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BREAKING NEWS
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The Fed tees up a first rate cut in September

Today's Fed meeting marked another incremental dovish shift, setting up the first rate cut of the cycle for as soon as the next policy meeting in September.

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WHAT HAPPENED?

The U.S. Federal Reserve kept policy unchanged for the eighth meeting, marking one full year since a change in rates after last July's hike. The updated policy statement and press conference leaned dovish relative to prior communications. The central bank continues to signal the first rate cut is likely imminent, possibly as soon as September.

The principal changes to the policy statement reflect the FOMC's increased concerns regarding the labor market. It says that job gains have "moderated" and that "the unemployment rate has moved up." At the same time, the statement notes "some further progress" toward 2% inflation. Rather than focusing on "inflation risks," the FOMC now highlights that there are "risks to both sides" of the dual mandate.

In his press conference, Chair Powell said that "a rate cut could be on the table as soon as the next meeting in September," assuming the data gives the FOMC greater confidence that inflation is declining and the labor market is back in balance. He said they have already gained confidence over recent months, as inflation has moderated further and the labor market has showed more signs of softening. But they want to see more data before committing to rate cuts. Between now and the September meeting, two more CPI reports and jobs reports will be released, which we expect to satisfy Chair Powell's criteria and to justify the first rate cut.

ECONOMIC DATA CONTINUES SOFTENING

Since the June Fed meeting, economic data continued softening. Although second quarter real GDP growth beat expectations at +2.8% quarter-over-quarter annualized, underling growth with volatile elements removed was lower, around +2.5%. We anticipate further slowing in both growth and inflation, justifying rate cuts as soon as September.

After a strong start to the year, the labor market has cooled off. The unemployment rate is up to a fresh cyclical high of 4.1%, while the pace of job creation slowed from +267,000 per month in Q1 to +177,000 today. Other gauges of the labor market also show loosening, including the number of job openings, the private quits rate and surveys of business hiring.

As the labor market has cooled, wage inflation has slowed encouragingly. This is feeding through to lower services sector prices, including housing. Although the pace of housing inflation is still too high to be consistent with the Fed's overall inflation target, it has already achieved roughly 80% of the needed deceleration. At the same time, goods price

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inflation remains low. Overall, core inflation has slowed to around 2.5% annualized, and remains on track to return to target by next year.

Softer labor markets and slower inflation are a mixed blessing for the U.S. consumer. On the one hand, slower job creation could pressure confidence and exacerbate areas of stress. As unemployment has risen, consumer delinquency rates have moved higher, to above pre-Covid levels. On the other hand, lower inflation supports real incomes and, by extension, overall spending. Real consumption is growing around 2.6% year-over-year, down from last year's breakneck pace, but still healthy.

WHAT DOES THIS MEAN FOR INVESTORS?

As the Fed preps for its first rate cut, we continue to find attractive opportunities across fixed income markets. Yields are still attractive across many sectors, including preferreds, securitized products, high yield corporates and senior loans.

Preferred securities stand out for both their current yields, and their tax efficiency. Certain preferreds generate qualified dividend income, which is taxed at 20% rather than at ordinary income tax rates. Given their relatively high absolute and taxable-equivalent yields, preferreds may be an appropriate allocation in either a taxable or tax-exempt portfolio. The asset class is bolstered by strong fundamentals for the largest issuers of preferred securities, banks. Earnings have been supported by higher fee income and healthy capital markets activity, while balance sheets remain healthy.

Elsewhere in fixed income, securitized assets are not only attractively valued, but also one of the few areas of the market where spreads are wider than their historical average, providing a favorable entry point. Within asset-backed securities, consumer and commercial credit performance continues to stabilize. As for commercial mortgage-backed securities, we see substantial reward potential for investors willing to accept the risks and challenges facing office and retail properties.

Senior loans and high yield corporate bonds continue to impress. Senior loans remain one of the highest-yielding asset classes across global fixed income markets. Loan fundamentals remain sound, with refinancings at a robust pace and borrowers still pushing out their maturity walls. Demand is particularly strong thanks to the ongoing formation of collateralized loan obligations, the largest purchaser of senior loans. We expect healthy demand to persist, supporting elevated income and solid total return potential. High yield corporates have benefited from resilience in the U.S. economy and also feature healthy fundamentals. We expect default rates to rise amid some signs of decelerating economic activity, but only to levels near their long-term average, as credit quality for the overall asset class has improved notably in recent years.

In the equity space, we highlight opportunities in several areas that have been less-favored recently. Many diversified equity allocations are weighted more toward the U.S., an emphasis we have favored over the past few years. Recently, however, we have become more comfortable reducing our U.S. overweight and shifting into non-U.S. equity opportunities in both developed and emerging markets. Currently, valuations for non-U.S. equities look more attractive (less expensive) than for their U.S. counterparts, which remain well above the long-term average. Of course, valuations can vary widely by individual markets and aren't the only criteria to consider when deciding where to allocate.

We see value in non-technology sectors in the U.S. that missed out on much of the year's big gains and may be due for a recovery. These include materials and health care, both of which offer more attractive valuations than the broader market. In materials, input prices have fallen recently after steep increases during Covid, while export demand has picked up in 2024. In health care, we like medical technology, which is boosted by soaring demand for elective procedures over recent quarters, and managed care, which has high cash levels and improving operating earnings. Both sectors are set to show improved earnings later this year.

For more information, please visit us at nuveen.com.

Endnotes

Sources

Federal Reserve Statement, July 2024.

Bloomberg, L.P.

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