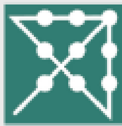
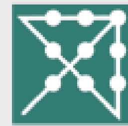
 Yardeni Research 

November 11, 2024

Morning Briefing

The Fed: Neutral Or Bust?

Check out the accompanying chart collection.

Executive Summary: Something's amiss with Fed Chair Powell's explanation for lowering the federal fund rate a second time in two months despite an economy he admits is performing remarkably well. He tied the rationale for the move to the theoretical "neutral FFR," implying that monetary policy needs to be less restrictive to reach that point, even though that point is intrinsically unknowable. Also implied was that the related risks are worth taking—including potentially overheating a strong economy, untethering inflation, and inciting a stock market meltup. Eric and Ed disagree that risking all that for an elusive goal makes sense. … Also: A few more questions they would have liked to put to Powell at his Thursday presser. ... Also: Ed reviews "Disclaimer" (+ +).

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*.

US Economy I: Looking For R-Star. Federal Reserve Chair Jerome Powell mentioned the word "neutral" 9 times at his Thursday *press conference*. He also mentioned the words "strong" or stronger" to describe the economy 20 times. There is a glaring contradiction in Powell's unsubstantiated claim that the federal funds rate (FFR) remains restrictive and needs to be lowered to its neutral rate and his assessment that the economy is strong.

With upward revisions to economic data and strong growth since the Fed cut the FFR by 50bps on September 18, Powell used his version of the neutral FFR story as justification for Thursday's 25bps cut. The neutral FFR is also sometimes referred to as "r*," or "R-Star." It's the FFR that would coincide with full employment and stable inflation at the Fed's 2.0% target over the long run.

The problem with using r* as the North Star for monetary policy is that it is unmeasurable and not constant. It's like an electron according to the Heisenberg Uncertainty Principle in physics: As soon as you think you've pinpointed where it is, it's moved. The neutral rate might be useful only as a theoretical concept for discussing how the economy changes over

time, rather than as a guide for setting short-term interest rates. In any case, Chair Powell and his colleagues on the Federal Open Market Committee (FOMC) believe that monetary policy remains restrictive since the FFR theoretically is still above this known unknown mystical level.

Here are some points Powell made that shine light on how the FOMC is thinking about the neutral rate and path of monetary policy:

(1) "*The precise timing of these things [interest rate cuts] is not as important as the overall arc of them, and the arc of them is to move from where we are now to the sense of neutral, a more neutral policy. We don't know exactly where that is, we only know it by its works. We're pretty sure it's below where we are now."*

Essentially, Powell told the financial markets not to focus as much on the meeting-by-meeting decision as on where interest rates are headed over the long run. Unfortunately, there's no way to gauge where the FFR will ultimately end up after this round of cutting is done. Market expectations have been all over the place (*Fig. 1*). After Powell's dovish speech at Jackson Hole, the futures market thought the FFR would eventually be cut to around 3.0%. By the Fed's September rate cut, the markets expected the FFR to be cut below 2.8%. As of Friday, 3.7% appears to be the finishing point.

Meanwhile, the FOMC's September 18 *Summary of Economic Projections* shows the 19 FOMC meeting participants' estimates range from 2.37% to 3.75% (*Fig. 2*). Collectively, their median estimate is to lower the FFR to 2.9% over the next couple of years. So they all agree it is lower, but they disagree on how much lower. In our opinion, the "strong" performance of the economy combined with full employment and near-target inflation strongly suggest that the FFR was at its neutral level *before* the September 18 rate cut.

It's unfortunate that no reporters asked Powell how the FOMC knows that monetary policy is restrictive if the economy is doing so well.

(2) For a Fed chief promising to deliver more rate cuts, Powell seemed remarkably optimistic on the economy: *"This is a strong economy. It's actually remarkable how well the U.S. economy has been performing with … strong growth, a strong labor market, inflation coming down. We're … really performing better than any of our global peers."*

With the FOMC so data dependent, it would be nice to know the metrics Fed officials are using to determine whether the economy is slowing or heating up. Cutting rates more than

necessary could certainly heat up a hot economy and fuel a stock market meltup; Powell didn't address any of that. There are certainly pockets of weakness in the economy, particularly in residential and commercial real estate and in some manufacturing industries. But because the Fed has achieved its dual mandate of moderating inflation and full employment with the FFR quite high, the economy is likely closer to neutral than the Fed thinks. The economy's diminished sensitivity to interest rates, strong productivity growth, and the persistent federal budget deficit all support this notion.

