January 21, 2025

Morning Briefing

Time To Recalibrate
Our Three Scenarios?

Check out the accompanying chart collection.

Executive Summary: Expectations for more rate cuts this year than previously expected buoyed both bond and stock markets last week. The prior week was bad for both markets as rate-cut expectations diminished. But last Thursday's comments by Fed Governor Waller that fueled the turnaround were wrong-headed, in our opinion. If inflation follows the course he expects down to 2.0%, the Fed's dual mandate would be achieved, so it wouldn't need to ease further. … Upon reassessing our subjective probabilities for three alternative outlooks for the economy and markets, we're sitting pat. Our base-case scenario (55% chance) remains the Roaring 2020s. … Supporting that scenario: Baby Boomers flush with wealth and spending it. … Dr Ed reviews "Nowhere Special" (+).

YRI Weekly Webcast. Join our live webcast with Q&A Tuesday 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*.

Strategy I: Waller's Dovish Coo. Last week was a good week for bonds and stocks, especially after December's cooler-than-expected PPI and CPI inflation reports on Tuesday and Wednesday, January 14 and 15. The week before was a bad week for bonds and stocks, especially after the release of December's hotter-than-expected NM-PMI and employment reports on Tuesday, January 7 and Friday, January 10.

Last week, the bond yield peaked at 4.79% on Tuesday, just before the PPI was released. It fell to 4.62% on Thursday and edged up to close the week at 4.63% (*Fig. 1*). The S&P 500 bottomed at 5827.04 after the employment report a week ago, down 1.9% for the week (*Fig. 2*). It rallied last week to close at 5996.66, up 2.9% for the week.

Pushing the yield lower last Thursday were comments by Federal Reserve Governor Christopher Waller. In a mid-day *interview* on CNBC, he said inflation "is getting close to what our 2% inflation target would be." Indeed, the CPI excluding shelter rose just 1.9% y/y during December and has been below 2.0% during 16 of the past 19 months (*Fig. 3*).

Waller concluded: “If we continue getting numbers like this, it is reasonable to think rate cuts could happen in the first half of the year ... I am optimistic that this disinflationary trend will continue, and we will get back closer to 2% a little quicker than maybe others are thinking.” Waller added that as many as three or four quarter-percentage-point rate reductions could be possible this year depending on how inflation behaves.

“If inflation is down and the labor market stays solid, you could think about restarting rate cuts several months from now ... I don’t think March could be completely ruled out,” Waller said, referring to the Fed's March 18-19 policy meeting. “If we make a lot of progress, you could do more.”

A week ago, after the employment report on Friday, the futures market signaled one 25bps cut in the federal funds rate (FFR) over the next 12 months. Now the market’s expectation is two such rate cuts (*Fig. 4*).

In any event, we still expect that the 10-year Treasury bond yield will range between 4.25% and 4.75% over the rest of the year. We continue to expect that yields above this range, closer to 2023’s high of 5.00%, will attract plenty of buyers. So far, so good.

We disagree with Waller’s assessment that the FFR remains restrictive and needs to be lowered further. However, he is a Fed governor and a voting member of the Federal Open Market Committee (FOMC), and we are not. (Message to the DOGE Boys: YRI reiterates our readiness, willingness, and ability to do the FOMC’s job for half the price.)

The Fed has achieved its dual mandate if inflation is on course to fall to 2.0%, as Waller believes, and the unemployment rate is currently 4.1% (*Fig. 5*). So why does the Fed need to lower the FFR any further? And doesn’t it matter that the bond yield has risen by as much as the FFR has been cut since September 18, signaling that the Bond Vigilantes think the Fed has made a mistake by easing (*Fig. 6*)?

