Yardeni Research

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# Morning Briefing

## Fed's Dream Economy Versus Ours

*Check out the accompanying chart collection.*

**Executive Summary:** The Fed is starting a new easing cycle to avoid a recession that we don't see coming, based on concern about labor market deterioration that we don't see occurring. Today, Dr. Ed compares and contrasts the world according to the Fed with the world according to our team, explaining the thinking behind both. Notably, the Fed is risking its credibility by easing without regard for election results, as both presidential candidates' policies would raise the federal deficit in a one-party sweep, an inflationary prospect. We are rooting for gridlock. … Also: Three misleading economic indicators continue to stoke recession fears unduly. … And: Dr. Ed reviews "The Unlikely Pilgrimage of Harold Fry" (+).

**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: Dream Economy Ignores Fiscal Nightmare.** Believe it or not, there are still a few diehard hard-landers who are still predicting that the economy is heading into a recession, even though the Fed has started a new monetary easing cycle aimed directly at averting a recession. It isn't even clear that the Fed needs to do so, since the economy, on balance, continues to grow at a solid pace. However, Fed officials have become increasingly concerned that the labor market may be weakening (not just normalizing as we believe) and might push the economy into a recession. They've concluded that inflation is now close enough to their 2.0% target that they can pivot from restrictive to less restrictive (or even accommodative) monetary policy to boost the labor market.

Fed officials can be justifiably proud that they have achieved a soft landing. They've managed to bring inflation down into the vicinity of their target rate without a recession. They've achieved a scenario we have often described as "Immaculate Disinflation" and has been our base-case scenario since 2022. Now they want to maintain it. We are betting they will do so.

We aren't giving the Fed all the credit for delivering Immaculate Disinflation. There have been lots of forces in play that have led to this development. Most of the pandemic shocks that boosted inflation and tightened the labor market have normalized. Global supply chains have done the same. China's economy remains weak and continues to export goods deflation and to depress commodity prices, especially the price of oil. Meanwhile, the US economy has remained resilient and less interest-rate sensitive than in the past.

In their latest *Summary of Economic Projections* (SEP), released on September 18, Fed officials provided a very rosy outlook for the economy over the next three years. They expect to accomplish that by lowering the federal funds rate (FFR) to 4.4% by the end of this year, then to 3.4% and 2.9% by the ends of 2025 and 2026 (*Fig. 1*). The projected results, according to the SEP, are as follow:

(1) *GDP growth*. The median projection of the FOMC participants is that real GDP will increase 2.0% every single year from 2024 through 2027 (*Fig. 2*). That seems too low to us given that it has grown on average by 3.1% since the late 1940s, including recessions (*Fig. 3*). The Fed's projection is probably based on an assumption that the labor force will continue to grow by only 1.0% y/y, implying that FOMC participants think that productivity will grow by just 1.0% y/y. Immigration flows suggest that the labor force should grow at a faster pace. Productivity has been growing at least twice as fast recently, spurred by a host of technological innovations (*Fig. 4*).

(2) *Unemployment rate*. For now, 2.0% y/y real GDP growth is deemed to be just the right growth rate to keep the unemployment rate at or slightly below 4.4%. The SEP's "longer run" estimate of the unemployment rate is 4.2%, which must be the FOMC's current projection for NAIRU, i.e., the nonaccelerating inflation rate of unemployment (*Fig. 5*). The jobless rate was 4.2% in August. We are at NAIRU.

Isn't the Fed risking reviving a wage-price spiral by stimulating an economy that is currently at full employment? In his *presser* last Wednesday, Fed Chair Jerome Powell explained that he and his colleagues agreed that it is time to "recalibrate" monetary policy to keep the jobless rate from rising.

We don't have a problem with the Fed's estimate of NAIRU. We agree that the economy is at it now. However, we question whether the Fed will need to lower the FFR as much as projected in the SEP.

In any event, the current monetary easing cycle will certainly boost demand for goods and services. However, we suspect that it will boost productivity more than it will boost the demand for labor. That's because we perceive that there is a shortage of workers available with the right skills to match the demand.

(3) *Headline and core inflation*. We also agree with the Fed's optimistic outlook for the PCED headline inflation rate, which is projected to fall from 2.6% this year to 2.2% next year and to 2.0% in both 2026 and 2027 (*Fig. 6*). Where we differ is on the FFR level that would be necessary to keep inflation down while providing enough stimulus to keep the economy growing.

