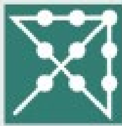
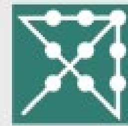
 Yardeni Research 

June 11, 2024

Morning Briefing

The Fed Ahead

Check out the accompanying chart collection.

Executive Summary: We expect that Wednesday's FOMC decision will be to maintain the federal funds rate at its current high level, where it's been for nearly a year. Today, Eric discusses the higher-for-longer phenomenon, including why this tightening cycle has defied both historical precedent and expectations just six months ago. The economy's resilience combined with labor market and inflation conditions argue against lowering rates now; doing so might incite a stock market meltup (and subsequent meltdown). … While the Fed typically leads other central banks in interest-rate moves, there are good reasons it's lagging in easing this time. … We don't buy the theories of monetarists that M2 matters vitally to inflation or the stock market.

Fed I: Curbing Enthusiasm for Rate Cuts. Eric and I have no doubt that on Wednesday, the Federal Open Market Committee (FOMC) will decide to keep the federal funds rate (FFR) at its highest level in roughly a quarter century. The Fed has pegged the benchmark rate between 5.25% and 5.50% since July 2023, having been lifted off the zero lower bound starting during March 2022 (*Fig. 1*).

Higher-for-longer interest rates flies in the face of expectations six months ago, when most market participants predicted the FFR would be much lower by now. Pundits assumed that the economy couldn't handle short-term rates above 5.00%. Many believed that if inflation continued to moderate, real interest rates would turn even more restrictive and cause a recession. The Fed would need to cut rates to avert this scenario. With only a few exceptions, the inverted yield curve has a history of accurately predicting US recessions; the 10-year yield has remained below the 2-year since November 2022 (*Fig. 2*).

So why is this time different? Below is our perspective on why interest-rate hikes have played out differently in this cycle and the implications for Fed policy through the remainder of the year:

(1) *Inflation moderating without a recession.* The consumer price index (CPI) has decelerated from a peak of 9.0% y/y in June 2022 to below 3.5% without the labor market

coming unhinged—unemployment is going on its third year at or below 4.00% (*Fig. 3* and *Fig. 4*). We expect Wednesday's CPI report to confirm that consumer inflation is continuing to fall toward the Fed's 2.0% target. In other words, inflation has been moderating without a recession this time forcing it down. The Fed is on course to achieve its dual mandate without causing a recession. That's different than in the past.

(2) *Curbing enthusiasm for rate cuts.* In January, the financial markets expected up to seven quarter-point interest rate cuts this year, according to the FFR futures market. Now they see just one or two, but over the next 12 months (*Fig. 5*)! Fed Chair Jerome Powell will likely caution Wall Street investors and traders to curb their enthusiasm for cuts during his Wednesday press conference.

(3) *SEP likely to show fewer rate cuts.* The FOMC's updated *Summary of Economic Projections* (SEP) will be released along with the meeting decision. It may show a median year-end FFR of around 5.00%, indicating that Fed officials anticipate just one quarter-point interest rate cut this year. That would be revised from the previous forecast of 4.60%, which suggested around three cuts. There's a good chance that the median longer-run rate (which most accept as the Fed's projection of r*) will increase again after inching up from 2.5% to 2.6% in March, the most recent release (for more on r*, see our June 4 *Morning Briefing* "Wishing Upon An R-Star") (*Fig. 6*).

FOMC officials might also raise their median 2024 PCED inflation forecast slightly from 2.4% in March and/or raise their real GDP growth forecast from 2.1% in March. They probably won't change this year's unemployment rate projection from 4.0%. In other words, their updated median economic forecast should justify their current stance of higher-for-longer interest rates. Several Fed officials have recently remarked that there's no rush to lower the FFR.

(4) *Fed contained latest financial crisis.* As it has often done in the past, the inverted yield curve did accurately predict a financial crisis, which occurred in March 2023 with the failure of Silicon Valley Bank and a couple of other regional banks. Rapid interest-rate hikes threatened to cause bank runs, with depositors moving into money market funds. The Fed swooped in to sap the market of duration risk and ensure depositors that there's nothing to worry about.

Domestic banks tapped the Fed for $167 billion from the latest emergency liquidity facility, the Bank Term Funding Program (BTFP) (*Fig. 7*). The Fed's reflex to nip crises in the bud before they cascade into a credit crunch and recession is another reason not to rely on the

inverted yield curve as a recession indicator. (For more on this, download our book *The Yield Curve: What Is It Really Predicting?*).

