August 27, 2024

Morning Briefing

On Another New Normal, Banks & Powell

Check out the accompanying chart collection.

Executive Summary: With the growing economy set to benefit from interest-rate cuts and a weaker dollar, will inflation heat up again? We're sanguine on the inflation outlook in the near term, but not as certain about the long run, which will depend on the outcome of November's elections. In our opinion, the economy is normalizing from pandemic-induced distortions to a higher "norm," meaning higher potential GDP, higher productivity growth, and a higher neutral interest rate. ... The economic backdrop should lift Financials stocks broadly, but large banks have more winds at their backs than small ones. … And: Why is Powell suddenly so dovish?

Weekly Webcast. If you missed Monday's live webcast, you can view a replay *here*.

US Economy I: Normalizing to a New Norm. In the coming quarters, interest-rate cuts and a weaker dollar will be winds at the backs of both the US economy and stock market. Eric and I believe that neither needed the extra push. But so be it.

We expect cyclical sectors in particular to benefit as investors realize that the economy is closer to the 5th inning of this business cycle than the 8th, even though federal funds rate (FFR) futures are implying a very late-cycle monetary easing campaign. Because we believe that US potential economic growth is higher than the consensus suggests, we are not overly concerned that hotter-than-expected growth will induce either stickier or higher inflation. That said, we're not ignoring the inflationary potential of the next administration's fiscal and trade policies as are the Fed and the markets.

Here's a brief rundown on why we predict that real GDP will continue to grow around 3.0% y/y (its historical average), with room for surprises to the upside (*Fig. 1*):

(1) *Back to buying goods*. Real consumer spending on goods spiked during the pandemic from 2020 and 2021 as Americans bought and renovated homes, spurring a wave of

furnishings and home appliances sales as well as auto sales. As consumer pent-up demand was met and the Fed raised interest rates, goods consumption flattened, though at a record-high level.

But the American consumer's insatiable need for stuff has returned. From January through June, real goods spending has increased at a 2.6% annualized growth rate, fast approaching its pre-pandemic trend since 2009 (now just a percentage point away) (*Fig. 2*).

(2) *Fueled by real income growth*. Rising real wages have boosted consumer spending, particularly among lower-wage workers. Real average hourly earnings among these workers hit a new record high in June, and we expect wage gains to continue beating inflation as productivity rises and inflation falls (*Fig. 3*).

Higher-wage workers—while enjoying much higher wages than prior to the pandemic—actually saw their incomes fall relative to inflation during much of the post-pandemic period. Their spending was supported by the massive wealth effect (i.e., dissaving as asset prices surged). But now, their real wages are growing once again. That doesn't support the story that the labor market is weakening since real wages matter as much to the state of the labor market as payroll employment, which is at a record high.

(3) *Speaking of a weak labor market.* Monthly payrolls continue to rise, and workers continue to outearn inflation. In July, more unemployed Americans were looking for a job after entering the labor force (39.2% of total unemployment) than were unemployed permanently or temporarily (38.3%). In fact, just 23.5% of unemployed workers were out of work due to a permanent layoff in July, the lowest share since September 2023 (*Fig. 4*).

August's Dallas Fed manufacturing survey, released Monday, showed a large jump in businesses reporting that they are at their ideal staff level, from 29.7% in December to 36.3% in August. The percentage of respondents reporting being overstaffed and laying off workers nudged up from 2.6% to 2.7% but was still below June 2023's 2.8%. Labor supply and demand are coming into balance.

(4) *Don't forget fiscal*. The US government is running a fiscal deficit that's 6.7% of nominal GDP—the largest deficit on record when excluding times of recessions or world wars. The deficit is expected to remain elevated for the foreseeable future, despite strong US growth (*Fig. 5*).

A note to the hard-landers out there: If the economy were to worsen as you expect and unemployment to rise, the deficit would widen even more. Along with the monetary easing that would occur if the economy were to slow, the backstops against a recession are massive.

(5) *Cautious on inflation expectations*. We believe US potential growth is higher than the consensus does, and we don't expect China to add inflationary pressures to the global economy anytime soon. So our outlook for inflation remains sanguine.

