THOUGHTS OF THE WEEK
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WEEKLY ECONOMICS

The Federal Reserve: Between a Rock and a Hard (Market) Place

The Federal Reserve (Fed), and markets, overreacted to the slightly higher inflation seen during the first quarter of the year. After that scare, the Fed went from expecting three cuts in the federal funds rate in 2024 to just one cut during its June dot plot release. Meanwhile, the markets went from expecting six to seven rate cuts in 2024 back in December of 2023 to barely one cut a little more than two months ago. Overreaction is how the market reacts to new information and, in the end, is the nature of the beast.

But the Fed should know better. We understand the increase in the institution's risk aversion generated by higher inflation and potentially higher, 'unanchored' inflation expectations. This is what happened during the 1970s and 1980s, a period that was called 'stagflation,' which combines very high inflation with very low economic growth. In our writings during the last two plus years, we have been fighting the idea that the current period bears any resemblance to the stagflationary period of the 70s and 80s; however, we understand Fed officials' fears about being careful not to agitate the inflation expectations waters.

At that time, inconsistent monetary policy as well as severe external shocks (a 184% increase in the price of petroleum in 1974 followed by a 149% increase in 1980) came together to create a perfect storm. Today, we still have an independent Fed and consistent monetary policy while we have been coming back from a very severe external shock, the COVID-19 pandemic, and a relatively smaller shock, the Russia-Ukraine war. But the effects of the pandemic and the war have been fading and thus the consistent monetary policy has taken over and is bringing inflation down to the institution's target.

In the US, the inflation target is 2.0% for the Personal Consumption Price Index over the long run.1 Back in the 70s and 80s the Fed did not have an inflation target, and monetary policy was conducted in a more, let's say, discretionary way than today. However, today, the Fed has to stick to its target and do whatever it needs to do to bring inflation down to that target. If it needs to keep interest rates high or higher for longer, it will do so.

Today, markets are overshooting again, pricing in almost 250 basis points in cuts between now and December 2025. We believe this is way too aggressive and that Fed officials are not ready to go along with such market expectations, especially if the economy continues to grow. For the market to expect such a strong reduction in rates, it would have to believe the economy is going into recession and so far, that doesn't appear to be the case.

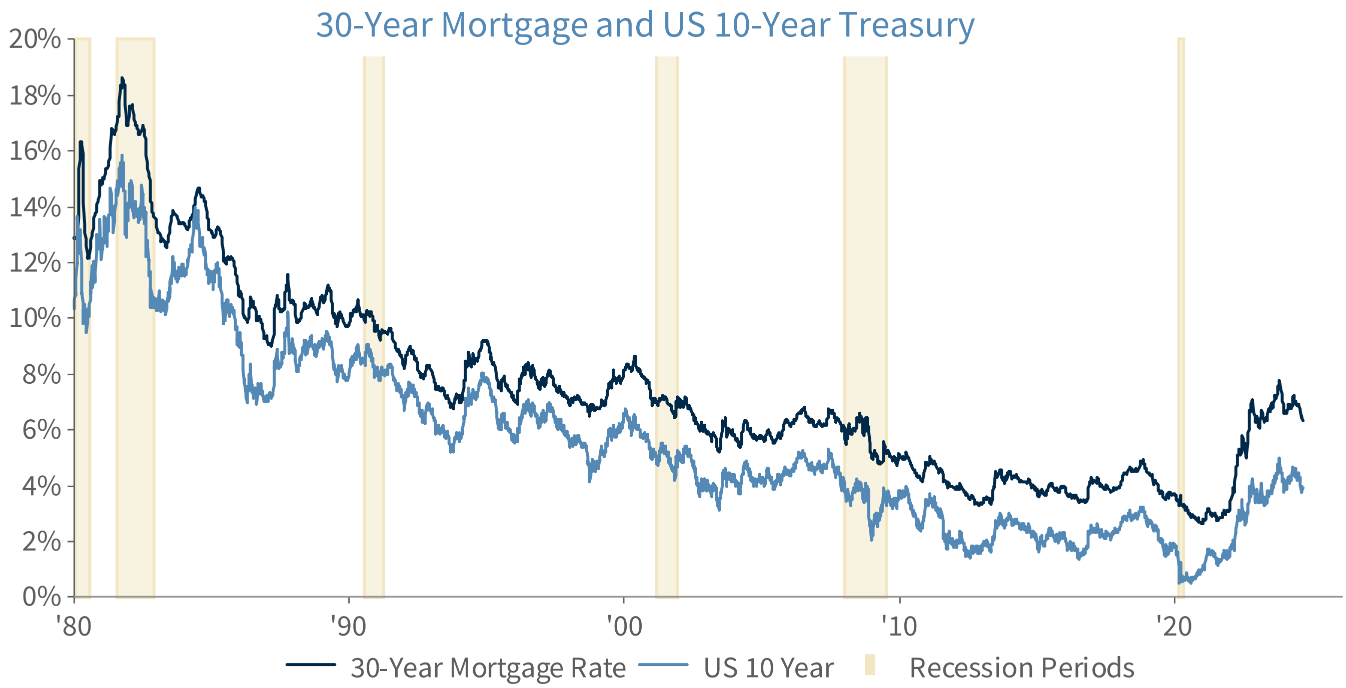
We still believe that the Fed is going to cut 25 basis points in September, probably another 25 basis points in November, and potentially another 25 basis points in December. Our argument is consistent with what we see in the economy as employment continues to slow down and inflation continues to approach the 2.0% target rate.

