Yardeni Research

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Morning Briefing

50 Basis Points:
Baked Or Half Baked?

Check out the accompanying chart collection.

Executive Summary: It's a foregone conclusion that the Federal Open Market Committee will be launching a new monetary easing cycle by cutting the federal funds rate when it meets this week. But a weighty decision faces the committee: To cut by 50 basis points or not to cut that much? Fifty is the usual amount kicking off an easing cycle, but the economic circumstances are different this time: There's no recession clearly barreling toward us. Dr. Ed explores the pros and cons of the decision before the committee, concluding that easing by 25 bps would be the wiser course.

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

The Fed: Fast or Gradual Dovish Pivot? During each monetary policy easing cycle associated with a financial crisis and a recession, the Fed started by cutting the federal funds rate (FFR) by at least 50 bps (*Fig. 1*). However, this time around is arguably more like the 1995 easing cycle, when the Fed cut the FFR in 25 bps increments to revive a slowing economy. Eric and I think that the Fed should cut the FFR by 25bps on Wednesday. Whether it will or not is unclear.

This time is especially different than the start of most easing cycles because the Fed is easing in response to concerns that the economy might fall into a recession if it doesn't do so. That's not obviously the case at this time. In the past, it was often obvious that a financial crisis had morphed into a credit crunch that was pushing the economy into a recession (*Fig. 2*).

Nevertheless, the FFR futures market is currently assigning probabilities of 50% for a 25bps cut and 50% for a 50bps cut on Wednesday (*Fig. 3*). Those betting on the larger cut must believe that what's past is prologue. Indeed, during the past 10 easing cycles, the FFR fell by 418 bps on average from peak to trough (*Fig. 4*). So past experience suggests that the Fed has a ways to go before the easing is over and should get on with it—i.e., cut by 50bps rather than 25bps—especially if the Fed is trying to reduce the risk of an imminent recession.

The problem with the notion that "what's past is prologue"—a phrase that comes from Shakespeare's last play *The Tempest*—is that it's not always the case (and indeed wasn't even the case in the play). We prefer Mark Twain's quip that "history doesn't repeat itself, but it often rhymes." We've been arguing since mid-2022 that the diehard hard-landers have been conjuring a tempest in a teapot. They're still doing that.

Nevertheless, recession fears undoubtedly are influencing Fed officials more now that they're much less worried about inflation than over the past two and a half years. That became quite clear after the CPI reports for July and August showed that inflation continues to moderate, while labor market reports showed that the hot labor market of the past couple of years has been cooling.

We've calmly concluded that this indicates that the labor market has been normalizing, not weakening as others have fretted, including Fed Chair Jerome Powell. His latest major pivot—this time from inflation hawk to employment dove—was evident in his August 23 *speech* at Jackson Hole:

"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. We will do everything we can to support a strong labor market as we make further progress toward price stability. 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. The current level of our policy rate gives us ample room to respond to any risks we may face, including the risk of unwelcome further weakening in labor market conditions."

Got that? Powell said that any additional weakening of the labor market wouldn't be welcomed. So why not go with a 50bps rather than a 25bps cut to avert that from happening? Here are the pros and cons of that notion:

(1) *Pro: Provide stimulus where it is needed.* A bigger rate cut would more quickly help to revive the sectors of the economy that have been the most depressed by the tightening of monetary policy. Both residential housing and commercial real estate (CRE) would get a

boost. CRE loans would be easier to refinance, reducing the risk of a financial crisis in that sector. A pickup in housing starts would provide a boost to manufacturing, which has been in a growth recession (*Fig. 5* and *Fig. 6*). A rebound in existing home sales would be good for housing-related retailers (*Fig. 7*).

(2) *Pro: Revive consumer and business confidence.* The consumer optimism index, which we calculate as the average of the consumer confidence index and consumer sentiment index, has been relatively depressed (*Fig. 8*). The small business optimism index dipped in August after a solid gain in July. It is also still relatively depressed and could use a lift from lower interest rates (*Fig. 9*).