If we were running the Fed, we certainly wouldn't use r* as reasoning for any actions. Nevertheless, it's one blunt tool the Fed has at its disposal to justify further FFR cuts.

US Economy II: Our Questions for Powell. Aside from the r* question, there are a few other questions we would've asked Powell on Thursday:

(1) *What level of bond yields would worry you*? Powell dismissed the recent runup in bond yields. In the past, FOMC officials have noted that rising long-term yields can do the Fed's work for them by tightening financial conditions. The 10-year Treasury yield has increased from around 3.6% to 4.3% since the Fed's September meeting, a noticeable difference (*Fig. 3*). Here's what Powell had to say:

"It appears that the moves are not principally about higher inflation expectations, they're really about a sense of more likely to have stronger growth and perhaps less in the way of downside risks."

Powell also mentioned last year's mini debt crisis as reason to not panic:

"If you remember, the 5% 10-year, people were drawing massively important conclusions only to find ... three weeks later that the 10-year was 50 basis points lower. So ... it's material changes and financial conditions that last, that are persistent, that really matter. And we don't know that about these... right now it's not a major factor in how we're thinking about things."

Powell's reluctance to worry much about long-term yields has some precedent. The 10-year yield followed a similar path after the first rate cut in 1995, an easing cycle that similarly was aimed at achieving a soft landing rather than responding to a recession (*Fig. 4*). That rise in yields proved transitory as the Greenspan-led Fed cut the FFR by 75bps over six months, and economic growth continued without reviving inflation.

Nevertheless, Powell might be too dismissive of the increase in bond yields at the same time as the Fed started a new monetary easing cycle by lowering the FFR. Might it be that the Bond Vigilantes perceive that the Fed is enabling a continuation of excessively stimulative fiscal policy? He blew that concern off by mentioning the word "model" four times—as in: "We don't know what fiscal policy will be until we know it; only then can we model it." In his own words:

"Let's say Congress is considering a rewrite of the tax laws, doesn't matter what's in the content. So, we would follow that. At a certain point, we'd think we see the outline, so we'd start to model it. And then we'd wait, and we'd wait, and then at a certain point the staff would brief the FOMC and say …'[T]hese are the likely effects.'"

(2) *At what level are inflation expectations "unanchored"?* When a reporter from *The Economist* followed up to ask specifically about the increase in breakeven inflation—the difference between yields on nominal and inflation-protected TIPS—Powell said it was mostly consistent with the Fed's target:

"So we would be concerned if we … thought we saw longer-term inflation expectations anchoring at a higher level. That's not what we're seeing. … I looked at the … 5-year earlier today, and it's … consistent with two percent PCE inflation ... [W]e will not allow inflation expectations to drift upward. But that's really why we reacted so sharply back in 2022 … to avoid that."

Breakeven inflation has increased (*Fig. 5*). The contract that Powell mentions, which is tied to the five-year average inflation rate for the period five to ten years in the future, has increased to 2.58%. The ten-year breakeven inflation rate is up to 2.33%. Both are historically normal but are certainly higher than they were when the Fed cut rates in September, i.e., at 2.3.4% and 2.10%, respectively. The problem with allowing inflation expectations to rise rapidly is that if they become unanchored and get too high, they can be incredibly difficult to rein in and can lead to actual inflation. Powell knows that but was remarkably unconcerned at his presser last Thursday.

(3) *What's the best way to measure inflation?* The Fed's preferred measure of inflation is the annual percentage change in the core PCED, which was 2.7% in September. However, the Fed has often used alternative measures to "better" describe current inflation. In November 2022, this was the supercore (core services excluding housing) inflation rate (*Fig. 6*). Today, it appears to be the three- or six-month change in the core PCED rate (*Fig. 7*).