1: https://www.federalreserve.gov/faqs/economy_14400.htm#:~:text=The%20Federal%20Open%20Market%20Committee,maximum%20employment%20and%20price%20stability.

That is, today's real federal funds rate is too high and has started to have an impact on economic activity, so the Fed is just adjusting its policy rate to take into account these factors. Thus, we now have three 25 basis points cuts this year but will wait for next week's dot-plot to update our forecast on rates.

But the Fed must deal with several challenging issues today. First, the fiscal tailwinds are still alive and well—the fiscal expansion created by the CHIPS, IRA, and Infrastructure Acts have many years to go. Second, employment is slowing down and is affecting economic growth. Third, the rate of inflation has continued to come down and is expected to hit the 2.0% early next year, and ahead of the Fed's schedule, according to our calculations. However, shelter costs remain an issue even in this, highly benign inflation environment.

Our argument for a more methodical/slow movement down with rates has to do with shelter costs. Typically, the Fed lowers the federal funds rate to affect long-term rates. The most important of these rates is the 30-year mortgage, which more than doubled over the last several years. But the 30-year mortgage rate has come down already this year as it typically follows the behavior of the yield of the 10-year Treasury. This reduction in the mortgage rate has started to benefit residential investment and the overall housing market.



Source: FactSet, BLS, RJ Economics

However, a much lower federal funds rate has the potential for 'super-sizing' these effects on the housing market and put further upward pressure on home prices. Thus, we believe that the Fed is going to be very careful as it moves rates lower so it doesn't create a large mortgage lending cycle that could threaten its inflation target in the years to come.

In conclusion, fiscal expansion will continue to support nonresidential investment, and we believe that the Fed wants to help residential investment. However, it will have to do this with caution, so it doesn't contribute to a large mortgage lending cycle that will have the potential to send home prices much higher and potentially threaten the inflation target down the road.