In other words, Immaculate Disinflation is no longer a destination; rather, it is the economy's current location. The answer to "When are we going to get there?" is "We have arrived." The question now is "What FFR will it take to keep the economy there?" If the Fed overshoots the FFR on the downside, consumer price inflation might rebound.

In our Roaring 2020s scenario, which remains the most probable, that's not likely to happen. Instead, more stimulative monetary policy will boost productivity-led economic growth, which will continue to subdue the unit labor costs (ULC) inflation rate, which was only 0.3% y/y during Q2 (*Fig. 7*).

In other words, our dream scenario is even dreamier than the one projected by the Fed because we see more technology-enabled productivity growth.

(4) *In the short and long run*. The main risk we see in the Fed's heating up a warm economy with more monetary easing than necessary is a reprise of the second half of the 1990s' stock market bubble. From a stock market valuation perspective, stock prices are about as overvalued as they were in 1999.

In the September 19 *QuickTakes*, we raised the odds of a meltup from 20% to 30%. We wrote: "The problem is valuation. Warren Buffett has been raising cash probably because his Buffett Ratio (measured as the S&P 500's price index to forward sales) is in record high territory at 2.83 during the September 20 week [*Fig. 8*]. Somewhat less irrational is the S&P 500's forward P/E [*Fig. 9*]. It's elevated at 21.1. But it isn't in record territory, yet. Its divergence with the S&P 500 forward price-to-sales ratio is attributable to the index's rising profit margin causing earnings to rise faster than sales."

Nevertheless, we decided to stick with our current year-end S&P 500 targets of 5800, 6300, and 6800 for 2024, 2025, and 2026. We concluded: "In a meltup scenario, the S&P 500 could soar to above 6000 by the end of this year. While that would be very bullish in the near term, it would increase the likelihood of a correction early next year."

As we've previously observed, the S&P 500 Information Technology and Communication Services sectors together account for about 40% of the market capitalization of the S&P 500 (*Fig. 10*). That's the same share as they had at the peak of the 1999-2000 tech bubble that burst. This time, they account for 34% of the forward earnings of the S&P 500 companies collectively versus 22% at the peak of the bubble.

Over the long run, we are still predicting 60,000 for the Dow Jones Industrials Average and 8000 for the S&P 500 by the end of the Roaring 2020s. That's because we agree with the Fed's long-run forecast, though we are expecting more productivity-led growth than it is.

(5) *Fiscal nightmare*. Among our various critiques of the Fed's sudden and all-in pivot toward monetary easing is that it totally ignores this fact: Both presidential candidates are promoting reckless fiscal policies that will further widen the federal government deficit and that could be inflationary to boot.

In our Roaring 2020s scenario, we are counting on gridlock to stymie the extremes of either presidential candidate. We can always change our minds if there is a sweep by either party on November 3. The Fed, however, is risking its credibility if the next administration's fiscal policies force another monetary policy pivot.

One more thought: By promising to lower interest rates, the Fed is enabling Washington's fiscal follies to continue. The federal government budget deficit was $2.1 trillion over the 12 months through August, pushing Treasury debt held by the public up to a record $26.9 trillion (*Fig. 11*). Net interest outlays rose to a record $872.5 billion over this period (*Fig. 12*).

**US Economy: Three Misleading Economic Indicators.** Let's update our analysis of the major misleading economic indicators that have led many economists to erroneously predict a recession since the Fed started to tighten monetary policy in early 2022:

(1) *Philips Curve*. The Fed started to raise the FFR in March 2022, from 0.00%-0.25% then to 5.25%-5.50% in July 2023, in response to soaring inflation. It was logical to expect such aggressive monetary tightening to cause a recession. It was also logical to believe that the only way to bring inflation back down was with a Fed-engineered recession. After all, the Phillips Curve shows an inverse relationship between inflation and the unemployment rate (*Fig. 13*).