"If you look at 3- and 6-month core PCE, you'll see they're around 2.3% ... we really have made significant progress. And we expect there to be bumps. For example, … the last three months of last year their core PCE readings were very, very low, probably unsustainably low. So that's why … forecasts generally see a couple of upticks toward the end of the year. On the other hand, the January reading certainly looks like an example of residual seasonality, as we saw last year. So, when that falls out of the 12-month calculation in February, we should see it staying down."

We agree that inflation is heading in the right direction. The issue with measuring inflation in this way is that it dismisses annual price resets, which tend to occur in January. But consumers and businesses certainly notice these price changes! Looking through various price increases adds up over time, creating the cumulative inflation that consumers and small business continue to cite as their most pressing issue.

Powell also mentioned that supercore inflation, which was 3.2% y/y in September, is "back to the levels they were at the last time we had sustained 2.0% inflation, which happens to be in the early 2000s for a period of 5, 6, 7 years."

Goods and energy prices have benefited from China's export glut and weak domestic demand (*Fig. 8*). But based on the latest spending data, consumer demand for goods is rebounding in the US (*Fig. 9*). China is also stimulating its economy through various measures, including a $1.4 trillion refinancing package for local governments *announced* on Friday. So there's potential for goods prices to rise. On the other hand, US net energy exports should continue to rise under the new Trump administration, weighing on oil prices (*Fig. 10* and *Fig. 11*).

(4) *What determines the strength of the labor market?* Powell several times said the labor market was strong. But he also said that the labor market is not a source of inflationary pressures because "a broad set of indicators suggests that conditions in the labor market are now less tight than just before the pandemic in 2019."

Powell mentioned a few key metrics. He described the unemployment rate as "notably higher than it was a year ago, but [it] has edged down over the past three months and remains low at 4.1% in October." Nominal wage growth "has eased over the past year," and the jobs-to-workers gap "has narrowed."

In our opinion, the labor market is stronger than it was before the pandemic. The cooldown from record tightness can make it seem weaker than it actually is, which caused many

economists wrongly to project a hard landing or outright recession after the Fed began raising rates. But there are more job openings per unemployed worker now, *after* a record number of openings were filled (*Fig. 12*). Labor supply still hasn't fully met labor demand (*Fig. 13*). Layoffs remain historically low (*Fig. 14*). Business applications are also settling at a much higher level than pre-pandemic, suggesting job openings will remain elevated (*Fig. 15*).

(5) *Do any FOMC officials favor a pause after this meeting?* We suspect this question will be answered in FOMC officials' speeches in the coming days. We were surprised that the vote to cut the FFR was unanimous after Governor Michelle Bowman dissented in the September 18 FOMC meeting.

(6) *What paths of policy are the FOMC considering?* Powell said the Fed will determine the pace of easing based on how the economy progresses. In his words, "[W]e're trying to steer between the risk of moving too quickly and perhaps undermining our progress on inflation or moving too slowly and allowing the labor market to weaken too much. We're trying to be on a middle path …"

The only certainty is that the Fed is cutting the FFR. How quickly and to what point are open questions. We would suggest a pause in December to assess the economy. This would also provide time for gauging the markets' reactions to the range of potential new policies under President Trump's administration. Should the Fed decide to continue cutting the FFR despite a strong economy that's about to be boosted by deregulation and tax cuts, the possibility of a stock market meltup would increase. In fact, one might already be underway.

Movie. "Disclaimer" (+ +) (*link*) is a psychological thriller. The TV series is about a famed documentary journalist, Catherine Ravenscroft, played by Cate Blanchett, who is shocked by the lurid details revealed in a book based on a series of events that to took place while she was on vacation with her husband and young son in Italy several years previously. Her husband had to return to London for his job and left the two of them at the Italian beach resort. A young man drowned saving Catherine's son from a similar fate when she fell asleep on shore. The parents of the young man are heartbroken and seek revenge for the loss of their son. The voice-over is annoying, but the twists and turns are worth the ride.

