

Powell Sets the Stage: Markets Lean into Fed Cuts

Overview of the Economy

August closed with policy and fiscal crosscurrents at the forefront. Inflation data showed only modest movement: PCE rose 0.2% headline and 0.3% core in July, leaving headline PCE unchanged at 2.6% year-over-year, while the core rate edged up to 2.9%. The increase was concentrated in services, while core goods were flat, signaling that tariffs and services demand are the main inflationary drivers for now.

At the same time, GDP was revised up to 3.3% annualized in Q2, a stronger showing than the initial 3.1%, though growth remains modest on a first-half basis. Durable goods orders also surprised positively, but the underlying theme is that growth has leaned heavily on AI-related investment, while broader demand shows signs of fatigue.

On the fiscal side, the U.S. debt burden remains a structural headwind. Federal interest payments reached \$283 billion in Q2, consuming 33.5% of available tax receipts, even as receipts rose from stronger capital gains taxes and tariff collections. The Debt-to-GDP ratio dipped temporarily to 119% due to the debt ceiling constraint but resumed rising in July as borrowing accelerated past \$37 trillion. These dynamics highlight the tension between fiscal expansion, tariffs as a revenue stopgap, and the Fed’s inflation fight.

Taken together, the macro picture suggests a fragile balance: inflation progress is slow, growth is uneven, and fiscal risks are mounting. Markets are leaning heavily on Powell’s dovish tone at Jackson Hole and the expectation of a September cut, but tariffs and debt-driven interest costs could complicate the disinflation narrative well into the 2026 midterm campaign season.

Macro View	MTD (%)	YTD (%)	1Y (%)	10Y (%)	10Y STD (±)
DJIA	3.42	8.30	11.45	13.02	15.57
S&P 500	2.03	10.78	15.85	14.47	15.50
NASDAQ	1.65	11.62	22.00	17.20	18.60
Equity EM Mkts.	1.46	20.36	18.37	7.31	16.85
EM Bond Mkt.	1.33	7.32	7.61	3.77	7.36
US Agg. Bond	1.20	4.99	3.14	1.79	5.03
Municipal Bond	0.87	0.32	0.08	2.18	5.13
US High Yield	1.24	6.29	8.15	5.70	7.62
Commodity	1.93	7.07	10.73	3.56	13.27
COMEX Silver	9.50	33.73	28.04	7.91	27.41
COMEX Gold	4.94	27.56	30.64	9.71	13.46
Brent Oil	-4.99	8.17	10.48	14.36	36.11
Dollar Index	-2.20	-9.91	-3.90	0.23	6.60

Taxable Fixed Income

August delivered solid returns across fixed income, underpinned by softer inflation data, Powell’s dovish tone at Jackson Hole, and growing conviction that the Fed will cut rates in September. Treasuries rallied most sharply at the front end, with the 2-year yield falling 35 basis points (bps) to 3.61% and the 10-year down 15 bps to 4.22%. This bull steepener left Treasuries up +1.06% for the month.

Mortgage-backed securities led performance, gaining +1.61%, supported by lower volatility and steady demand from real-money accounts. Taxable municipals also held their value, offering competitive spreads versus corporates and a liquidity profile that appeals in a shifting rate environment.

Investment grade credit posted a +1.01% return, but spreads widened modestly to 79 bps, resulting in slightly negative excess returns. Health insurers, finance companies, and restaurants were standouts, while food & beverage, telecom, and pipelines lagged. Supply normalized at \$104 billion, in line with seasonal averages, with a heavier September calendar expected.

We continue to favor rotating out of low- and intermediate-duration corporates, where spread compression leaves little value, into mortgage-backed securities (MBS) and Treasuries for carry and ballast. At the long end, we are avoiding +10-year exposure until the 10s/30s spread, currently near 70 bps, widens closer to 100 bps, which would offer more compelling relative value.