(3) *Pro: Good for the labor market*. All of the above should create more job openings, leading to more hiring. According to the September 4 *Beige Book*, the labor market can use some more love from the Fed: "Five Districts saw slight or modest increases in overall headcounts, but a few Districts reported that firms reduced shifts and hours, left advertised positions unfilled, or reduced headcounts through attrition—though accounts of layoffs remained rare. Employers were more selective with their hires and less likely to expand their workforces, citing concerns about demand and an uncertain economic outlook. Accordingly, candidates faced increasing difficulties and longer times to secure a job."

The various measures of layoffs show that they remain low (*Fig. 10*). However, the unemployment rate is up to 4.2% in August from 3.8% a year ago because there are fewer job openings for the unemployed to go after. Easier monetary policy should help to boost job openings, thereby putting a lid on the unemployment rate.

(4) *Con: Too soon to declare "mission accomplished" on inflation.* While inflation has moderated significantly, it isn't at 2.0% y/y just yet. The moderation in the overall rate has been led by deflating consumer durable goods prices in recent months. They might continue to fall given that the US import price index for goods made in China has continued to decline (*Fig. 11*).

China's weak economy is also putting downward pressure on the crude oil price, which is deflating the energy components of the CPI. A big decrease in the FFR may not be necessary if falling gasoline prices and falling durable goods prices boost consumers' confidence, real purchasing power, and spending (*Fig. 12*).

Meanwhile, inflation remains relatively sticky in the CPI services component. Rent has a big weighting in the CPI and is moderating slowly but not so surely given its August uptick.

Excluding shelter, CPI services rose 4.3% y/y during August (*Fig. 13*). This suggests that it might be too soon for the Fed to declare "mission accomplished" when it comes to the 2.0% inflation target.

(5) *Con: There might be a shortage of skilled labor*. As we observed last week, the rising pool of unemployed workers currently is attributable to teens with less than a high school education (*Fig. 14* and *Fig. 15*). If the Fed lowers the FFR too fast, two results are likely to be an increase in demand for goods and services and an increase in job openings.

That would be wonderful. However, what if the supply of unemployed workers lacks the skills to meet the requirements of the increased job openings? During August, the NFIB survey of small business owners found that 56% said that they can't find qualified workers for the jobs they have open (*Fig. 16*). That's up from 49% in July and the highest since September 2023.

In our Roaring 2020s scenario, businesses would continue to solve this structural problem by boosting technology-driven productivity growth. However, the Fed is not in a position to bet the farm on YRI's happy forecast. Fed officials must be concerned that by boosting demand for goods and services when the labor market is tight, the result could be a wage-price spiral.

(6) *Con: The real federal funds rate is unreal.* The Fed stopped raising the FFR 14 months ago, presumably because the rate was restrictive enough to bring inflation down to the Fed's 2.0% y/y target. Powell often stated that might be accomplished without triggering a recession. So far, so good.

However, Powell & Co. seem to be concerned that the real FFR is rising as inflation is falling (*Fig. 17*). So the Fed's monetary policy is automatically turning more restrictive. We've long observed that the real FFR is an unreal concept. It makes no sense to adjust the overnight lending rate in the bank reserves market with the yearly percent change in the CPI.

Real GDP is up 5.5% since the Fed started raising the FFR in March 2022. It is up in record-high territory since the Fed stopped doing so. Economic growth has been resilient and is showing few signs of buckling at the current level of interest rates.

(7) *Con: Stock prices could melt up.* If the Fed goes big, stock prices might resume soaring, with the potential of inflating a bubble that could be comparable to the dot.com bubble of the

late 1990s.

What about the bearish carry-trade story that Eric and I have been telling since early August? We think the unwinding of the yen carry trade is mostly finished. The yen has strengthened over the past week, yet the Nasdaq has rallied—unlike the situations at the beginnings of both August and September (*Fig.18*). Eric wrote about last week's carry-trade status in the September 11 *Morning Briefing*.

(8) *Bottom line: No recession ahead*. If the Fed cuts the FFR by only 25bps, that might alarm the hard-landers, who undoubtedly would claim that such a small cut is too little too late. We, on the other hand, think 25bps would be enough for now pending the next batch of data releases—which we expect once again will confirm the economy's resilience.