Calendars

US: Mon: None. **Tues:** NFIB Small Business Optimism 91.9; Consumer Inflation Expectations; OPEC Monthly Report; Kashkari; Waller; Harker; Barkin. (FXStreet estimates)

Global: Mon: Australia NAB Business Survey; McCaul; Balz. **Tues:** Eurozone ZEW Economic Sentiment 13.2; Germany ZEW Economic Sentiment 13.2; Germany CPI 0.4%m/m/2.0%y/y; UK Claimant Count Change 30.5k; UK Unemployment Rate 4.1%; UK Average Earnings Including Bonu 3.9%; Japan Machine Tool Orders; Pill. (FXStreet estimates)

Strategy Indicators

Global Stock Markets (US$ Performance) (*link*): The US MSCI index soared 4.8% last week back to a record high. The AC World ex-US index rose 0.6% w/w and is now 5.8% below its June 15, 2021 record high. EM Asia was the best performing region last week, with a gain of 1.3%, followed by EM (1.2%), EM Latin America (1.2), EMEA (0.7), and the AC World ex-US. EMU was the worst regional performer, with a drop of 2.0%, followed by Europe (-1.9), and EAFE (0.0). Ten of the 18 major selected country markets that we follow rose last week. The US MSCI performed the best with a gain of 4.8%, followed by Japan (4.3), Taiwan (4.0), Canada (2.7), and Australia (2.6). Spain was the worst performer, falling 3.8%, followed by France (-1.9), Switzerland (-1.8), and the United Kingdom (-1.5). The US MSCI's 25.7% ytd gain remains well ahead of the AC World ex-US index's (7.0). EM Asia is still ahead of the pack as the leading region ytd with a gain of 16.0%, followed by EM (10.9) and the AC World ex-US. The worst performing regions so far in 2024: EM Latin America (-20.6), EMU (2.5), Europe (2.7), EMEA (4.0), and EAFE (4.5). Looking at the major selected country markets that we follow, Taiwan is the best ytd performer with a gain of 37.4%, followed by the United States (25.7), China (22.0), South Africa (15.6), and India (14.4). The worst performing countries ytd: Mexico (-23.3), Brazil (-22.5), Korea (-13.6), France (-4.4), and Sweden (0.6).

US Stock Indexes (*link*): All 48 of the major US stock indexes that we follow rose w/w, up from just four rising a week earlier. The Russell MidCap Growth index was the best performer, with a gain of 9.2%, ahead of S&P 600 SmallCap Pure Growth (9.1%), Russell 2000 Growth (9.0), and S&P 600 SmallCap Pure Value (8.9). The Dow Jones 15 Utilities index was the worst performer, albeit with a gain of 1.3%, followed by S&P 500 Transportation (3.5), S&P 500 LargeCap Value (3.5), S&P 100 Equal Weighted (3.8), and Russell 1000 (3.9). Looking at their ytd performances, all 48 indexes are now 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 34.5%, ahead of Russell 1000 Growth (31.5), S&P 500 LargeCap Pure Growth (31.2), Russell 3000 Growth (31.0), and S&P 100 MegaCap (29.6). The worst performing major US stock indexes ytd: S&P 500 Transportation (7.4), S&P 600 SmallCap Pure Value (7.7), S&P 400 MidCap Pure Value (8.5), and Dow Jones 20 Transports (9.2).

S&P 500 Sectors Performance (*link*): All 11 S&P 500 sectors rose last week, and five were ahead of the S&P 500's 4.7% gain. That compares to two sectors rising a week earlier when seven were ahead of the composite index's 1.4% decline. The outperformers last week: Consumer Discretionary (7.6%), Energy (6.2), Industrials (5.9), Financials (5.5), and Information Technology (5.4), Communication Services (1.5%), and Consumer Staples (-1.3). The underperformers last week: Utilities (1.2), Consumer Staples (1.2), Materials (1.5), Health Care (1.6), Real Estate (2.7), and Communication Services (3.7). The S&P 500 is up 25.7% ytd, with all 11 sectors in positive territory and three sectors ahead of the index. During the September 6 week, a ytd high of five sectors were ahead of the index for the first time since mid-May. Information Technology is now the best ytd performer, with a gain of 36.1%, ahead of Communication Services (34.9) and Financials (30.5). These sectors are lagging the S&P 500 so far in 2024: Real Estate (9.4), Health Care (10.0), Materials (10.0), Energy (12.2), Consumer Staples (14.3), Consumer Discretionary (22.8), Industrials (24.4), and Utilities (24.7).