Economic Forecast:

	Actual		Forecast						Actual	Forecast	
	1Q24	2Q24	3Q24	4Q24	1Q25	2Q25	3Q25	4Q25	2023	2024	2025
Real Gross Domestic Product [1]	**1.4**	**3.0**	**1.0**	**0.8**	**2.3**	**2.5**	**2.4**	**2.5**	**2.5**	**2.4**	**2.0**
Real Gross Domestic Product [2]	2.9	3.1	2.2	1.5	1.8	1.6	2.0	2.4	2.5		
Consumer Price Index [2]	**3.2**	**3.2**	**2.6**	**2.4**	**2.0**	**1.8**	**2.1**	**2.2**	**4.1**	**2.9**	**2.0**
Ex-food & energy [2]	3.8	3.4	3.2	3.0	2.5	2.2	2.3	2.2	4.8	3.4	2.3
PCE Price Index [2]	**2.6**	**2.6**	**2.3**	**2.3**	**2.0**	**1.9**	**2.0**	**2.1**	**3.7**	**2.4**	**2.0**
Ex-food & energy [2]	2.9	2.6	2.6	2.6	2.2	2.1	2.1	2.2	4.1	2.7	2.2
Unemployment Rate	**3.8**	**4.0**	**4.3**	**4.4**	**4.5**	**4.4**	**4.3**	**4.2**	**3.6**	**4.1**	**4.4**
Fed Funds Rate [3]	5.50	5.50	5.25	4.75	4.50	4.25	3.75	3.50	5.1	5.2	4.0

[1] Annualized Quarter-Over-Quarter Growth
[2] Year-Over-Year Percentage Change
[3] Upper Bound of the Federal Funds Target Range

Economic Releases:

Wholesale Inventories: Wholesale inventories were slightly lower than consensus but the inventories to sales ratio remained at “healthy” levels and currently do not pose risks for the wholesale sector. However, there are several sectors whose higher inventories to sales ratio will probably put downward pressure on those sector’s prices, specifically the automotive and machinery sectors. Business inventories were up 0.2% during the month of July and compared to June of this year, but slightly weaker than FactSet expectations for a 0.25% increase, according to the US Census Bureau. Total inventories were up 0.4% on a year earlier basis. Sales of merchant wholesalers were up strongly, up 1.1% month-over-month and 2.9% year-over-year. The inventories to sales ratio was 1.35 in July of this year compared to a 1.38 for July of last year. The Census Bureau also indicated that the original decline in sales of merchant wholesalers of 0.6% reported for the month-on-month in June was revised up to a decline of 0.3%. Inventories to sale ratios for the automotive industry declined slightly in July, at 1.80 compared to a reading of 1.81 in June but they are still much higher than in July of last year in which the inventories to sales ratio was at 1.78. Another sector where inventories to sales ratio were much higher in July of this year than during the same month of last year was machinery—the inventories to sales ratio was at 3.09 in today compared to just 2.71 in July of last year.

Consumer Price Index: Although the Consumer Price Index (CPI) increased as expected during the month of August and was lower than expected on a year-over-year basis, at 2.5%, down from a 2.9% reading in July, shelter costs remained very strong, increasing by 0.5%. The year-over-year rate was the lowest year-over-year rate since February 2021. However, the core CPI was stronger than expected as shelter costs continue to make the Federal Reserve’s (Fed) job more difficult. Although we were already calling for the Fed to lower interest rates by 25 basis points next week, this result will give the Fed more ammunition to argue that its job is not done and that it will be moving interest rates lower more methodically than the markets have been expecting. Still, the increase in shelter costs is not a deal breaker for the Fed and it will start lowering rate next week. The Consumer Price Index increased as expected, by 0.2%, during the month of August while the year-over-year rate slowed to 2.5% compared to a reading of 2.9% for the year ending in July, according to the Bureau of Labor Statistics. The core CPI, that is, the CPI that excludes food and energy prices, increased by 0.3%, which was more than expected while remaining stable on a year-earlier basis, at 3.2%. Food prices increased by 0.1% during the month while energy prices declined by 0.8%. Within energy commodities, which declined by 0.6%, gasoline prices declined by 0.6% while fuel oil prices declined by 1.9%. Energy services also declined in August, by 0.9%, as electricity prices declined by 0.7% while utility (piped) gas service prices declined by 1.9%. Within the core CPI, the biggest contributors during the month were a 1.0% decline in used care and trucks prices while apparel prices increased by 0.3%. Medical care commodities declined by 0.2% while services less energy services increased by 0.4%. The biggest culprit for the increase in core CPI was, once again, the strong increase in shelter costs, up 0.5%, while transportation services prices increased by 0.9%. The biggest surprise in August was a very strong increase in shelter costs, which rose by 0.5% after increasing by 0.4% in July and 0.2% in June.