If the Fed cuts by 50bps, the chances of a recession are lessened even more, of course. But the odds of igniting consumer price and/or asset inflation would go up.

(9) *Another bottom line: Beware November 5.* We hate to mix politics into this discussion. So do Fed officials, who regularly claim that the Fed is apolitical. In his July 31 *press conference*, Powell was adamant about that: "[W]e would never try to make policy decisions based on the outcome of an election that hasn't happened yet. … [T]hat would just be a line we would never cross. You know, we're a nonpolitical agency. We don't want to be involved in politics in any way."

Maybe so. But shouldn't the Fed consider the possibility of either a Democrat or Republican sweep? Unchecked and unbalanced political power would allow either party to conduct fiscal and trade policies that would further widen the federal budget deficit and possibly fan inflation flames. Certainly, that realistic possibility should temper the Fed's readiness to cut the FFR by 50bps rather than 25bps.

After all, the 12-month federal government's budget deficit rose to $2.07 trillion during August (*Fig. 19*). The government's net interest outlays rose to a record $872.5 billion over the past 12 months (*Fig. 20*). Do Fed officials really want to enable such fiscal excesses by rapidly lowering interest rates?

Then again, we can't ignore the possibility that some members of the FOMC strongly dislike Donald Trump, especially since he is more likely to challenge the Fed's independence than Kamala Harris. That might sway them to go for 50bps on Wednesday if that is more likely to reduce Trump's chances of winning than a 25bps cut. Of course, they will totally repudiate any such suggestion. After all, the Fed is apolitical.

Then again, we previously speculated that Powell's abrupt shift from inflation hawk to employment dove in his August Jackson Hole speech might reflect his desire to be reappointed Fed chair when his term expires on May 15, 2026. That almost certainly won't happen if Trump wins. If Harris wins, she might reappoint Powell; though Lael Brainard—who is the current director of the National Economic Council and more liberal than Powell—probably has a better shot at winning the prize.

Calendars

US: Mon: Empire State Manufacturing Index -4.1. **Tues:** Retail Sales Headline, Core, Ex Gase & Autos -0.2%/0.2%/0.3%; Industrial Production 0.1%; Capacity Utilization 77.9%; Business Inventories 0.4%; NAHB Housing Market Index 41; Atlanta Fed GDPNow 2.5%; API Weekly Crude Oil Inventories. (FXStreet estimates)

Global: Mon: Italy CPI -0.1%m/m/1.3%y/y; Germany Buba Monthly Report; Lane; De Guindos. **Tues:** Germany ZEW Economic Sentiment 16.4; Canada CPI 0.1%m/m/2.2%y/y; Elderson; McCaul; Buch; Rogers. (FXStreet estimates)

Strategy Indicators

Global Stock Markets (US$ Performance) (*link*): The US MSCI index soared 4.1% last week, and is now just 0.8% below its record high on July 16. The AC World ex-US index increased 1.2% w/w to 5.5% below its June 15, 2021 record high. EM Latin America was the best performing region last week with a gain of 2.6%, followed by EMU (1.8%), Europe (1.5), EAFE (1.2), and the AC World ex-US. EMEA was the worst regional performer, with a decline of 0.7%, followed by EM (0.7) and EM Asia (0.7). Fourteen of the 17 major selected country markets that we follow rose last week. Mexico performed the best, with a gain of 5.4%, followed by the United States (4.1), Spain (3.0), Sweden (2.9), and Canada (2.8). Hong Kong was the worst performer, with a decline of 0.8%, followed by China (-0.5), Korea (-0.2), Japan (0.2), and Switzerland (0.4). The US MSCI's 17.6% ytd gain remains well ahead of the AC World ex-US index's (7.3). EM Asia is still ahead of the pack as the leading region ytd with a gain of 8.8%, which puts it ahead of Europe (8.0), EAFE (7.8), and the AC World ex-US. The worst performing regions so far in 2024: EM Latin America (-15.5), EMEA

(2.4), EM (5.7), and EMU (6.8). Looking at the major selected country markets that we follow, Taiwan is the best ytd performer, with its gain of 24.0%, but that country is down 10.4% from its July 11 record high. Taiwan is followed by India (22.6), the United States (17.6), Spain (14.2), and the United Kingdom (10.0). Mexico is the worst performing country so far in 2024, with a decline of 19.6%, followed by Brazil (-16.2), Hong Kong (-10.2), Korea (-8.2), and China (-1.0).