US Economic Indicators

Productivity & Unit Labor Costs (*link*): Nonfarm productivity during Q3 recorded another healthy gain, while unit labor costs remained elevated. Productivity expanded 2.2% (saar)—vs 2.3% expected—after climbing a downwardly revised 2.1% (from 2.5%) during Q2. Output increased 3.5% (saar) during the quarter, while hours worked advanced 1.2%. *Versus a year ago*, these measures rose 2.8% and 0.7%, respectively. Unit labor costs rose 1.9% (saar) during Q2, as a 4.2% rise in hourly compensation was partially offset by the 2.2% increase in productivity. (Increases in hourly compensation tend to increase unit labor costs, and increases in productivity tend to reduce them.) *Versus a year ago*, unit labor costs rose 3.4%, accelerating from 1.2% during Q3-2023, with hourly compensation increasing 5.5% and productivity up 2.0%. Unit labor costs at the start of this year spiked 8.5% (saar) during Q1, slowing to 2.4% and 1.9% during Q2 and Q3, respectively.

Consumer Sentiment Index (*link*): Consumer sentiment is showing some signs of life in early November, climbing to a seven-month high. *Consumer sentiment* climbed from 66.4 in July to 73.0 in mid-November—considerably higher than the 71.0 expected reading.

Sentiment is now nearly 50% above June 2022's trough, though remains below pre-pandemic levels. *Expectations* drove overall sentiment higher this month, climbing from 74.1 in October to 78.5 this month—its highest level since July 2021—as a measure of households' expectations for the future climbed to its highest reading in over three years, led by brightening outlook among Republicans. Meanwhile, *current conditions* were little changed, edging down from 64.9 in October to 64.4 this month. *Turning to inflation*, *year-ahead* inflation expectations fell from 2.7% last month to 2.6% this month—the lowest since December 2020—remaining within the 2.3%-3.0% range seen in the two years pre-pandemic. *Long-run inflation expectations* ticked up from 3.0% last month to 3.1% this month, only modestly elevated relative to their pre-pandemic readings.

Global Economic Indicators

Eurozone Retail Sales (*link*): Eurozone retail sales growth eased in September, reflecting a drop in food sales and a sharp slowdown in auto fuels. *Headline retail sales* rose 0.5% (vs 0.4% expected), increasing at roughly half August's 1.1% gain. The *components of retail sales* show spending on *non-food products ex auto fuels* posted the biggest gain, climbing 1.1% in September; it has averaged monthly gains of 1.0% the past three months after contracting by 0.5% during both July and June. *Automotive fuels* increased 0.2% in September after a 1.3% jump in August; these sales fell 0.6% during the two months through July. Meanwhile, *food, drinks, and tobacco* continued the up-and-down pattern, falling 0.4% in September, following a 1.1% gain in August and a 0.1% downtick in July. September data are available for *three of the Eurozone's four largest economies*, with Germany (+1.2% m/m & +3.9% y/y) posting the strongest gain in September, followed by Spain (+1.0 & +4.3), while sales in France (-0.5 & 3.4) fell during the month. All three countries posted solid gains versus a year ago.

Germany Industrial Production (*link*): German industrial production still isn't bottoming out, continuing to bounce around recent lows. Germany's *industrial production*, which includes construction, contracted 2.5% in September, virtually reversing August's downwardly revised 2.6% gain, first reported up 2.9%. September's decline in output covered all sectors. *Within industry*, capital goods (-4.0%) production contracted at the fastest pace, followed by intermediate goods (-1.6) and consumer goods (-1.4). *Outside industry*, both energy (-2.1%) and construction (-1.4) slumped in September; excluding energy and construction, output was 2.7% below August's level and 5.2% below September 2023. *Auto* production was a big drag on growth in September, tumbling 7.8%, with *chemicals* (-4.3%) output also posting a steep decline during the month. On the plus side,

production of *machinery & equipment* expanded 1.7%.

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