October 15, 2024

Morning Briefing

Will Fed Get Stuck With Sticky Inflation?

Check out the accompanying chart collection.

Executive Summary: By cutting interest rates despite strong economic growth, the Fed now risks overstimulating demand and reviving inflation. Services and wage inflation remain sticky, raising the risk that headline inflation gets stuck above 2.0%. … The bond market agrees with our assessment that the Fed turned abruptly too dovish recently, boosting market expectations for long-term inflation higher. ... Now, the FOMC's obsession with the so-called neutral federal funds rate or r* may be coming back to bite them as the notion of the real federal funds rate is upended by these increased inflation expectations.

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US Economy I: Why Sticky Inflation Matters for the Real Economy. Immediately following the Fed's supersized 50bps cut to the federal funds rate (FFR) on September 18, we raised our subjectivity probability of a 1990s-style stock market meltup from a 20% to 30%.

Since then, the Bureau of Economic Analysis revised Gross Domestic Product (GDP) and Gross Domestic Income (GDI) higher. Personal savings was revised higher also thanks to better-than-expected personal income. Furthermore, the Bureau of Labor Statistics (BLS) reported a better-than-expected payroll employment gain for September and revised July and August increases higher too. September's unemployment rate fell to nearly 4.0% from 4.3% in July. Not surprisingly, the Citigroup Economic Surprise Index has climbed into positive territory in recent weeks (*Fig. 1*).

Now, Fed officials must choose. They can either leave the FFR unchanged because the economy is doing so well, or they can persist with their newly revived dovishness. If the Fed continues to cut the FFR despite the economy growing at a stronger-than-expected pace, inflation could very well remain sticky above the Fed's 2.0% target. That would put the Fed in a very tricky (and sticky) spot in terms of both signaling and communications. To ascertain how much room the Fed has to ease from current levels, let's assess the inflation outlook:

(1) *Sticky services*. Supercore inflation (core services inflation, excluding housing) was previously referred to as "possibly the most important category for understanding the future evolution of core inflation" by Fed Chair Jerome Powell. Last week, September's supercore CPI inflation ticked up from 4.3% to 4.4% y/y (*Fig.2*).

A somewhat less comparable version of supercore inflation in the PPI—PPI finished services less trade services (which represent wholesaler and retailer margins)—fell from 3.9% to 3.7% last month. Despite some progress on the producer front, both indexes point to core services inflation in the PCED remaining sticky at levels inconsistent with inflation remaining sustainably at-or-around 2.0%. The supercore PCED was up 3.3% y/y in August.

The Atlanta Fed's version of "sticky" prices, which is based on the least volatile categories of CPI, suggests the same. The sticky core CPI ex-shelter prices increased 2.9% y/y in September, while the headline sticky CPI was up 4.0%. Furthermore, the Atlanta Fed's Wage Growth Tracker increased to 4.9% y/y (*Fig.3*). Perhaps that's why Atlanta Fed President Raphael Bostic *said* on Thursday that he was open to skipping a rate cut at the Fed's November 6-7 meeting. Maybe he is more data dependent on the useful statistics that his research staff generates than are other Fed bank presidents.

(2) *Calculation quirks*. We don't think September's PCED services inflation rate will decline much from August's 3.7% y/y increase. However, it will benefit from some calculation choices by the BLS. For instance, during September, the 2.9% m/m (nsa) increase in CPI airline fares and 1.1% increase in CPI auto insurance won't be reflected in the month's PCED. Those components are derived from the PPI report, where airfare inflation fell 1.7% and auto insurance inflation rose just 0.2% m/m during September (*Fig. 4* and *Fig. 5*).

(3) *Revisions*. Revisions of key economic and inflation indicators continue to suggest that the Fed pivoted to easing too soon and by too much. On the inflation front, the PPI was revised higher for several months from May through August (*Fig. 6*). So Fed officials had even less PPI disinflation than they believed when they cut the FFR by 50bps in September.

(4) *Durable goods.* One of the biggest factors supporting overall disinflation has been deflating goods prices. CPI durable goods fell 3.7% y/y in September, thanks partly to falling import prices for Chinese goods (*Fig.7*). Consumer spending on durable goods has also been relatively weaker for the past couple years, after the buying binge during the pandemic depressed future demand. However, deflation may be entering the rearview mirror as base effects and rising demand begin to put upward pressure on durables prices (*Fig.8*).

(5) *Summary of economy projections.* Our near-term outlook for inflation remains optimistic, as it has been since mid-2022 (*Fig. 9*). That said, we disagree with the Federal Open Market Committee's (FOMC) assumption of the FFR level that is consistent with an "acceptable" headline inflation rate. In the latest Summary of Economic Projections (SEP),

the FOMC projected a 3.4% FFR and 2.2% core PCED rate by the end of next year (*Fig. 10* and *Fig.11*). In our opinion, cutting interest rates by 150bps might be inconsistent with inflation falling by 50bps from its current level.