US Stock Indexes (*link*): All 48 of the major US stock indexes that we follow rose w/w, up from just one rising a week earlier. The S&P 500 LargeCap Pure Value index was the best performer, with a gain of 6.3%, ahead of Russell 1000 Growth (6.0%), Russell 3000 Growth (6.0), Nasdaq Composite (6.0), Nasdaq 100 (5.9), and S&P 500 LargeCap Growth (5.9). The S&P 500 LargeCap Pure Value index was the worst performer, albeit with a gain of 1.2%, followed by S&P 500 Transportation (1.4), S&P 500 LargeCap Value (1.6), and Russell 1000 Value (1.9). Looking at their ytd performances, 45 of the 48 indexes are positive so far. The S&P 500 LargeCap Growth index remains in the top spot as the best performer so far in 2024, with a gain of 24.2%, ahead of S&P 100 MegaCap (21.0), Russell 1000 Growth (20.9), and Russell 3000 Growth (20.4). The worst performing major US stock indexes ytd: S&P 400 MidCap Pure Value (-2.6), S&P 600 SmallCap Pure Value (-1.1), Dow Jones 20 Transports (-1.1), S&P 500 Transportation (1.5), and S&P 600 SmallCap Value (1.9).

S&P 500 Sectors Performance (*link*): Ten of the 11 S&P 500 sectors rose last week, but only three were ahead of the S&P 500's 4.0% gain. That compares to two sectors rising a week earlier when six were ahead of the composite index's 4.2% decline. The outperformers last week: Information Technology (7.3%), Consumer Discretionary (6.1), and Communication Services (4.3). The underperformers last week: Energy (-0.7), Financials (0.5), Consumer Staples (1.1), Health Care (1.4), Materials (3.2), Utilities (3.4), Real Estate (3.4), and Industrials (3.7). The S&P 500 is up 18.0% ytd, with all 11 sectors in positive territory and three sectors ahead of the index. A week earlier, a ytd high of five sectors were ahead of the index, that many for the first time since mid-May. Information Technology is now the best ytd performer with a gain of 26.2%, ahead of Utilities (23.2) and Communication Services (21.1). These sectors are lagging the S&P 500 so far in 2024: Energy (1.8), Materials (8.0), Consumer Discretionary (9.1), Real Estate (12.3), Industrials (14.2), Health Care (14.2), Consumer Staples (17.7), and Financials (17.9).

US Economic Indicators

Consumer Sentiment Index (*link*): Consumer sentiment rose to its highest level since May 2024, as inflation expectations fell to the lowest percentage since December 2020. *Consumer sentiment* rose for the second month, from 66.0 in July to 69.0 in mid-September. *Sentiment* is now roughly 40% above its June 2022 low, "though consumers remain guarded as the looming election continues to generate substantial uncertainty," the Conference Board warned. The *current conditions* improved for the first time in six months, climbing to 62.9 this month after falling the prior five months from 82.5 in March to 61.3 in August—which was the lowest since December 2022. *Expectations* moved up for the second month, to 73.0 in mid-September, after sliding from a recent high of 77.4 in March to 68.8 in July. *Turning to inflation*, year-ahead inflation expectation fell for the fourth successive month, dropping to 2.7% in mid-September, well within the 2.3%-3.0% range recorded in the two years prior to the pandemic. Long-run inflation expectations were little changed this month, edging up to 3.1% from 3.0%—remaining modestly elevated relative to the pre-pandemic range. *Turning to politics*, the report notes that a growing share of both Republicans and Democrats are anticipating a Harris win. The Conference Board noted that the interview for this release occurred prior to the presidential debate and noted that a more comprehensive look at election expectations will be released next week.

