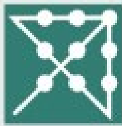

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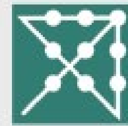

August 26, 2024

Morning Briefing

Powell's Latest Pivot Won't Be His Last

Check out the accompanying chart collection.

Executive Summary: It was an unambiguously dovish Fed Chair Powell who described the Fed's intentions for US monetary policy at the Jackson Hole gathering of global central bankers on Friday. In our opinion, he was too dovish for this point in the economic cycle. After all, successful execution of the Fed's dual mandate basically has been achieved: Inflation is headed on autopilot down to the 2.0% target (thanks to solid productivity gains) and unemployment remains low. Why tamper with success? Powell's pivot to dovishness assured the financial markets that they were right to expect more easing after the widely anticipated September rate cut. But if the labor market remains resilient or inflation reheats, Powell likely will have to pivot again. … And Dr. Ed favorably reviews "Young Woman And The Sea" (+++).

YRI Weekly Webcast. Join Dr. Ed's live webcast with Q&A on Mondays at 11 a.m. EST. You will receive an email with the link one hour before showtime. Replays of the weekly webcasts are available *here*.

The Fed I: Hooray, Powell Is Dovish Again! Fed Chair Jerome Powell was dovish in his Jackson Hole *speech* on Friday (overly so, in Eric's and my opinion). He didn't hedge. He didn't push back against market expectations of several rate cuts ahead, as we anticipated he might. He wasn't more dovish than the market, but he didn't utter any hawkish views whatsoever to alter the market's dovish expectations for several rate cuts. Indeed, the federal funds rate (FFR) futures market shows cuts totaling 100bps to 4.25% by the end of this year (*Fig. 1*). The FFR is expected to be down to 3.00% by the end of next year.

Powell unambiguously declared that the Fed is now on course to lower interest rates: "The time has come for policy to adjust. The direction of travel is clear, and the timing and pace of rate cuts will depend on incoming data, the evolving outlook, and the balance of risks." So the only ambiguities about coming rate cuts are how many and how much. For a Fed chair, that pledge is about as dovish as it could be.

In effect, the speech could have been titled "Mission Accomplished!" Inflation is close

enough to the Fed's target that Powell stated: "My confidence has grown that inflation is on a sustainable path back to 2 percent." Indeed, he also said: "With an appropriate dialing back of policy restraint, there is good reason to think that the economy will get back to 2 percent inflation while maintaining a strong labor market." So inflation is now on autopilot making its way toward the Fed's 2.0% target. There's no reason to worry about it anymore.

In effect, Powell implied that the Phillips Curve is dead. During the previous seven recessions prior to the pandemic, rising unemployment coincided with falling inflation (*Fig. 2*). This time, headline PCED inflation plunged from a peak of 5.5% y/y during September 2022 to 2.6% in June. It did so without a recession but with an insignificant rise in the unemployment from a low of 3.4% during January 2023 to 4.3% in July.

That makes sense to us. Inflation has been going our way since the summer of 2022, when we said it had peaked and would be heading back down to the Fed's 2.0% target over the next couple of years (*Fig. 3*). We also said that this would happen without a recession.

Powell declared that the "upside risks to inflation have diminished," while "the downside risks to employment have increased." His proof for the latter claim is that the unemployment rate is up to 4.3%, a full percentage point above its level in early 2023, with most of that increase occurring over the past six months, as he observed. However, he acknowledged that most of that increase was attributable to an influx of workers into the labor force rather than an increase in layoffs (*Fig. 4*).

In a key *speech* on November 30, 2022 titled "Inflation and the Labor Market," Powell introduced a chart showing that the demand for workers well exceeded the supply (*Fig. 5* and *Fig. 6*). The labor market was too hot back then. On Friday, Powell said: "Today, the labor market has cooled considerably from its formerly overheated state." During July, excess demand for workers had dropped to 1.02 million, down from a record high 6.12 million during April 2022.

