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MARKETINSIGHT

Rate Cuts: How much and when? 29 months ago, the Federal Reserve began hiking interest rates in order to combat the surge in inflation. The effective rate range went from 0-0.25% to 5.25-5.5% in a series of 0.25% and 0.5% hikes. As the rate of inflation has fallen, the market has been well ahead of the Fed in anticipation of **when** and **how much** the Fed will lower rates. It has been a roller coaster ride this year in the Bond markets with rates first falling, then rising, and now falling again as the market interprets the economic data and the Fed's expected reaction. To the frustration of the markets, the Fed has been stubbornly slow, and only now at the most recent FOMC meeting, Fed Chair Powell signaled a rate cut (likely only 25 basis points) is possible at the next FOMC meeting in September.

Is 'good' news good or bad? Is 'bad' news good or bad? The Fed has a dual mandate of achieving full employment (around 4.5% unemployment) and price stability (inflation near 2%). The conundrum the market is wrestling with is that strong economic news means the Fed is likely to move very slowly (if at all) in lowering rates. Or, if the economy weakens significantly (a recession) the Fed would move rates lower aggressively. But the market is pricing in significantly lower rates AND solid growth: a 'goldilocks' scenario that is vulnerable to domestic and foreign changes. This vulnerability played out last week.

Last week's market volatility was a result of a convergence of separate events in Japan and the US. The Bank of Japan signaled rates will be moving higher (first time in 17 years) while at the same time weaker employment data in the US fueled recession fears. In simple terms, for the first time in nearly two decades, interest rates rose in Japan and fell in the US, igniting what is now understood as the "Yen Carry Trade Reversal". Historically, Japan's rates have been extremely low, which gave global investors a chance to borrow Yen at very low rates and then turn around and invest elsewhere for higher returns - this is called an arbitrage spread. With Japanese rates now rising, these trades need to be unwound, which means many financial assets including stocks will be under pressure. The Yen Carry Trade Reversal sparked a 'mini' panic in the stock market as prices gapped lower but have since mostly recovered. This volatility shows the vulnerability to changing monetary policy (both domestic and foreign) and the delicate balancing act of moving too fast or too slow. As the saying goes 'be careful what you wish for'.

Stability for now: The realization that the US economy is still strong, inflation is on a downward path towards 2%, and employment at near full levels has eased fears of an immediate market crash or hard recession. Market participants are now back in line with the Fed's projections of a 25bps cut in September, and potentially another 25bps in November and December for a total of 0.75% decrease in rates to a range level of 4.50-4.75%. This delicate balance of **how much to cut and when** is solely up to the Fed, and in line with their objective of price stability and full employment.

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