This time has been different for several reasons. Demand for goods was overheated by fiscal policies and overwhelmed global supply chains. That inflationary shock during 2021 and 2022 dissipated in 2003 and 2024. In addition, the Chinese government encouraged exporters to dump goods at deflated prices over the past couple of years to offset weakness in China's property market. China's weak economy also depressed commodity prices, especially oil prices, especially this year. The prices of numerous services, including rents, also soared as a result of the pandemic. They've been mostly disinflating since mid-2023.

Most importantly, proponents of the Phillips Curve model rarely if ever mention productivity. That's a major flaw in their analysis since there is an inverse relationship between the unemployment rate and productivity growth (*Fig. 14*). A tight labor market tends to be associated with faster growing productivity, which offsets the upward pressure on wages. As noted above, ULC inflation is down to only 0.3% y/y.

(2) *Yield curve*. Melissa and I literally wrote the *book* on the yield curve back in 2019. We observed that inverted yield curves neither cause nor predict recessions. They do predict that if the Fed continues to tighten, the result is likely to be a financial crisis that quickly turns into a credit crunch and a recession (*Fig. 15*).

More recently, hard-landers have warned that a disinverting yield has tended to be associated with an imminent recession. We've countered that this time is different because there's been no unchecked financial crisis to generate a credit crunch and a recession. The Fed quickly doused the one mini-banking crisis there was, in March 2023, by providing an emergency liquidity facility; that prevented it from turning into an economy-wide run on the banks and a recession.

(3) *Leading economic indicator*. Back in 2022, we started to argue that the falling Index of Leading Economic Indicators (LEI) might be a misleading indicator of a looming economy-wide recession, mostly because it is a better indicator of the goods economy than the services one. That's confirmed by the high correlation between the national M-PMI and yearly percent change in the LEI (*Fig. 16*). However, this time, both indicators have been signaling a recession in real GDP goods that remains a no-show (*Fig. 17* and *Fig. 18*)! The yearly percent change in real GDP goods has been solidly positive since Q3-2020. It really has been different this time.

**Movie.** "The Unlikely Pilgrimage of Harold Fry" (+) (*link*) is an odd film about an odd fellow, who walks 500 miles in the UK to bring comfort to an old friend who is dying of cancer. Along the way, he becomes a media celebrity and attracts a crowd of people who join his pilgrimage. Those scenes are very reminiscent of similar scenes in *Forrest Gump*. Jim Broadbent's performance as protagonist Harold Fry is brilliant.

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## Calendars

**US:** **Mon:** M-PMI & NM-PMI Flash Estimates 48.6/55.3; Goolsbee; Kashkari; Bostic. **Tues:** Consumer Confidence 103.5; Richmond Fed Manufacturing Index -17; S&P/CSI Composite Index 5.9%y/y; Bowman; API Weekly Crude Oil Inventories. (FXStreet estimates)

**Global:** **Mon:** Eurozone, Germany, and France Flash C-PMI Flash Estimates 50.6/48.2/53.1; Eurozone, Germany, and France M-PMI Flash Estimates 45.7/42.4/44.3; Eurozone, Germany, and France NM-PMIs 52.3/51.1/53.0; UK M-PMI & NM-PMI Flash Estimates 52.3/53.5; UK CB Industrial Trend -23; Elderson. **Tues:** Germany Ifo Business Climate Index, Current Assessment, and Expectations 86.1/86.0/86.3; RBA Interest Decision 4.35%; Nagel; McCaul; Balz; Macklem. (FXStreet estimates)

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## Strategy Indicators

**Global Stock Markets (US$ Performance)** (*link*): The US MSCI index rose 1.4% last week, and is just 0.2% below Thursday's first record high since July 16. The AC World ex-US index increased 1.0% w/w to 4.6% below its June 15, 2021 record high. EM Asia was the best performing region last week with a gain of 2.6%, followed by EM (2.2%), EMEA (2.2), and the AC World ex-US. EM Latin America was the worst regional performer, with a decline of 1.0%, followed by Europe (0.1), EAFE (0.4), and EMU (0.7). Fourteen of the 17 major selected country markets that we follow rose last week. Hong Kong performed the best, with a gain of 5.8%, followed by China (4.6), South Africa (4.0), Australia (2.7), and Spain (2.6). Brazil was the worst performer, with a decline of 1.7%, followed by the United Kingdom (0.4). The US MSCI's 19.2% ytd gain remains well ahead of the AC World ex-US index's (8.4). EM Asia is still ahead of the pack as the leading region ytd, with a gain of 11.6%, and is now the only region ahead of the AC World ex-US. The worst performing regions so far in 2024: EM Latin America (-16.4), EMEA (4.7), EMU (7.6), Europe (8.1), EM (8.1), and EAFE (8.3). Looking at the major selected country markets that we follow, Taiwan is the best ytd performer, with its gain of 26.6%, but that country is down 8.4% from its July 11 record high. Taiwan is followed by India (24.6), the United States (19.2), Spain (17.1), and South Africa (14.1). Mexico is the worst performing country so far in 2024, with a decline of 19.8%, followed by Brazil (-17.5), Korea (-7.8), Hong Kong (-5.0), and France (1.1).