(6) *Transitory redux*. A few economists have said that increases in various components of the September CPI are irrelevant, because either they will not filter into the PCED or they will prove transitory. Among these were airfares and insurance, as noted above, as well as the 1.2% m/m increase in the apparel category (*Fig.12*). They might be right. In our opinion, the nitty gritty details can be useful for forecasting but ultimately may be less helpful for investors with medium- to long-term time horizons. The overarching story is that if the Fed stimulates already-strong aggregate demand, inflation will likely remain sticky, if not rise. The inflation devil may not be in the details, but in the inflation picture nonetheless.

US Economy II: Why Sticky Inflation Matters for Investors. Again, in our opinion, there is now an increased risk that the Fed in effect declared mission accomplished a wee bit prematurely in the inflation fight. To understand why this matters for investors, look no further than those who wrongly believed that inflation was a blip and that the Fed would maintain ultra easy monetary policy forever (such as the asset-liability managers at Silicon Valley Bank and others). While the level changes in interest rates and bond yields will not be as drastic as they were during the latest hiking cycle, there is some risk in being wrong sided by inflation. While stocks have climbed to new records alongside rising bond yields, that relationship is less likely to continue. Let's discuss why:

(1) *Premature pivot.* The bond market has started to judge the Fed's pivot to be premature, as the 10-year Treasury yield has risen from 3.63% to 4.10% in less than a month. However, stocks haven't skipped a beat.

Since September 2022, the six-month rolling correlation between stocks and bonds has become the most positive since 1998 several times (*Fig. 13*). This correlation fell dramatically as the 10-year Treasury yield rose over the past month, largely because the Fed's rate cut and dovish guidance reduced the likelihood that economic growth slows. In other words, the Fed raised the strike price on their put and boosted stocks. The 10-year yield mostly rose as concerns of a recession waned, yet remains well below its 5.0% peak reached last fall.

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(2) *Bonds don't like volatility*. Bond returns and bond volatility tend to be very negatively correlated (*Fig.15*). Higher bond volatility can be driven by varying expectations for long-term interest rates and inflation, or increased Treasury supply.

(3) *Fiscal stimulus*. Expanding supply-side capacity has helped reduce inflationary pressures. Investments in technology and infrastructure are growing rapidly and powering broader productivity-driven growth. But the economy may now have both monetary and fiscal tailwinds at its back. If the Fed cuts rates and stimulates, demand is likely to increase quicker than supply.

If the next presidential administration also stimulates aggregate demand with fiscal policy faster than supply can keep up, there could be another inflationary shock as there was during the pandemic.

(4) *Inflation hedging*. Higher nominal growth is not bad for stocks. That said, an economy where 2.5%-3.0% inflation is tolerated after two decades of sub-2.0% inflation will create different outcomes—particularly if there is no Fed quantitative easing (QE) supporting asset prices. Quality stocks (including tech), equities linked to real assets, and gold are likely to outperform. Assets with fixed cash flow streams, such as utilities, REITS, and bonds, are likely to underperform.

The bottom line is that it is difficult to expect tame inflation when adding interest-rate cuts to fiscal deficits running hotter than 6.0% of GDP and real GDP growing at roughly 3.0% y/y (*Fig.16*). The private sector is not embarking on mass deleveraging as it was immediately following the Great Financial Crisis, having put the finishing touches on its balance sheet during the pandemic. Better yet, consumers seem to be marginally re-leveraging (*Fig.17*).

All that said, we are relatively optimistic about the outlook for inflation given the strong productivity growth that we expect to continue (*Fig. 18*). But we're mindful of the growing risk of higher inflation, or at least occasional surprises to the upside.

US Economy III: Are Fed Officials Ignoring Sticky Inflation? While a few Fed officials have noted that they're still worried about inflation, doves like New York Fed president John Williams and Chicago Fed President Austan Goolsbee are cooing the loudest. In our opinion, they are focusing on a faulty concept of the neutral and real FFRs. Let's discuss:

(1) *The Fed's biggest star.* Williams has a permanent vote on the FOMC as the head of the Fed's most important regional bank. So his view carries extra weight. He is particularly concerned with the neutral FFR—the one that does not stimulate or dampen aggregate demand. In September, the median view of Fed officials was that this neutral FFR is 2.9% over the long run, or 0.9% when adjusted for their 2.0% inflation target, which they presume will soon be achieved (*Fig. 19*). We should note that there's a wide range of long-run FFR estimates among Fed officials, anywhere from a 2.4% to 3.8% nominal rate!