That said, the fiscal excess that already contributes to inflation will now be accompanied by lower interest rates, more housing activity, and more production and consumption of goods. A weaker dollar (DXY is now down 0.7% ytd on rate-cut expectations) will provide a boost to exporters and raise import costs. US consumers may opt to buy higher-priced made-in-America products and travel more domestically.

The biggest inflationary risk in 2025 is that either the Democrats or the Republicans take it all—winning control of the White House, the House of Representatives, and the Senate. The Democrats likely would go on a spending binge, while the Republicans likely would cut taxes once again. Either outcome would swell the federal deficit, possibly boosting demand faster than supply, as occurred during the pandemic with inflationary consequences. We will wait to see the election results on November 5.

Meanwhile, the financial markets' inflation expectations are the lowest since March 2023 (*Fig. 6*). That's based on the difference between yields on 10-year Treasuries and 10-year TIPS, as well as swaps linked to inflation over the period five to ten years out. The 10-year TIPS are now trading below 1.70%.

We see strong economic growth and stimulative fiscal policy as two important factors contributing to a higher neutral interest rate in the post-pandemic period. That means both long-term interest rates and inflation will likely be higher than the markets are pricing in.

US Economy II: Big Banks Vs Small Banks. We've been recommending overweighting the S&P 500 Financials sector. Financial services firms would benefit from the strong growth environment of our Roaring 2020s scenario.

Regional banks in particular rallied swiftly in response to Powell's dovish tune on Friday. The SPDR S&P Regional Banking ETF (KRE) rose 5.1% on Friday alone, while the broader Financial Sector ETF (XLF) added just 0.9%. Of course, big banks have outperformed their smaller counterparts so far this year (XLF is up 17.7% ytd vs KRE's 9.8% gain).

Over the short term, there's a runway for smaller banks to rally as the Fed cuts rates. They should benefit not just from the rate cuts themselves but also from economic momentum. Over a longer investment horizon, however, we see big banks as a much better play. Consider the following:

(1) *Rally out of the dirt.* Regional banks have yet to reclaim the valuations they sported before the Silicon Valley Bank crisis (*Fig. 7*). It wouldn't be surprising if they rose at least 5% back to pre-March 2023 prices by the time the Fed cuts rates in September. Small banks' $2 trillion of commercial real estate loans will rise from deeply underwater levels as the FFR is lowered (*Fig. 8*). Trading at just 10.7 times forward earnings as of the August 23 close, small banks are plenty cheap relative to history. In fact, large banks have been trading at a historically large premium over regionals since last March (*Fig. 9*).

Despite a positive setup for regional banks over the next couple quarters, we don't favor them over the long run. Big banks have regulatory and policy tailwinds, pent-up dealmaking demand, and higher macroeconomic volatility to look forward to.

(2) *Regulatory tailwinds*. If the Fed relaxes the GSIB surcharge, which *Reuters* reported as a possibility last month, big banks would have more room to use their balance sheets for banking activities rather than setting aside excessive capital for reserves. Should that pan out, it would also suggest that the Basel III endgame regulatory framework will be relatively loose. Combined with the end of Chevron deference, financials may be entering a sustained period of more favorable regulatory change after a decade-plus of tighter oversight following the Great Financial Crisis (GFC).

(3) *Waning QT*. The Federal Open Market Committee (FOMC) slowed its quantitative tightening (QT) in June. We expect it will end QT and stop paring the size of the Fed's balance sheet in 2025. That would mean large banks that serve as primary dealers for government debt won't have to absorb as much bond risk on their balance sheets (*Fig. 10*).

(4) *Potential recession indicator?* During the pandemic crisis and the GFC, banks' provisions for losses on loans and leases spiked, then fell as bad debts were charged off. The difference between loan-loss provisions and net charge-offs then turned negative as provisions first fell due to charge-offs and subsequently due to the economic recovery.

Currently, this spread looks to be headed for negative territory as charge-offs rise and provisions peak (*Fig. 11*). One might look at the relationship and claim that a recession is near. Alternatively, we think this is a sign that banks no longer fear a slowdown, as suggested by the Fed's latest Senior Loan Officer Opinion Survey (*Fig. 12*). We expect provisions and charge-offs to fall simultaneously and this spread to remain flat around zero rather than plunge negative. That would provide another boost for banks as more cash is freed up for new loans.