Economic Releases:

Producer Price Index: The Producer Price Index (PPI) for final demand showed weak goods prices but strong services prices in August as final demand services trade prices recovered strongly, up 0.6%, after declining by 1.7% during the previous month. Overall, after peaking at 2.7% on a year-earlier basis in June, PPI for final demand has come down to 1.7% for the year ending in August. This is good news for inflationary pressure going forward. According to the Bureau of Labor Statistics, the PPI for final demand increased as expected, by 0.2% in August. On a year-earlier basis, the PPI for final demand increased by 1.7%, slightly lower than expectations. PPI for final demand goods was flat during August as foods prices increased by 0.1% while energy prices declined by 0.9%. PPI final demand goods less foods and energy increased by 0.2%. PPI final demand services increased by 0.4% as trade prices increased by 0.6%, transportation and warehousing prices were down 01%, and other services prices were up 0.3% during the month. The increase in the PPI final demand in August was due to a relatively large increase in final demand services prices while final demand goods prices remained flat.

Import Prices: Import prices, both fuel as well as nonfuel prices declined in August as imported petroleum prices and natural gas prices experienced large declines. Nonfuel import prices also declined but the decline matched the increase in the previous month. Petroleum prices are highly volatile and that is the reason why the Federal Reserve (Fed) typically likes to look at core prices, which exclude these volatile items. However, the fact that petroleum prices and thus, gasoline prices, have continued to come down over the last several months is good news for the Fed's confidence and supports our view that the institution will start to lower interest rates starting next week. Import prices declined more than expected in August, down 0.3% versus expectations for a 0.1% decline, according to the Bureau of Labor Statistics. This followed an increase of 0.1% in July. The year-over-year rate for import prices was 0.8%, down from a reading of 1.7% for the year ending in July. Both fuel and nonfuel import prices were lower during the month. Fuel import prices declined by 3.0% during August after inching up 1.1% during July. On a year-earlier basis, fuel import prices declined by 4.6% in August. This was the first year-over-year decline since February of 2024. The price of imported petroleum declined by 3.2% in August, the largest monthly decline since December of 2023. On a year-earlier basis, petroleum import prices declined by 3.2%, the largest year-over-year decline since January of this year. The price for imported natural gas also declined, by 3.7% month-over-month and was down by 51.7% compared to August of last year. Nonfuel import prices also declined in August, by 0.1% after a similar increase during the previous month. On a year-earlier basis, nonfuel import prices were up 1.3% in August. Export prices declined also, by 0.7%, during August, which followed a 0.5% increase in July. Agricultural export prices declined by 2.0% during the month, a similar rate of decline to July while non-agricultural prices declined by 0.6% after increasing by 0.8% in July. On a year-earlier basis, export prices were down by 0.7% as agricultural export prices were down by 6.9% and non-agricultural prices were down by 0.1%. The decline in import prices in August was the largest month-over-month decline since December of 2023, according to the release. The decrease in import fuel prices was the largest monthly decline since a 8.0% decline in December of 2023.

DISCLOSURES

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Consumer Price Index is a measure of inflation compiled by the US Bureau of Labor Statistics. Currencies investing is generally considered speculative because of the significant potential for investment loss. Their markets are likely to be volatile and there may be sharp price fluctuations even during periods when prices overall are rising.