Most Fed officials, including Waller, share the same conceit, namely that the neutral interest rate at which the dual mandate is achieved is around 3.0% as measured by the FFR. That’s their median projection for the FFR in the “longer run” (*Fig. 7*). The rest of the yield curve doesn’t seem to matter to them. The bond yield obviously matters a great deal to lots of borrowers. In fact, we believe that there are more reasons to believe that the neutral rate should be measured using the 10-year Treasury bond yield than the overnight bank lending rate.

This is especially true when the neutral rate is adjusted for inflation using the yearly percent change in the CPI. This adjustment makes more sense for a 10-year yield than for an overnight bank rate. Many more borrowers and lenders make their financial and economic decisions based on the former than the latter.

We can make the argument that the nominal neutral 10-year bond yield is 4.00%. The 10-year TIPS yield is currently 2.20% (*Fig. 8*). That's about the same as the 2.00% average of the inflation-adjusted 10-year yield (using the CPI inflation rate) since the late 1950s. Add back the Fed's 2.0% inflation target, and the result is a longer-run nominal yield of 4.00%, with the longer-run real yield at 2.00%. Perhaps the members of the FOMC should incorporate the opinion of the bond market in determining where the FFR should be.

Or maybe, the entire concept of the neutral interest rate is nonsense. All economists agree that it can't be measured and that it is unlikely to be a constant like "pi" in mathematics. It will change as the economy changes. It is affected not only by monetary policy but also by fiscal policy.

Trump 2.0 is about to make significant changes in immigration, regulatory, energy, and trade policies. They'll surely affect the magical, mystery neutral interest rate too. Waller addressed only one aspect of the new changes, reassuringly at that: "I don't think tariffs would have a significant impact or persistent effect on inflation."

Sounds to us as though Waller is hoping that President Donald Trump will consider appointing him Fed chair when Jerome Powell's term expires early next year.

Strategy II: Our Three Scenarios Reconsidered. We regularly assess the subjective probabilities that we assign to our three scenarios: the Roaring 2020s (55%), the Meltup 1990s (25%), and Stagflationary 1970s (20%). The last scenario, with the lowest probability currently, is our what-could-go-wrong "bucket." Our main concern since early 2022 was that geopolitical crises might cause oil prices to soar as occurred during the 1970s. Along the way, we have included other potential bearish developments for the economy, as well as for the bond and stock markets, such as overly restrictive monetary policy, a US debt crisis, a Chinese debt crisis, and more recently tariff and currency wars.

The Fed has been easing since September 18 and leaning toward easing some more. Oil prices have remained amazingly subdued despite the conflicts in the Middle East and the war between Russia and Ukraine. Oil prices have increased recently after the outgoing Biden administration toughened sanctions on Russian oil exports, but the incoming Trump administration is expected to boost US oil production. The latest ceasefire agreement between Israel and Hamas is in place.

Meanwhile, last week's drop in bond yields suggests that a US debt crisis isn't imminent.

However, the Trump administration will likely announce hefty tariff hikes today, especially on China. Recent stimulus measures by the Chinese government seem to have boosted China's real GDP at the end of last year (*Fig. 9*). During December, Chinese industrial production and real retail sales rose 6.2% and 3.7% y/y, respectively (*Fig. 10*). However, additional US tariffs on Chinese imports could exacerbate China's property-led economic woes.

On balance, we are thinking about reducing the odds of the bearish scenarios in our bucket of what could go wrong. We aren't doing that yet, but we are thinking about it. If we do so, then we will most likely increase the odds of the meltup scenario, assuming that Waller's dovish cooing last Thursday represents the majority view of the FOMC. As we've been saying since August of last year, the Fed shouldn't be stimulating an economy that doesn't need to be stimulated. That's especially so given that Trump 2.0 policies are only now about to be announced and may have lots of unanticipated consequences.

The bottom line is that we are still assigning a subjective probability of 80% to a continuation of the current bull market in stocks with our S&P 500 targets for 2025 and 2026 currently at 7000 and 8000.