Powell has unmistakably pivoted away from doing whatever it takes to bring inflation down to 2.0%. In his speech, he pledged: "We will do everything we can to support a strong labor market as we make further progress toward price stability." He further stated: "It seems unlikely that the labor market will be a source of elevated inflationary pressures anytime soon. We do not seek or welcome further cooling in labor market conditions."

In our opinion, Powell was too dovish on Friday, needlessly so, because the labor market has simply normalized after pandemic-related effects rather than cooled in response to

economic weakness. In any event, the markets seem to have fully discounted a very dovish outlook for interest rates given their positive but relatively tame response to Powell's very dovish speech.

The Fed II: Just Before the Latest Pivot. Only a month ago, at his July 31 *press conference*, Powell said, "We are maintaining our restrictive stance of monetary policy in order to keep demand in line with supply and reduce inflationary pressures." He reiterated again, as he had many times since 2022, that he and his colleagues at the Fed "are strongly committed to returning inflation to our 2 percent goal in support of a strong economy that benefits everyone." Furthermore, he also reiterated: "My colleagues and I are acutely aware that high inflation imposes significant hardship, as it erodes purchasing power, especially for those least able to meet the higher costs of essentials like food, housing, and transportation."

At that presser a month ago, Powell mentioned the Fed's dual mandate 11 times. In his introductory prepared remarks, he said, "My colleagues and I remain squarely focused on achieving our dual-mandate goals of maximum employment and stable prices for the benefit of the American people." He stated that the "risks are coming back into balance" for both mandates, i.e., to keep both inflation and unemployment low.

Yet one month later at Jackson Hole, he mentioned the mandate only twice, and he indicated that keeping a lid on the unemployment rate is more important than worrying about inflation, which is why "the time has come" to cut rates. A month ago, he said the dual-mandate risks are coming back into balance. In his latest speech, he said, "the balance of the risks to our two mandates has changed." He then went on to say that the risks are actually no longer in balance, as they were just a month ago!

What happened since July 31 to convince Powell that it is time to lower interest rates and to pivot so hard in this dovish direction? The key developments were as follow:

(1) *Purchasing managers indexes.* July's M-PMI was released on August 1, and it was surprisingly weak at 46.8 (*Fig. 7*). Its new orders (47.4), production (45.9), and employment (43.4) subindexes were all well below 50.0. The employment subindex was shockingly weak. It certainly didn't jibe with the 1,000 increase in manufacturing employment during July, which was reported the next day (*Fig. 8*). Nor did it make sense in the context of the relatively less negative regional business surveys conducted by five of the Federal Reserve District banks (*Fig. 9*).

By the way, July's NM-PMI—for nonmanufacturing businesses—was released on August 5, and it showed a big jump in its employment subindex from 46.4 in June to 51.1 in July (*Fig. 10*). Payroll employment in the private services sector rose 72,000 during July.

August's flash NM-PMI, compiled by S&P Global, remained strong at 55.2, up from 55.0 in July. This month's M-PMI remained weak at 48.0, down from 49.6 in July. That's been the same old story for about the past two years.

(2) *Payroll employment.* July's payroll employment report was released by the Bureau of Labor Statistics (BLS) on August 2 with a weak number for the month and downward revisions for the previous two months. On August 21, the BLS released its preliminary benchmark payrolls revision for the 12-month period through March 2024. Both reports seem to have freaked Powell, because he saw fit to mention them in footnote 4 of his speech:

"Payroll employment grew by an average of 170,000 per month over the three months ending in July. On August 21, the Bureau of Labor Statistics released the preliminary estimate of the upcoming annual benchmark revision to the establishment survey data, which will be issued in February 2025. The preliminary estimate indicates a downward adjustment to March 2024 total nonfarm employment of 818,000."