This bank-related recession indicator is just another example of why economic relationships that coincided with previous recessions cannot be viewed in isolation.

US Economy III: Why Is Powell Suddenly So Dovish? In short, maybe Fed Chair Jerome Powell wants to keep his job. His born-again dovishness during Jackson Hole reminds us of his dovish stance during the pandemic, which earned him a second term from President Joe Biden. Powell's second term is up in May 2026, and his governorship ends in January 2028. That means he would be up for one more renomination as chair.

It was left-leaning Lael Brainard, now the Biden administration's director of the National Economic Council, who Powell beat out back in 2021. Brainard likely would be Kamala Harris' pick to replace Powell in a Harris administration. Meanwhile, Donald Trump has insinuated that he might seek to remove Powell from his post early, should Trump win the November election.

Powell lately seems to be following a playbook similar to the one that secured him a second term. Consider the following:

(1) *From hawk to dove*. Until Jackson Hole, Powell would often use his press conferences following FOMC meetings to reiterate the Fed's commitment to data dependence or push back on prevailing market dovishness. The markets often gripped onto any hint of dovishness as Powell's pressers progressed. Riskier assets would rally through the close of the trading on the day of the presser. But for much of this year, FFR futures showed waning rate-cut expectations in the days following FOMC meetings (*Fig. 13*). That suggests that Powell's pushback was at least somewhat effective.

(2) *A big policy mistake.* As inflation reheated during the pandemic, Powell was overly dovish while trying to cement his chances of being renominated for Fed chair, in our opinion.

In August 2020, three months before Biden won the presidential election, the Fed decided to begin targeting an average inflation rate, meaning that it would allow inflation to run hotter than 2.0% because of its persistent undershooting in years prior. It wasn't until November

2021—just before Biden nominated Powell for another term—that the Fed announced a response to surging inflation: It would gradually taper its $120 billion-per-month bond-buying spree. The CPI already had risen to 6.9% y/y by then, up from 1.2% y/y a year earlier. It continued climbing to 9.0% by June 2022 (*Fig. 14*).

During that time, the Fed actually helped inflate home prices by adding mortgage-backed securities (MBS) to its balance sheet through May 2022, building a massive $2.73 trillion book. By then, home prices were up 33% from the start of 2020. The Fed's MBS holdings have only shrunk to $2.32 trillion since.

(3) *Legacy on the line*. As Powell's legacy stands now, the financial markets will remember Jerome Powell as the Fed chair who rescued the economy and stock market from the effects of the pandemic, then clipped the largest inflationary shock since the 1970s without causing a recession and avoiding a second surge of inflation (*Fig. 15*). He has done much to earn these plaudits—especially considering that most developed economies experienced similar inflation outcomes.

However, as we've argued since 2022, disinflation without a recession was the likely outcome as supply chains normalized and China's recession depressed goods prices. The transmission of monetary policy is weaker today than during past tightening campaigns.

Powell likely believes, as we and several Fed officials do, that the labor market is cooling but remains in good shape. He opted to chop off the tail risk of an acceleration in unemployment to cement his legacy. We hope that decision does not come back to bite him. For now, the markets don't think it will.

Calendars

US: Tues: Consumer Confidence 100.2; Richmond Fed Manufacturing Index -17; SP/HPI Composite 6.9%y/y; API Weekly Crude Oil Inventories. **Wed:** MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production; Bostic; Waller. (FXStreet estimates)