**US Stock Indexes** (*link*): Forty-seven of the 48 major US stock indexes that we follow rose w/w, up from all 48 rising a week earlier and just one the week before that. The S&P 400 MidCap Pure Growth index was the best performer, with a gain of 3.3%, ahead of S&P 400 MidCap Pure Value (3.2%), S&P 600 SmallCap Pure Growth (3.2), S&P 500 LargeCap Pure Growth (3.1), and S&P 600 SmallCap Pure Value (2.6). The Dow Jones 15 Utilities index was the worst performer with a decline of 0.3%, followed by S&P 500 Transportation (0.2), Dow Jones 20 Transports (0.2), Dow Jones 65 Composite (1.0), and S&P 500 LargeCap Value (1.0). Looking at their ytd performances, 47 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 26.2%, ahead of Russell 1000 Growth (22.8), S&P 100 MegaCap (22.6), and Russell 3000 Growth (22.3). The worst performing major US stock indexes ytd: Dow Jones 20 Transports (-0.9), S&P 400 MidCap Pure Value (0.6), S&P 600 SmallCap Pure Value (1.5), S&P 500 Transportation (1.6), and S&P 600 SmallCap Value (3.9).

**S&P 500 Sectors Performance** (*link*): Eight of the 11 S&P 500 sectors rose last week, but seven were ahead of the S&P 500's 1.4% gain. That compares to 10 sectors rising a week earlier when only three were ahead of the composite index's 4.0% gain. The outperformers last week: Energy (3.8%), Communication Services (3.7), Financials (2.3), Consumer Discretionary (2.3), Industrials (2.0), Utilities (2.0), and Materials (1.5). The underperformers last week: Real Estate (-1.3), Consumer Staples (-1.2), Health Care (-0.6), and Information Technology (1.0). The S&P 500 is up 19.6% ytd, with all 11 sectors in positive territory and four sectors ahead of the index. Several weeks earlier, a ytd high of five sectors were ahead of the index, that many for the first time since mid-May. Information Technology is the best ytd performer, with a gain of 27.4%, ahead of Utilities (25.6), Communication Services (25.6), and Financials (20.7). These sectors are lagging the S&P 500 so far in 2024: Energy (5.7), Materials (9.6), Real Estate (10.9), Consumer Discretionary (11.6), Health Care (13.6), Consumer Staples (16.3), and Industrials (16.5).

## US Economic Indicators

**Leading Indicators** (*link*): Leading Economic Indicators (LEI) fell again in August, sinking for the sixth straight month, by 0.2% in August and 2.3% over the six-month period. The LEI has plunged 15.5% from December 2021's record high, falling near the prior-cycle low recorded during April 2020. August's LEI sank to its lowest level since October 2016. Over the six-month period between February and August 2024, the LEI fell 2.3%, smaller than the 2.7% drop over the six-month period between August 2023 and February 2024. The Conference Board notes, "Overall, the LEI continued to signal headwinds to economic growth ahead." It expects real GDP growth to lose momentum in the second half of this year as higher prices, elevated interest rates, and mounting debt erode domestic demand, though did note that lower interest rates are on the horizon, which should lower borrowing costs and support stronger economic growth. Of the 10 component of the LEI, four contributed negatively, while six contributed positively, with new orders (-0.23 ppt) posting the largest drag on the LEI—falling to its lowest level since May 2023, followed by the interest-rate spread (-0.18), consumer expectations (-0.08), and stock prices (-0.04). Partially offsetting those declines were building permits (+0.14), average manufacturing workweek (+0.06), initial claims (+0.05), nondefense capital goods orders ex-air (+0.01), and consumer goods orders (+0.01).