What he didn't mention is that the latest three-month average is consistent with the 179,000 average monthly increase in payrolls during 2018 and 2019 before the pandemic (*Fig. 11*). Over this period, the unemployment rate fell to a low of 3.5% in September 2019.

Nor did Powell bother to mention the weather's depressing impact on July's employment and other economic indicators. Fed Governor Michelle Bowman did so in an August 10 *speech*: "The rise in the unemployment rate in July was centered in workers experiencing a temporary layoff, who are more likely to be rehired in coming months, and Hurricane Beryl likely contributed to weaker job gains, as the number of workers not working due to bad weather increased significantly last month."

(3) *Inflation.* July's CPI inflation rate was reported on August 14. It was down to 2.9% y/y, the lowest since March 2021 (*Fig. 12*). The core CPI inflation rate was down to 3.2%. Stock and bond prices soared on those numbers as the markets priced in lower and sooner rate cutting by the Fed. Those numbers are still above 2.0%, but excluding shelter, which is a well known lagging component of inflation, the headline and core CPIs were 1.8% and 1.7% in July (*Fig 13*).

Meanwhile, the headline and core PCED inflation rates fell to 2.5% and 2.6% in June (*Fig. 14*). July's data will be released on August 30 and should show further moderation toward 2.0%.

The Fed III: If It Ain't Broke. Based on the above, it seems to us that the dual mandate's balance of risk is well balanced. But our opinion doesn't matter. What matters is that Powell believes that higher unemployment is a riskier prospect than the possibility that inflation might stop moderating or start to move higher again. So he and his colleagues are all set to fine-tune the economy with "an appropriate dialing back of policy restraint."

September's widely anticipated rate cut will almost certainly be delivered; the only question is "the timing and pace of rate cuts" afterwards. Powell did hedge that a bit, however, by saying future moves "will depend on incoming data, the evolving outlook, and the balance of risks."

Our opinion is that the economy is performing well, with real GDP currently growing 3.1% y/y and inflation on course to fall to 2.0% y/y in coming months (*Fig. 15*). Why mess with success? Why fix it if it ain't broke?

Yes, we know: In the past, when the Fed started to lower interest rates, it was just the beginning of numerous rate cuts. However, those past easing cycles were associated with credit crises that morphed into credit crunches that caused recessions. That scenario has been a no-show, just as we've been predicting since early 2022.

Yes, we know: At 2.0% inflation, the real federal funds rate would be 3.25% if the Fed doesn't cut rates. So what? The economy has performed well with the real FFR around 2.00% for over a year now (*Fig. 16*).

Maybe we are there: Perhaps the current FFR is the elusive neutral rate because better-than-expected productivity growth since last year has been boosting real GDP growth (*Fig. 17*). It also brought inflation down, as unit labor costs rose just 0.5% y/y during Q2 (*Fig. 18*)!

The Fed should abandon the concept of a neutral real FFR. It's a theoretical fantasy number. Everyone agrees that it can't be measured or even estimated because it surely isn't a constant. Besides, it's a nonsensical construct: Who makes an economic or financial decision based on a nominal overnight bank reserves lending rate less the yearly percent change in a measure of consumer prices? Only the Fed seems to do so.

Instead, the Fed should aim for a nominal FFR that seems to be working to achieve the Fed's dual mandate. It seems to us that both aspects of the mandate have been met. In our opinion, Powell was too dovish at Jackson Hole. If, as we expect, the next batch of economic indicators is stronger than widely expected, then Powell might have to pivot again toward a more balanced risk assessment of the Fed's dual mandate and dial down his dovishness.

A pivoting Powell makes for unwelcome financial market volatility.

Movie. "Young Woman and the Sea" (+ + +) (*link*) is an excellent biopic about Trudy Ederle, who was the first female swimmer to cross the English Channel. She did so on August 6, 1926, in 14 hours and 31 minutes, setting a record that beat the time of all five men who had crossed the Channel before she did. She and her sister were encouraged to learn to swim by their mother, whose sister had died in a drowning accident. The family lived in Little Germany located on Manhattan's Lower East Side. That community experienced the worst disaster in New York City maritime history when a ferry boat sank on June 24, 1904, causing over 1,000 riders to drown because they couldn't swim.