Looking ahead, the labor backdrop remains critical. Slower jobs growth and likely payroll revisions point to weaker employment momentum, reinforcing the Fed’s easing path but raising questions about the durability of credit fundamentals. In this environment, maintaining a quality bias in investment grade (IG) credit, emphasizing MBS and Treasuries, and selectively adding taxable Munis remains the most balanced approach.

US Fixed Income	Price	Cpn	Total Returns (%)		Dur	Yield
	(%) Rtn	% Rtn	Mo.	YTD	+/-	+/-
Agg. Bond	0.85	0.34	1.20	4.99	6.03	4.44
US Treasury	0.77	0.29	1.06	4.48	5.85	3.97
US Agencies	0.69	0.31	1.01	4.37	3.17	4.13
Corporate	0.63	0.39	1.01	5.30	6.80	4.91
Taxable Muni	0.99	0.38	1.36	5.08	7.80	4.92
TM/BABs	0.67	0.50	1.16	5.13	8.77	5.51
US Agency MBS	1.20	0.41	1.61	5.48	5.91	4.86
Gov/Credit	0.73	0.32	1.05	4.81	6.13	4.30
TIPs	1.44	0.10	1.54	6.41	4.60	4.08
AAA Corporate	0.44	0.34	0.79	4.11	10.23	4.76
AA Corporate	0.53	0.35	0.88	4.56	7.67	4.65
A Corporate	0.62	0.38	1.00	5.32	6.81	4.78
BBB Corporate	0.65	0.40	1.05	5.43	6.58	5.08

Tax-Exempt Markets

Municipal bonds closed August with yields largely steady, even as Treasuries rallied post-Jackson Hole. Heavy issuance—approaching \$50 billion for the month—was absorbed without significant curve disruption, aided by the absence of mega-deals that had weighed on pricing earlier in the year. Fund flows turned slightly negative late in the month, reflecting caution ahead of September’s seasonally heavy calendar.

Curve dynamics continue to highlight the relative value in the long-intermediate range. The 10s–20s Muni slope has widened to more than 115 bps, offering meaningful incremental yield without the diminished extension value of 30-year maturities. Benchmark AA 20-year yields near 4.50% equate to taxable-equivalent yields in the 7–8% range, rivaling long-term equity returns.

Against this backdrop, we modestly extended out the curve, focusing on high-quality credits in sectors that have lagged, such as healthcare and education. While federal budget pressures may increase risks for issuers reliant on Medicaid or education transfers, selective opportunities remain attractive where balance sheets are strong and demand profiles resilient. By emphasizing essential-service revenue structures and well-secured higher-education credits, we have been able to capture the steepness of the curve while maintaining portfolio quality.

Overall, municipals remain one of the few fixed-income asset classes offering both compelling after-tax yields and structural ballast. Dislocations tied to heavy supply and sector divergence create selective opportunities, particularly in the 5- to 12-year and long-intermediate ranges, where our allocation strategy continues to focus.

Municipal Market	Price	Cpn	Total Returns (%)		Dur	Yield
	(%) Rtn	(%) Rtn	Mo.	YTD	+/-	+/-
Municipal Agg	0.49	0.38	0.87	0.32	7.13	3.89
1-Yr Muni (1-2)	0.03	0.37	0.41	2.81	1.27	2.50
3-Yr Muni GO (2-4)	0.22	0.37	0.59	3.38	2.37	2.41
5-Yr. Muni GO (4-6)	0.41	0.36	0.77	3.90	3.61	2.62
7-Yr. Muni (6-8)	0.60	0.36	0.96	3.61	4.88	3.15
10-Yr. Muni (8-12)	0.55	0.36	0.91	2.07	6.27	3.61
15-Yr. Muni (12-17)	0.59	0.37	0.97	-0.63	8.28	4.34
30-Yr. Muni (22+)	0.47	0.41	0.87	-3.59	11.64	4.99
AAA Muni	0.54	0.37	0.91	0.20	7.30	3.72
AA Muni	0.48	0.38	0.85	0.37	7.01	3.75
A Muni	0.53	0.38	0.91	0.45	7.05	4.13
BBB Muni	0.34	0.39	0.73	-0.48	8.10	4.79
Gen. Oblig.	0.53	0.37	0.90	0.45	6.80	3.63
State GO	0.47	0.37	0.84	1.60	5.71	3.33
Local GO	0.57	0.36	0.93	-0.38	7.57	3.85
Revenue	0.48	0.38	0.87	0.21	7.32	4.01
California	0.63	0.37	1.00	0.28	6.93	3.66
New York	0.36	0.38	0.74	-0.48	7.56	4.00