Global: Tues: Germany GDP -0.1%q/q/-0.1%y/y; UK CBI Distributive Trade Survey -11; Nagel. **Wed:** Germany Gfk Consumer Climate -18.1; France Consumer Confidence 92; Italy Industrial Sales; Eurogroup Meetings; Japan Leading & Coincident Indicators -2.6%-3.4%. (FXStreet estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): LargeCap's forward earnings rose last week by 0.2% w/w to a new record high. It has achieved new record highs for 34 straight weeks and in 45 of the 50 weeks since mid-September; last week's result now makes for the lengthiest string of weekly record-high forward earnings for LargeCap in nearly 19 years (since the November 11 week of 2005, when it hit record highs for 42 straight weeks). MidCap's rose for the first time in four weeks, gaining 0.2% w/w to 2.2% below its record high in early June 2022, but has risen in 18 of the past 23 weeks. SmallCap's fell for a third straight week, declining 0.1% w/w to 10.1% below its mid-June 2022 record, but has posted gains in 16 of the past 24 weeks. Through the week ending August 23, LargeCap's forward earnings has soared 18.0% from its 54-week low during the week of February 1, 2023; MidCap's is 6.4% above its 55-week low during the week of March 10, 2023; and SmallCap's is 4.0% 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 just over a year ago, but LargeCap's is improving faster than the SMidCap's. Here are the latest consensus earnings growth rates for 2024 and 2025: LargeCap (9.5%, 15.2%), MidCap (0.1, 17.2), and SmallCap (-7.0, 19.1).

S&P 500/400/600 Valuation (*link*): Valuations were higher during the August 23 week for these three indexes but remain at near recent multi-year highs. LargeCap's forward P/E rose 0.2pt w/w to a six-week high of 21.1 from 20.9 a week earlier and a 14-week low of 20.1 the week before that. It's just 0.3pts below its 30-month high of 21.4 during the July 12 week, but is up 4.1pts from a seven-month low of 17.0 during the October 27 week. It's now up 6.0pts 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 rose 0.4pt w/w to a 21-week high of 15.8. It's just 0.2pt below its 27-month high of 16.0 at the end of March and up 3.5pts from a 12-month low of 12.3 at the end of October. 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 gained 0.4pt w/w to 15.3 and is just 0.1pt below its 32-month high of 15.4 during the July 26 week. It's up 4.7pts 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 26% discount to LargeCap's P/E is up from a 25-year-low 29% discount during the July 5 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 29% discount is up from a 24-year-low 34% discount during the July 5 week. That 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.

US Economic Indicators

Durable Goods Orders & Shipments (*link*): Durable goods orders rose for the fifth time in six months in July to its highest level since last November. *Durable goods orders* rebounded 9.9% (vs 4.0% expected) in July following a 6.9% drop in June; the m/m volatility was primarily driven by aircraft, with transportation orders jumping 34.8% in July after tumbling 20.6% in June. Over the six months through July, headline durable goods orders expanded 4.7%. *Excluding transportation*, orders edged down 0.2% in July, led by orders for motor vehicles & parts (-2.6%), followed by communication equipment (-1.1) and primary metals (-0.9). The one bright spot in the report was the new orders for computers, which jumped 3.2% m/m and 13.0% y/y. Meanwhile, *nondefense capital goods orders excluding aircraft* (a proxy for future business investment) slipped 0.1% in July following a 0.5% uptick in June—continuing to bounce around record highs—while *nondefense capital goods shipments excluding aircraft* (used in calculating GDP) slipped 0.4%, and is only 1.9% below January's record high.

Global Economic Indicators

Germany Ifo Business Climate Index (*link*): "The German economy has settled into stagnation," Ifo president Fuest noted. German business confidence came in slightly above expectations in August—though fell to a six-month low. The *business climate index* fell for the fourth successive month to 86.6 (vs 86.0 expected) this month from 89.4 in April. The *expectations* component fell for the third month, from 90.3 in May to a six-month low of 86.8 in August, while the *current situation* component fell for the third time in four months, from 88.9 in April to 86.5 this month—the lowest reading since July 2020. The *manufacturing* sector shows the business climate index declined significantly again in August, with expectations falling to the lowest level since February, while companies were significantly less satisfied with their current situation. The *service sector* index deteriorated, falling into negative territory for the first time in six months. Expectations led the decline, though the current situation also worsened somewhat. *Trade's* business sentiment improved for the first time in three months, as businesses were slightly less pessimistic about expectations, but were less satisfied with the current situation. *Construction's* business climate index held steady this month, as companies were slightly more satisfied while expectations deteriorated a bit.

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