Calendars

US: Mon: Headline & Core Durable Goods Orders 4.0%/0.0%; Dallas Fed Manufacturing Survey; Atlanta GDPNow 2.0%. **Tues:** Consumer Confidence 100.2; Richmond Fed Manufacturing Index -17; SP/HPI Composite 6.9%y/y; API Weekly Crude Oil Inventories. (FXStreet estimates)

Global: Mon: Germany Ifo Business Climate Index, Current Assessment, and Expectations 86.0/86.5/86.5. **Tues:** Germany GDP -0.1%q/q/-0.1%y/y; UK CBI Distributive Trade Survey -11; Nagel. (FXStreet estimates)

Strategy Indicators

Global Stock Markets (US$ Performance) (*link*): The US MSCI index rose 1.5% last week, and is now just 0.6% below its record high on July 16. It's up 8.8% since it bottomed at 8.6% below its record on August 5. The AC World ex-US index rose 2.1% w/w. It's now 4.4% below its June 15, 2021 record high after rising 9.7% from its 12.9% correction on

August 5. EMU was the best performing region last week with a gain of 3.2%, followed by Europe (3.0%), EAFE (2.7), and the AC World ex-US. EM Latin America was the worst regional performer with a decline of 1.0%, followed by EM (0.6), EM Asia (0.7), and EMEA (1.5). Fourteen of the 17 of the major selected country markets that we follow rose last week. Spain performed the best with a gain of 4.6%, followed by Sweden (4.5), Switzerland (3.6), Germany (3.5), and France (3.5). Mexico was the worst performer with a decline of 3.3%, followed by Taiwan (-0.2), Brazil (-0.2), China (0.1), and Korea (0.8). The US MSCI's 17.8% ytd gain remains well ahead of the AC World ex-US index's (8.6). EM Asia is still ahead of the pack as the leading region ytd with a gain of 10.6%, which puts it ahead of Europe (9.4), EAFE (9.1), and the AC World ex-US. The worst performing regions so far in 2024: EM Latin America (-13.9), EMEA (4.4), EM (7.5), and EMU (8.2). Looking at the major selected country markets that we follow, Taiwan is the best ytd performer with its gain of 26.2%, but that country is down 8.8% from its July 11 record high. Taiwan is followed by India (20.1%), the United States (17.8), South Africa (13.0), and Spain (12.5). Mexico is the worst performing country so far in 2024 with a decline of 17.7%, followed by Brazil (-14.7), Hong Kong (-10.1), Korea (-1.6), France (2.3), and China (2.3).

US Stock Indexes (*link*): All 48 of the major US stock indexes that we follow rose for a second straight week. The Russell 2000 Value index was the best performer with a gain of 3.7%, ahead of Russell 2000 (3.6), Russell 2000 Growth (3.4), S&P 400 MidCap Pure Growth (3.3), and S&P 600 SmallCap Growth (3.2). The Dow Jones 15 Utilities index was the worst performer, albeit with a gain of 0.6%, followed by Nasdaq 100 (1.1), Russell 1000 Growth (1.2), Dow Jones Industrials (1.3), and S&P 100 MegaCap (1.3). Looking at their ytd performances, all 48 indexes are higher so far for the first time this year. The S&P 500 LargeCap Growth index remains in the top spot as the best performer so far in 2024, with a gain of 24.9%, ahead of Russell 1000 Growth (21.4), S&P 100 MegaCap (21.4), Russell 3000 Growth (20.9), and S&P 400 MidCap Pure Value (19.6). The worst performing major US stock indexes ytd: Dow Jones 20 Transports (0.5), S&P 400 MidCap Pure Value (0.9), S&P 600 SmallCap Pure Value (1.2), S&P 500 Transportation (1.8), and S&P 600 SmallCap Value (3.4).