PPI (*link*): Both the headline and core PPIs were a tick above expectations in August, led by services. *Final demand* rose 0.2% in August (vs 0.1% expected), following no change in July and a 0.2% uptick in June. August's yearly inflation rate was 1.7% (vs 1.8% expected), easing from its recent peak of 2.7% in June, which was the highest since March 2023. It was at a recent low of 0.8% last November. *Core prices* rose 0.3% (vs 0.2% expected), following July's flat reading, with the yearly rate holding at July's 2.4% rate, a tick below the 2.5% expected increase and down from June's 3.0%. Excluding trade services from the core group, the rate edged up to 3.3% after easing from 3.4% in May (the highest since last April) to 3.2% in both June and July. *Final demand services* rose 0.4% in August after falling below zero in July (-0.3%) for the first time this year, after averaging monthly gains of 0.4% during the three months through June. These prices rose 0.6% in April—matching January's gain, which was the biggest monthly increase since last July. Nearly 60% of August's increase is attributable to a 0.3% increase in the index for final demand services less trade, transportation, and utilities. The services' yearly rate rose to 2.6% in August, after easing from 3.5% (the highest since February 2023) in June to 2.4% in July. It was at 1.8% at the end of last year, which was the lowest since January 2021. *Final demand goods* was flat in August, easing from July's 0.6% gain, which followed declines in three of the prior four months. The yearly rate was flat in August, slowing from July's recent peak of 1.7%. The PPI for *personal consumption* eased for the third month, from May's 15-month high of 3.0% to a seven-month low of 1.8% in August; it was at 0.9% last November. The yearly rate for *personal consumption excluding food & energy* rose from a recent low of 2.1% last November to 3.2% y/y this June—which was the highest since April 2023—easing to 2.4% in July before ticking up to 2.5% in August. The former and latter reached record highs of 10.4% and 8.1%, respectively, in March 2022.

Import Prices (*link*): Import prices posted its biggest decline in eight months in August, encompassing a broad range of goods. *Import prices* fell 0.3% in August, the largest monthly decline since December 2023, after upticks of 0.1% in both July and June, which followed May's 0.1% downtick. These prices averaged monthly gains of 0.6% the first four months of the year. On a year-over-year basis, import prices jumped from -2.4% in December by 1.7% in July, though easing to 0.8% in August. Petroleum prices fell 3.2% in August, the largest one-month decline since December 2023. Despite August's drop in petroleum prices, *import prices excluding petroleum* increased 1.2% y/y, the highest since January 2023's 1.4% and up from its recent bottom of -1.6% at the end of last year.

Global Economic Indicators

Eurozone Industrial Production (*link*): Eurozone industrial production remains depressed, not posting a gain since March. *Headline* production, which excludes construction, fell for the third time in four months, by 0.3% in July and 1.4% over the period, with June's output flat during the month. Production is down 3.2% ytd and 2.2% y/y to its lowest level since September 2020. Among the *main industrial groups*, intermediate goods production contracted for the fourth time in five months, by 1.3% in July and 2.1% over the period; consumer goods production was a mixed bag. Durable goods production has been volatile in recent months, falling 2.8% in July and 2.4% over the five months through July, while consumer nondurable goods output rose for the third time in four months, by 1.8% m/m and 4.8% over the period. Energy output increased 0.3% in July, after gains of 1.7% and 0.6% in June and May, respectively, which followed a string of declines. Capital goods output sank in two of the past three months, by 1.6% in July and 3.3% over the period. *Compared to a year ago*, total production fell 2.2%, led by shortfalls in capital goods (-5.3%), consumer durable goods (-4.4), and intermediate goods (-2.9), while consumer nondurable goods (2.2) and energy (1.7) output were above year-ago levels. Looking at the *largest Eurozone economies*, production fell on both a monthly and a yearly basis in July: France (-0.5% m/m & -2.3% y/y), Spain (-0.7 & -0.9), Italy (-0.9 & -3.3), and Germany (-3.0 & -5.5%).

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