Bell Institutional

September 2024

ECONOMIC OUTLOOK

This month, I'd like to revisit the concept of an economic "soft landing" – in which inflation cools, unemployment does not rise much and the consumer continues spending. Although conversations among forecasters still drift toward a soft landing as our most probable economic direction, I don't believe the market shares that same confidence.

Why do I say this? First, the stock market seems twitchy. It might be more correct terminology to say the stock market is more volatile, but that description doesn't seem to capture the essence of today's environment – so I'm going to stick with twitchy. Investors want to believe in the idea of a soft landing, but they are fearfully on guard against any factors indicating something to the contrary.

In early August, the Bank of Japan raised its overnight lending rate (similar to our fed funds rate in the U.S.) by 15 basis points, from 0.10% to 0.25%. The impact was a decline in U.S. stocks, caused by investors having to cover their "carry trades." In this case, a carry trade is money borrowed at a low interest rate from Japanese lenders, then reinvested elsewhere in a more favorable return environment (namely, the U.S. stock market). When interest rates increased, investors had to sell the stocks and raise money to pay back loans borrowed in Japan.

By my math, a 0.15% increase in borrowing costs should not totally disrupt the relationship of the carry trade strategy. If it does, the expected rate of return was not adequate for the risk in the first place. Yes, there are other factors such as currency exchange rates, but the yen had been appreciating against the dollar before the Bank of Japan increased its rates.

If the bond market believed in the soft landing idea, I suspect the fed funds rate would settle in around the level of 3.5% in the coming 24 months. This reflects both my estimate that inflation in a soft landing scenario will remain in the area of 2.75% to 3% and my belief that the Fed will keep the real cost of money in the area of 0.50%. However, the 2-year Treasury is currently priced as if the fed funds rate will be in the range of 2.5% two years from now. I see two primary reasons for this: either there is a belief that inflation will get back down to 2%, or investors are positioning defensively for some recessionary pressure. >>>

Greg Sweeney, CFA®
SVP/Chief Investment Officer
Tenure: 1992
Investment Experience: 39 years
Education: Bachelor's degree in business, University of North Dakota; Chartered Financial Analyst designation

I believe that with a soft landing, the Treasury curve would revert to a normal shape, with longer-term yields higher than shorter-term yields. The long-term average spread between 2-year and 10-year Treasury yields is 100 basis points or 1%. With a 3.5% fed funds terminal rate, the 10-year Treasury yield should be in the range of 4.5% instead of 3.75%, where it is currently. In short, the bond market appears to be leaning in the direction of a recession – and the stock market is "twitchy" in that direction as well.

Now, if I could get the timing right, it would be a great forecast. After all, predicting the result is worthless unless your timing is also correct!

Thank you for your confidence in Bell!

www.bell.bank | Investing and wealth management products are: Not FDIC Insured | No Bank Guarantee | May Lose Value | Not a Deposit | Not Insured by Any Federal Government Agency | WMD24-236