S&P 500 Sectors Performance (*link*): Ten of the 11 S&P 500 sectors rose last week, and seven were ahead of the S&P 500's gain of 1.4%. That compares to all 11 sectors rising a week earlier when the only two were ahead of the composite index's 3.9% gain. The outperformers last week: Real Estate (3.6%), Materials (2.4), Consumer Discretionary (2.1), Industrials (1.8), Health Care (1.7), Consumer Staples (1.6), and Financials (1.5). The underperformers last week: Energy (-0.5), Information Technology (1.1), Communication Services (1.2), and Utilities (1.2). The S&P 500 is up 18.1% ytd, with all 11 sectors in

positive territory but only three are ahead of the index. That's down from five sectors ahead of the index during mid-May. Information Technology is the best ytd performer with a gain of 28.4%, ahead of Communication Services (23.2) and Utilities (18.6). These sectors are lagging the S&P 500 so far in 2024: Consumer Discretionary (6.0), Energy (7.6), Real Estate (8.1), Materials (8.3), Industrials (13.3), Health Care (13.9), Consumer Staples (14.9), and Financials (17.8).

US Economic Indicators

Existing Home Sales (*link*): "Despite the modest gain, home sales are still sluggish," noted Lawrence Yun, NAR's chief economist. "But consumers are definitely seeing more choices, and affordability is improving due to lower interest rates." *Existing home* sales in July rose for the first time in five months, increasing 1.3% to 3.95mu (saar), following a four-month slide of 11.0%. They had increased three of the prior four months by an impressive 13.8% over the period to 4.38mu (saar), up from its recent low of 3.85mu. July sales are 2.5% below a year ago. Single-family sales advanced 1.4% in July to 3.57mu (saar), down 1.4% y/y, while *condominium and co-op sales* were unchanged m/m in July at 380,000 units (saar) and down 11.6% y/y. *Regionally*, existing home sales rose in three of the four regions in July and was flat in one, while on a y/y basis, sales rose on both coasts but fell in the South and Midwest: Northeast (4.3%m/m & 2.1% y/y), West (1.4 & 1.4), South (1.1 & -3.8), and the Midwest (0.0 & -5.2%). Total *housing inventory* at the end of July was 1.33 million units, up 0.8% from June and 19.8% from last July—with unsold inventory at 4.0 months' supply at the current sales pace, down from 4.1 month's in June but up from 3.3 months' last July. The *median price* of an existing home for all housing types in July was $422,600—up 4.2% y/y (from $405,600), the 13th consecutive y/y gain. Once again, all four regions posted price gains in July.

New Home Sales (*link*): New home sales (counted at the signing of a contract) climbed to their highest level in more than a year in July, as lower mortgage rates helped boost demand. *New home sales* soared 10.6% in July to 739,000 units (saar), the highest level since May 2023 and the sharpest monthly gain since August 2022. At July's sales pace, it would take 7.5 months to clear the *supply of houses* on the market. *Regionally*, sales rose in all four regions: West (+33.8% to 194,000 units, saar), Midwest (+9.9 to 89,000), Northeast (+6.9 to 31,000), and South (+2.9 to 425,000). Of the 739,000 *homes sold* in July, 335,000 were completed, 285,000 were under construction, while 119,000 weren't started. Of the 462,000 *homes for sale* during July, 102,000 had been completed, 260,000 were under construction, and 100,000 hadn't yet broken ground.