**Coincident Indicators** (*link*): The Coincident Economic Indicators (CEI) index increased 0.3% in August, to a new record high, after dipping 0.1% in July from June's previous record high. The CEI expanded 0.8% during the six-month period ending in August 2024, slightly above its 0.6% growth rate over the previous six-month period. All four components of August's CEI—payroll employment, personal income less transfer payments, manufacturing & trade sales, and industrial production rose during the month—with industrial production recovering most of July's decline.

**Regional M-PMIs** (*link*): The *Philadelphia district* has now released manufacturing data for September, which show its general activity index moved from contraction to expansion, though barely. This report follows the New York Fed's report, which was the first region to report on manufacturing activity for September, and it revealed that business activity in New York State expanded for the first time in nearly a year—with its general activity index (to 11.5 from -4.7) jumping to its highest reading July 2021. Turning to the *Philadelphia* survey, its general activity index (to 1.7 from -7.0) moved back into positive territory, though showed little growth, as both the shipments (-14.3 to 8.5) and new orders (-1.5 from 14.6) measures fell 22.8 points and 16.1 points, respectively, with the shipment's measure sinking to its lowest level since March 2023. Meanwhile, the employment measures improved, with employment (to 10.7 from -5.7) showing manufacturers adding to payrolls this month—for only the second time in the past three months—after mostly negative readings since March 2023. This month, more than 89% of the firms reported no change in employment levels—the highest share reporting steady employment since December 1978, while nearly 11% reported increases in payrolls while none reported decreases. The average workweek (-

13.6 from -2.3) declined at a much faster pace this month than last month. *As for pricing*, both the prices-paid (34.0 from 24.0) and prices-received (24.6 from 13.7) measures accelerated. Looking ahead, firms' broad indicators for future activity suggest more widespread expectations for growth over the next six months, with the future general activity (15.8 from 15.4) expanding at a steady pace.

**Existing Home Sales** (*link*): "Home sales were disappointing again in August, but the recent development of lower mortgage rates coupled with increasing inventory is a powerful combination that will provide the environment for sales to move higher in future months," noted Lawrence Yun, NAR's chief economist. "The home-buying process, from the initial search to getting the house keys, typically takes several months." *Existing home* sales in August fell 2.5% to 3.86mu (saar) and were 4.2% below a year ago, led by *single-family* sales, which dropped 2.8% and 3.3% over the comparable periods to 3.48mu. Existing *condominium and co-op* sales were flat in August, at 380,000 units (saar), though were 11.6% below year-ago levels. *Regionally*, existing home sales, both on a monthly and yearly basis, fell in three of the four regions and was flat in one: South (-3.9% m/m & -6.0% y/y), West (-2.7 & -1.4), Northeast (-2.0 & 0.0), and the Midwest (0.0 & -5.2%). Total *housing inventory* at the end of August was 1.35 million units, up 0.7% from July and 22.7% from last August—with unsold inventory at 4.2 months' supply at the current sales pace, up from 4.1 months in July and 3.3 months' last August. Yun noted, "The rise in inventory—and, more technically, the accompanying months' supply—implies home buyers are in a much-improved position to find the right home and at more favorable prices. However, in areas where supply remains limited, like many markets in the Northeast, sellers still appear to hold the upper hand." The *median price* of an existing home for all housing types in July was $416,700—up 3.1% y/y (from $404,200), the 14th consecutive y/y gain. Once again, all four regions posted price gains in August.

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Contact us by *email* or call 480-664-1333.

Ed Yardeni, President & Chief Investment Strategist, 516-972-7683
Eric Wallerstein, Chief Markets Strategist, 201-661-3575
Debbie Johnson, Chief Economist, 480-664-1333
Joe Abbott, Chief Quantitative Strategist, 732-241-6502
Melissa Tagg, Director of Research Projects & Operations, 516-782-9967
Mali Quintana, Senior Economist, 480-664-1333
Jackie Doherty, Contributing Editor, 917-328-6848
Valerie de la Rue, Director of Institutional Sales, 516-277-2432
Mary Fanslau, Manager of Client Services, 480-664-1333
Sandy Cohan, Senior Editor, 570-228-9102