(5) *Easing QT.* The Fed's aggressive rate hikes have been offset by easing the Fed's restrictive balance-sheet policy. We expect the Fed to leave its current quantitative tightening (QT) policy unchanged after lowering the cap on maturing Treasury roll-offs from $60 billion per month to $25 billion at its last meeting, while monitoring changes in bank reserves.

The Fed doesn't want another financial plumbing mishap like its last attempt at QT, in 2019. Some Fed officials think the FOMC slowed the balance-sheet rundown prematurely, per the May FOMC meeting minutes. That's probably because bank reserves have actually risen to $3.41 trillion from a local low of $3.25 trillion in May (*Fig. 8*). With relatively few homeowners prepaying their mortgages and with money market funds buying the deluge of Treasury bills being issued by the government, QT has had minimal impact on the markets thus far.

(6) *Rate cuts would increase meltup risk.* We don't think the Fed should lower the FFR unless unemployment rises significantly. The only other reason for it to cut interest rates would be to ease off the brakes as inflation moderates. We think this won't be necessary and could be a mistake by fueling a stock market meltup. The S&P 500 is trading at 20.9 times forward earnings; preemptive cuts would likely expand its valuation closer to the 24.5 reached in July 1999 (*Fig. 9*).

(7) *Inflation fight isn't over.* The scars from being too late on fighting inflation in late 2021 and early 2022 seem to have made a lasting impression on Fed officials. Now, they might prefer to be sure that inflation remains subdued even if that might risk causing a recession. Minneapolis Fed President Neel Kashkari, historically one of the FOMC's most vocal doves, recently told the *FT* that he thinks workers despise inflation even more than recessions.

Fed II: Behind the Central-Bank Curve? Debate is afoot over whether the Fed is late to the easing game, as the People's Bank of China, the Swiss National Bank, the Swedish Riksbank, and the Bank of Canada all have started cutting interest rates. Typically, the Fed leads the pack in both raising and cutting rates. But this is a unique environment, with the US economy on stronger footing than the rest of the world.

Consider the divergence among global economies' current strength:

(1) *Growth.* The US is heading for its eighth consecutive quarter of inflation-adjusted

growth, with the Atlanta Fed's *GDPNow* model currently tracking 3.1% real GDP for Q2 (*Fig. 10*).

China is dealing with a major property recession, which has helped drag its real GDP growth to 5.3% y/y in Q1 (*Fig. 11*). That's well below the 6.0%-8.0% levels seen before the pandemic. Not to mention that those are likely fictitious numbers that overstate China's true growth. The Eurozone's real GDP grew just 0.4% y/y during Q1 (*Fig. 12*). Japan's economy actually shrank 0.3% in Q1, its first quarter of negative growth in three years (*Fig. 13*).

(2) *Inflation.* America's core inflation rate is still higher than that of other advanced economies. The US core CPI was last seen at 3.6% y/y; the Eurozone (2.9%), Japan (2.4%), and China (0.3%) are all well below that rate (*Fig. 14*). On the other hand, many inflation measures used by other countries don't weight shelter as much as the US's do (roughly one-third of the CPI).

(3) *Foreign exchange.* Some other central banks may be cutting interest rates to devalue their currencies, which boosts their exports. Doing so also risks boosting inflation via costlier imports—a gamble that the ECB is seemingly willing to risk. The EU's trade surplus with America is around a record high of $217 billion, as of April (*Fig. 15*).

Fed III: Does M2 Matter? Monetarists contend that inflation is always and everywhere a monetary phenomenon. From their perspective, a worrying sign for inflation is arising—global monetary aggregates like the M2 monetary base are once again increasing. However, we think that the relationship between money supply and inflation, in isolation, is spurious at best.

Here's the latest on M2 in the US:

(1) *Monetary base*. The y/y percent change in M2 turned negative in December 2022 after skyrocketing during 2020, when the Fed and Treasury unleashed a wave of stimulus measures (*Fig. 16*). It flipped positive to 0.6% in April.

(2) *Velocity.* The ratio of nominal GDP to M2—which is the velocity of money and also determines how effective a growing base is at stimulating nominal economic growth—is unpredictable. Just have a look at the Eurozone, which saw money velocity fall from 45% in 1995 to 25% in 2019 (*Fig. 17*).

(3) *China.* While money supply grows in the West, China's is decelerating at the fastest rate

in its modern history (*Fig. 18*).

(4) *Fed's balance sheet.* After the Great Financial Crisis, some commentators charted the growth in the Fed's balance sheet versus price action in the S&P 500, contending that the Fed was the key macro variable in the stock market's direction. Well, the Fed has been shrinking its balance sheet since 2022, yet the S&P 500 is trading around all-time highs (*Fig. 19* and *Fig. 20*). The S&P 500's ascent has proved that changes in money supply are by no means the core factor driving stock prices.