Regional M-PMIs (*link*): The *Kansas Fed district* has now released manufacturing data for August; the data show manufacturing activity declined at a slower pace than in July, while expectations for future activity remained positive. This report follows the *New York Fed's survey* of manufacturing activity for the month, which showed activity contracted for the eighth straight month, while the *Philadelphia survey* posted its first negative reading since the start of this year, with the general activity index plummeting 20.0 points to -7.0. Looking at August's *Kansas City survey,* the composite index (to -3 from -13), fell at a slower pace than in July, nearing the breakeven point of zero. The production (6 from -12) measure moved from contraction to expansion, while the new orders (-12 from -21) gauge fell at roughly half the pace of last month. Meanwhile, the volume of shipments (-1 from -18) measure posted a wide swing back toward positive territory. The two employment measures, number of employees (-7 from -12) and average employee workweek (-10 from -17), continued to fall, though at a slower pace. Meanwhile, the future composite index (to 8.0 from 5.0) improved this month, posting its best reading since the start of this year, as both the production (20 from 13) and employment (17 from 13) measures posted impressive gains.

Global Economic Indicators

US PMI Flash Estimates (*link*): Business activity in the US remained strong in August, according to flash estimates, signaling a sustained expansion in economic activity over the Q3 level, led by the service sector. August's C-PMI was little changed at 54.1, ticking down from July's 54.3—remaining in expansionary territory for the 19th consecutive month and among the highest seen over the past two years. The *NM-PMI* (to 55.2 from 55.0) fell just shy of June's 26-month high, while the *M-PMI* (48.0 from 49.6) dipped to an eight-month low, and the *M-PMI* outp*ut* (47.8 from 50.5) measure contracted for the first time since January, sinking to a 14-month low. According to the report, "The solid growth picture in August points to robust GDP growth in excess of 2% annualized in the third quarter." Turning to prices, *input* price inflation remained elevated by historical standards, particularly in the service sector, though did slow slightly from July's four-month high, while the rate for input cost inflation accelerated for manufacturers at the fastest pace since May.

Eurozone PMI Flash Estimates (*link*): "Eurozone business activity rises at faster pace, but new orders continue to fall" was the headline of August's flash estimate report. The *Eurozone's C-PMI* (to 51.2 from 50.2) continued to expand at a modest pace, posting a three-month high this month, with the NM-PMI (53.3 from 51.9) reaching a four-month high,

while the M-PMI (45.6 from 45.8) sank to an eight-month low. Looking at the two largest Eurozone economies, Germany's C-PMI (to 48.5 from 49.1) fell deeper into contractionary territory in August, with both the NM-PMI (to 51.4 from 52.5) and the M-PMI (42.1 from 43.2) falling to five-month lows, though the former continued to expand, just at a slower pace. *France's* private sector posted its first month of expansion since April during August, with the C-PMI (to 52.7 from 49.1) jumping to a 17-month high led by the NM-PMI (55.0 from 50.1), which showed the strongest growth in the service sector in over two years; the M-PMI (42.1 from 44.0) dropped to an eight-month low. *Growth in the rest of the region* continued to see output increase midway through Q3. Turning to pricing, although *input* prices in the overall Eurozone continued to increase markedly at Q3's midpoint, the pace slowed to an eight-month low, with prices in the service sector rising at the slowest pace since April 2021, while manufacturing prices were flat at July's 18-month high. Meanwhile, *output* prices increased at the fastest pace in four months, with services charges rising at the sharpest rate in three months, while manufacturing output prices increased for the first time since April 2023.

Japan PMI Flash Estimates (*link*): Private-sector activity in Japan expanded at the fastest pace since May 2023. The *C-PMI* (to 53.0 from 52.5) moved further into expansionary territory, as the NM-PMI (54.0 from 53.7) showed the service sector accelerated at a solid pace for the second successive month, while the M-PMI (50.9 from 49.7) output index returned to growth. Supporting the latest uptick in service-sector activity were stronger new business inflows, including export business—which returned to growth in August. In addition, the service sector added to payrolls to deal with ongoing workloads and clear outstanding work. *As for pricing*, service providers raised prices at the slowest pace in nine months, even as input cost inflation increased, with manufacturers following suit.

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