### Precious Metals and Digital Assets

Gold rallied 5.1% in August, setting new highs above \$3,400, supported by falling real yields and strong ETF inflows. Central banks now hold more gold than U.S. Treasuries for the first time since 1996, reinforcing its strategic role in reserves. The dollar's renewed weakening bias further lifted bullion and supported international equity and commodity returns. Silver also broke out, reaching new 14-year highs above \$40/oz.

Bitcoin fell -6.9% in August, its first loss since March, underperforming gold, which has outpaced it more than two-to-one in 2025 (+33% vs. +16%). Still, Bitcoin is increasingly viewed as a strategic hedge against de-dollarization, while Ethereum continues to establish itself as the standard for tokenization infrastructure.

Strategically, we hold positions in gold and silver stocks and miners, but do not hold digital assets, as both asset classes can exhibit extreme volatility. We remain vigilant on new developments and regulations for digital assets, but in the meantime, we continue to favor precious metals over digital exposure.

### Equities

August was defined by a rotation into recent laggards. U.S. small caps surged, with the Russell 2000 advancing +7.0% versus +1.9% for the S&P 500, marking only the second time this year that small caps outperformed large caps by a wide margin. Value outpaced Growth across both large and small caps, while Health Care (+5.4%) and Consumer Discretionary (+4.7%) sectors led performance after trailing much of the year. Apple and Alphabet each rallied over 10%, reversing earlier underperformance, while AI leaders Nvidia and Microsoft lagged, highlighting a shift away from concentrated tech leadership.

International equities also benefited from a weaker dollar, which declined 0.5–1.9% against developed and emerging market currencies. The euro and yen added significant tailwinds to European and Japanese equity returns, allowing global indices to outperform the S&P 500 in August.

Looking ahead, September has historically been the weakest month for U.S. equities, though Fed easing and stable earnings revisions provide a buffer. Analysts have modestly increased Q4 forecasts and history shows that equities often reach annual highs in Q4, particularly during rate cutting cycles.

### Summary and Strategy Outlook

August ended with optimism around Fed easing, but September begins with a sharper focus on the labor market. Recent downward revisions to payrolls raised questions about whether job growth has been overstated throughout the past year. The preliminary benchmark revisions due September 9 are expected to cut between 475k–790k jobs from the March 2025 level, implying that average monthly job gains may have been closer to 80–110k, rather than the 149k currently reported. If confirmed, this would mark the second consecutive year of significant downward adjustment, underscoring that the labor market has been running weaker than headline figures suggested.

For the Fed, softer employment momentum carries dual implications: it strengthens the case for rate cuts, but also raises concerns about the durability of household spending and corporate earnings. Wage pressures have moderated, yet service inflation remains elevated, leaving the Fed in a delicate balancing act between supporting growth and preserving credibility on inflation.

While markets remain focused on rate cuts, the true test in September will come from labor data. If revisions confirm a lower trajectory for job creation, it will validate the Fed's dovish pivot but could also reframe growth expectations heading into year-end. In short, the employment picture — more than market positioning — is set to dictate the tone for policy, inflation, and risk sentiment through the fall.

Disclaimer: This publication contains the current opinions of the manager and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. Such opinions are subject to change without notice. This publication is distributed for education purposes only. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed. Forecasts are based on proprietary research and should not be interpreted as an offer or solicitation, nor the purchase or sale of any financial instrument. No part of this publication may be reproduced in any form, or referred to in any publication, without the express written permission of Smith Affiliated Capital Corp. Graph Source: Bloomberg/Barclays Capital.