Calendars

US: Tues: NFIB Small Business Optimism Index 89.7; API Weekly Crude Oil Inventories; OPEC Monthly Report; EIA Short-Term Energy Outlook. **Wed:** FOMC Interest Rate Decision 5.50%; FOMC Economic Projections; Headline & Core CPI 0.1%m/m/3.4%y/y & 0.3%m/m/3.9%yy; Consumer Inflation Expectations; Federal Budget Balance -$268.0b; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production; IEA Monthly Report; WASDE Report. (FXStreet estimates)

Global: Tues: UK Unemployment Rate 4.3%; UK Claimant Count Change 10.2k; UK Average Earnings Including Bonus 5.7%; Japan PI 0.4%m/m2.0%y/y; China CPI & PPI 0.4%/-1.5% y/y. **Wed:** Germany CPI 0.1%m/m/2.4%y/y; UK GDP 0.0%m/m; UK Headline & Manufacturing Industrial Production -0.1%/-0.2%; UK RICS House Price Balance -5%; Australia Westpac Consumer Sentiment; Australia Employment Change 30k; Australia Unemployment & Participation Rates 4.0%/66.7%; Eurogroup Meetings; E Guindos; McCaul; Schnabel; Tuominen; Nagel; Mauderer; Balz; Macklem. (FXStreet estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose last week simultaneously for all three of these indexes, and has done so in seven of the past eight weeks. LargeCap's forward earnings rose 0.2% w/w to a new record high. It has achieved new record highs for 23 straight weeks and in 34 of the 39 weeks since mid-September; last week is now the lengthiest string of record-high forward earnings for LargeCap in six years (since the September 21 week of 2018, when it hit record highs for 26 straight weeks). MidCap's rose 0.7% w/w and improved to 2.5% below its record high in early June 2022.

SmallCap's rose 0.2% w/w to 10.6% below its mid-June 2022 record. Through the week ending June 6, LargeCap's forward earnings has soared 15.1% from its 54-week low during the week of February 1, 2023; MidCap's is 6.2% above its 55-week low during the week of March 10, 2023; and SmallCap's is 3.4% above its 72-week low during the March 17, 2023 week. These three indexes' forward earnings downtrends since mid-2022 have been relatively modest compared to their deep double-digit percentage declines during the Great Virus Crisis and the Great Financial Crisis. Their forward earnings momentum has improved from three-year lows ago a year, but LargeCap's is improving faster than the SMidCap's. Here are the latest consensus earnings growth rates for 2024 and 2025: LargeCap (10.5%, 14.2%), MidCap (3.5, 16.6), and SmallCap (-4.1, 19.1).

S&P 500/400/600 Valuation (*link*): Valuations were mostly lower during the June 7 week for these three indexes and remain slightly below their recent two-year highs. LargeCap's forward P/E rose 0.3pts w/w to 20.6 from a four-week low of 20.3. That's just 0.3pts below its 27-month high of 20.9 at the end of March and up from a seven-month low of 17.0 during the October 27 week. It's now up 5.5pts from its 30-month low of 15.1 at the end of September 2022, which compares to an 11-year low of 11.1 during March 2020. MidCap's forward P/E fell 0.4pts w/w to 15.0. That's down from a 27-month high of 16.0 at the end of March and up 2.7pts from a 12-month low of 12.3 at the end of October. It's now up 4.3pts from its 30-month low of 11.1 at the end of September 2022; these compare to a record high of 22.9 in June 2020 and an 11-year low of 10.7 in March 2020. SmallCap's forward P/E was down 0.3pts w/w to 14.2, and is now 0.5pts below its 28-month high of 14.7 during the May 17 week. It's up 3.6pts from its 14-year low of 10.6 in September 2022 and compares to a record low of 10.2 in November 2009 during the Great Financial Crisis. That also compares to its record high of 26.7 in early June 2020 when forward earnings was depressed. The forward P/Es for the SMidCaps have been mostly below LargeCap's since August 2018. MidCap's 27% discount to LargeCap's P/E is up from its 24-year-low 29% discount during the June 1, 2023 week. It had been at a 19% discount during the March 2, 2023 week, which was near its best reading since October 14, 2021. SmallCap's 30% discount is up from a 23-year-low 34% discount during the October 19, 2023 week, which compares to a 20% discount during the March 2, 2023 week; that one was near its lowest discount since August 2021. The SMidCap's P/Es had been mostly above LargeCap's from 2003 to 2018.

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