As inflation has fallen, the real FFR has climbed. Adjusting the nominal FFR for the y/y percent change in the CPI, the real FFR is now around 2.9% (*Fig.20*). Officials like Williams and Goolsbee deem this rate to be excessively restrictive. So as the inflation fight is nearly won, by their judgement it is time to reduce restrictiveness by lowering the nominal FFR.

(2) *Powell Paradox*. The bond market has a different opinion thus far, agreeing with us that the Fed's 50bps cut was too much too soon. In any event, adjusting an overnight borrowing rate by the annual percentage change in inflation doesn't really make sense to us in the first place. Perhaps adjusting actual borrowing rates for households and businesses by long-

term inflation expectations better reflects how households and businesses make financing decisions.

However, unlike actual inflation falling, the market's daily measure of long-term inflation expectations has risen since the Fed cut rates. Adjusting the FFR by this measure of inflation shows the real FFR has fallen from 3.3% to 2.5% in a matter of weeks (*Fig.21*). So the Fed is unintentionally raising inflation expectations by cutting the nominal FFR. That's quite a paradox for those officials who believed interest rates were too restrictive.

(3) *Loosening financial conditions, or tightening?* The Fed's dovishness has increased expected inflation, and therefore raised benchmark Treasury yields. So households and businesses are seeing their borrowing rates rising as the Fed started easing.

We've seen plenty of commentators say that the Fed must cut rates to reduce the interest expense of the US Treasury or mortgage rates. But as the 10-year yield rises, so do the financing costs of government bond issuance and mortgage borrowing (*Fig.22* and *Fig.23*). Ultimately, both burdens fall on taxpayers.

In January, Senator Elizabeth Warren and several other senators sent a *letter* to Fed Chairman Jerome Powell arguing that high interest rates are worsening the housing unaffordability crisis. They must have forgotten that the average consumer does not borrow overnight money. In fact, very few participants in the real economy do.

Calendars

US: Tues: NY Empire State Manufacturing Index 3.40; IEA Monthly Report; Daly; Bostic. **Wed:** Import Prices -0.3%; MBA Mortgage Applications; API Weekly Crude Oil Inventories. (FXStreet estimates)

Global: Tues: Eurozone Industrial Production 1.8%m/m/-1.2%y/y; Eurozone ZEW Economic Sentiment 16.9; Germany ZEW Economic Sentiment 10.2; Germany WPI 0.2%; France CPI -1.2%m/m/1.5%y/y; Spain CPI -0.1%/m/1.7%y/y; UK Average Earnings Including & Excluding Bonus 3.8%/5.0%; UK Claimant Count Change 20.2k; UK Unemployment Rate 4.1%; Canada CPI -0.2%m/m/1.2%y/y; Japan Industrial Production -3.3%; Japan Core Machinery Orders -0.1%m/m/3.6%y/y; Nagel. **Wed:** Italy CPI -0.2%m/m/0.7%y/y; UK Headline & Core CPI 1.9%/3.4% y/y; UK Input & Output PPI -0.5%/-0.3%; Australia Unemployment Rate 4.2%; RBA Bulletin; Lagarde. (FXStreet estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Two of these three indexes had forward earnings move higher during the October 11 week. LargeCap's forward earnings rose for a second week after falling for two straight weeks for the first time since December, when it fell for three straight weeks. It's now just a whisker below its record high during the September 13 week when LargeCap snapped its 37-week streak of record-high forward earnings, which was its lengthiest string of weekly record-high forward earnings in nearly 19 years (since the November 11 week of 2005, when it hit record highs for 42 straight weeks). MidCap's rose 0.4% w/w, and is just

1.9% below its record high in early June 2022. SmallCap's dropped 0.3% w/w to 11.1% below its mid-June 2022 record. Through the week ending October 11, LargeCap's forward earnings has soared 19.0% from its 54-week low during the week of February 1, 2023; MidCap's is 6.8% above its 55-week low during the week of March 10, 2023; and SmallCap's is 2.8% 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 (9.4%, 14.0%), MidCap (-0.7, 15.9), and SmallCap (-9.5, 18.1).

S&P 500/400/600 Valuation (*link*): Valuations were mixed during the October 11 week for these three indexes but all remain at or close to their recent multi-year highs. LargeCap's forward P/E rose 0.2pt w/w to a 41-month high of 21.6 and is 1.5pts above its 14-week low of 20.1 during the August 9 week. It's also up 4.6pts from a seven-month low of 17.0 during the October 27 week and 6.5pts from its 30-month low of 15.1 at the end of September 2022, which compares to an 11-year low of 11.1 during March 2020. MidCap's forward P/E rose 0.2pt w/w to a 34-month high of 16.1 and is up 3.8pts 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 rose 0.1pt w/w to 15.5 and is just 0.1pt below its 34-month high of 15.6 during the September 27 week. It's up 4.9 pts 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.

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