truncated at 41

Japanese yen. This will be a blow to yen-funded carry trades. CFTC figures show that speculators have cut their short yen trades. However, domestic Japanese investors are heavily exposed to unhedged foreign bond holdings (**Chart 8**). There could be a rush to hedge the FX risk as the carry shrinks.

- The BoE will lag the Fed in easing policy. Keeping rates unchanged this week, the BoE noted that *"in the absence of material developments, a gradual approach to removing policy restraint remains appropriate."* Wage pressures are strong in the U.K. with unit labor costs growing more than 6% (**Chart 9**, top panel). Additionally, the economy is proving to be resilient with the composite PMI on an uptrend (**Chart 9**, bottom panel). Consequently, U.S. short-term interest rates should fall below U.K. rates. That is, the British pound could become the highest yielding G10 currency.

Finally, the combination of declining interest rates and a softer U.S. dollar should be bullish for gold. Since Russia's invasion of Ukraine in 2022, heavy central bank demand has been pushing gold higher

(**Chart 10**, top panel). These purchases were so strong that they overwhelmed the weakness in demand from private investors (**Chart 10**, bottom panel). A downside reversal in the dollar and real interest rates could revive investors' appetite for gold. If central banks also continue with their purchases, gold could head much higher.

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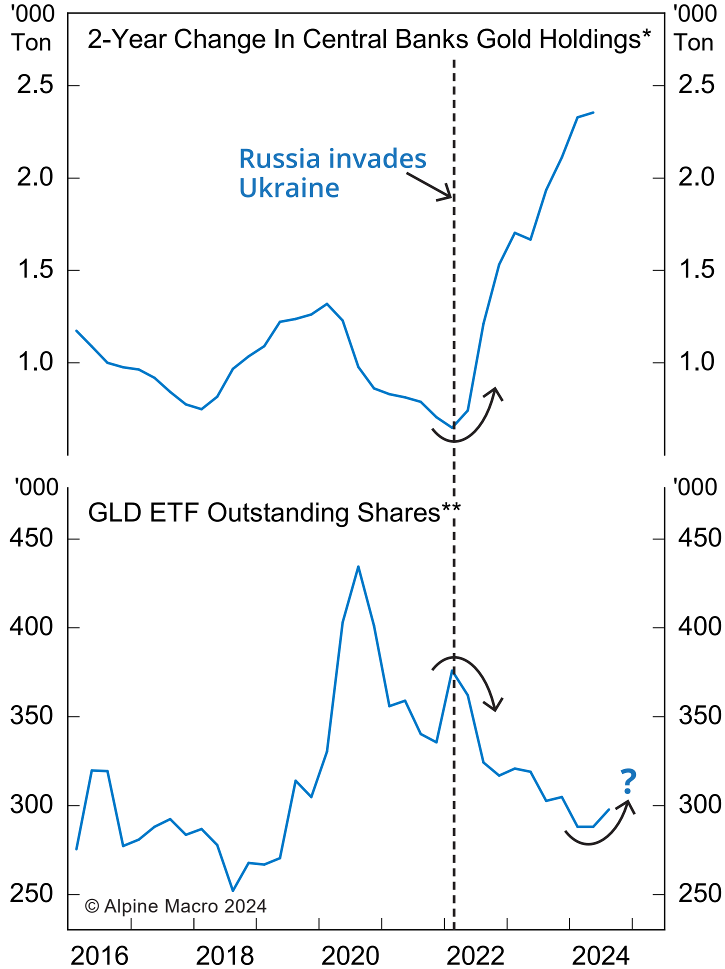
Chart 10 Will Private Investors Return To Gold?



*Source: World Gold Council
**Source: Bloomberg Finance L.P.

Currency Outlook

Vs THE DOLLAR		
	1-3 Months	9-12 Months
EUR	UP	UP
JPY	UP	UP
GBP	UP	UP
CHF	UP	UP
CAD	FLAT	UP
AUD	FLAT	UP
NZD	FLAT	UP

Vs THE EURO		
	1-3 Months	9-12 Months
JPY	UP	UP
GBP	UP	UP
CHF	UP	UP
SEK	FLAT	UP
NOK	FLAT	UP

Fixed-Income Outlook

OVERALL PORTFOLIO DURATION

AT BENCHMARK

COUNTRY ALLOCATION*	
U.S.	4
Japan	1
Eurozone	3
Core	4
Periphery	2
U.K.	3
Switzerland	2
Norway	2
Sweden	3
Canada	4
Australia	4

* Numbers denote allocation where 1 = maximum underweight and 5 = maximum overweight

Currency Positions

Recommendations	Open Date	Open Level	Target	Stop	P&L		
					Spot	Carry	Total
Long AUD/NZD	2019-04-29	1.0574	1.2000	-	3.22%	-4.02%	-0.80%
Long Gold	2022-03-04	1,928	-	-	34.18%	-	34.18%
Short USD/JPY	2024-08-23	146.23	-	-	2.47%	-0.39%	2.08%
Long GBP/USD	2024-08-23	1.3094	-	-	1.46%	-0.02%	1.44%

Fixed Income Positions

Recommendations	Open Date	Open Level	Target	Stop	P&L
Long 2-Year/Short 10-Year U.S. Treasuries	2022-12-02	4.24%/3.51%	-	-	85.92 bps

A Unique Mind On The Markets