Consumer Sentiment is a consumer confidence index published monthly by the University of Michigan. The index is normalized to have a value of 100 in the first quarter of 1966. Each month at least 500 telephone interviews are conducted of a contiguous United States sample.

Personal Consumption Expenditures Price Index (PCE): The PCE is a measure of the prices that people living in the United States, or those buying on their behalf, pay for goods and services. The change in the PCE price index is known for capturing inflation (or deflation) across a wide range of consumer expenses and reflecting changes in consumer behavior.

The Consumer Confidence Index (CCI) is a survey, administered by The Conference Board, that measures how optimistic or pessimistic consumers are regarding their expected financial situation. Current Situation Index (CSI) and Future Expectations Index (FEI) are the end-results of CCI, covering economic conditions, employment, price, income, and expense. The reading is 100 plus the average of said five factors

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GDP Price Index: A measure of inflation in the prices of goods and services produced in the United States. The gross domestic product price index includes the prices of U.S. goods and services exported to other countries. The prices that Americans pay for imports aren't part of this index.

The Conference Board Leading Economic Index: Intended to forecast future economic activity, it is calculated from the values of ten key variables.

The U.S. Dollar Index is an index of the value of the United States dollar relative to a basket of foreign currencies, often referred to as a basket of U.S. trade partners' currencies. The Index goes up when the U.S. dollar gains "strength" when compared to other currencies.

The FHFA House Price Index (FHFA HPI®) is a comprehensive collection of public, freely available house price indexes that measure changes in single-family home values based on data from all 50 states and over 400 American cities that extend back to the mid-1970s.

The Pending Home Sales Index (PHSI) tracks home sales in which a contract has been signed but the sale has not yet closed.

Supplier Deliveries Index: The suppliers' delivery times index from IHS Markit's PMI business surveys captures the extent of supply chain delays in an economy, which in turn acts as a useful barometer of capacity constraints.

Backlog of Orders Index: The Backlog of Orders Index represents the share of orders that businesses have received but have yet to start or finish. An increasing index value usually indicates growth in business but shows that output is below its maximum potential.

DISCLOSURES

Import Price Index: The import price index measure price changes in goods or services purchased from abroad by U.S. residents (imports) and sold to foreign buyers (exports). The indexes are updated once a month by the Bureau of Labor Statistics (BLS) International Price Program (IPP).

ISM Services PMI Index: The Institute of Supply Management (ISM) Non-Manufacturing Purchasing Managers' Index (PMI) (also known as the ISM Services PMI) report on Business, a composite index is calculated as an indicator of the overall economic condition for the non-manufacturing sector.

Consumer Price Index (CPI) A consumer price index is a price index, the price of a weighted average market basket of consumer goods and services purchased by households.

Producer Price Index: A producer price index (PPI) is a price index that measures the average changes in prices received by domestic producers for their output.

Industrial production: Industrial production is a measure of output of the industrial sector of the economy. The industrial sector includes manufacturing, mining, and utilities. Although these sectors contribute only a small portion of gross domestic product, they are highly sensitive to interest rates and consumer demand.

The NAHB/Wells Fargo Housing Opportunity Index (HOI) for a given area is defined as the share of homes sold in that area that would have been affordable to a family earning the local median income, based on standard mortgage underwriting criteria.

Conference Board Coincident Economic Index: The Composite Index of Coincident Indicators is an index published by the Conference Board that provides a broad-based measurement of current economic conditions, helping economists, investors, and public policymakers to determine which phase of the business cycle the economy is currently experiencing.

Conference Board Lagging Economic Index: The Composite Index of Lagging Indicators is an index published monthly by the Conference Board, used to confirm and assess the direction of the economy's movements over recent months.

New Export Index: The PMI new export orders index allows us to track international demand for a country's goods and services on a timely, monthly, basis.

Durable Goods: Durable goods orders reflect new orders placed with domestic manufacturers for delivery of long-lasting manufactured goods (durable goods) in the near term or future.

Source: FactSet, data as of 9/13/2024

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