Strategy III: The Wealth Effect. The consensus view among Fed officials seems to be that monetary policy remains restrictive, requiring more interest-rate cuts this year. This view doesn't square with record-high stock and home prices. The resulting positive wealth effect is undoubtedly boosting consumer spending, especially of retiring Baby Boomers, who are enjoying the windfalls in the value of their stock portfolios and homes:

(1) The latest available quarterly data show that total household net worth was $168.8 trillion at the end of Q3-2024 (*Fig. 11*). Here was the value of their assets: equity shares directly and indirectly held by market value ($55.7 trillion), owners' equity in household real estate ($35.0 trillion), pension fund reserves ($32.2 trillion), deposits and money market funds ($23.2 trillion), equity in noncorporate business ($15.6 trillion), debt securities ($6.3 trillion), and life insurance reserves ($2.1 trillion) (*Fig. 12*).

(2) Over the past 12 months through November, the median existing home price is up 4.1%

(*Fig. 13*). Since the start of the pandemic in March 2020, it is up a whopping 47.3%.

(3) Over the past 12 months through the end of December, the market capitalization of the S&P 500 is up 24.4%, and it's up 168.5% since the pandemic bottom on March 23, 2020 (*Fig. 14*).

(4) There certainly never has been such a huge positive wealth effect affecting so many millions of people as the Baby Boomers now are enjoying in their retirement years. They're likely to spend much of that wealth and leave what's left to their progeny. The Baby Boomers account for about half of the net worth of the household sector, i.e., $83.5 trillion, at the end of Q3-2024 (*Fig. 15*). The personal saving rate is likely to turn negative since they will be spending out of their retirement assets and nonlabor income rather than earned income.

Movie. "Nowhere Special" (2020, +) is a sad movie about John, a 34-year-old window washer whose wife has abandoned him and their three-year-old son. John is sick and has only a few months to live. So he must find the perfect family to adopt his young son. It's a terrible situation, but John rises to the occasion for the sake of his son. (See our movie reviews *archive*.)

Calendars

US: Tues: None. **Wed:** Leading Indicators 0.0%; MBA Mortgage Applications; Weekly Crude Oil Inventories. (FXStreet estimates)

Global: Tues: Eurozone ZEW Economic Sentiment Index 16.9; UK Unemployment Rate 4.3%; UK Employment Change 35k. **Wed:** Canada PPI 0.6%m/m; Lagarde. (FXStreet estimates)

Strategy Indicators

Global Stock Markets (US$ Performance) (*link*): The US MSCI index rose 3.0% w/w to 1.7% below its December 6 record high. The AC World ex-US index underperformed, with a 1.7% gain w/w out of a correction to 8.8% below its June 15, 2021 record high. It had been just 0.7% below its record high at the end of September. EMU was the best performing region last week, with a gain of 3.7%, followed by EM Latin America (3.2%), Europe (2.9), EAFE (1.9), EMEA (1.9), and the AC World ex-US. EM Asia was the worst regional performer, albeit with a gain of 1.0%, followed by EM (1.2). The Sweden MSCI index performed the best last week, with a gain of 5.0%, followed by Brazil (4.4), France (4.2), Germany (3.9), and South Africa (3.8). India was the worst performer, falling 1.4%, followed by Japan (-0.5), Korea (0.3), Mexico (0.7), and Australia (0.9). The US MSCI's is up 2.1% ytd, and lengthened its lead last week against the AC World ex-US (0.7). EMU is ahead of the pack as the leading region ytd with a gain of 3.9%, followed by EM Latin America (3.6), Europe (2.7), EMEA (2.3), EAFE (1.2), and the AC World ex-US. The worst performing regions so far in 2024: EM Asia (-1.3) and EM (-0.5). Looking at the major selected country markets that we follow, Korea is the best ytd performer with a gain of 6.3%, followed by Sweden (5.1), Brazil (4.8), Germany (4.4), and France (3.8). The worst performing countries ytd: India (-3.7), China (-3.3), Japan (-3.2), and Hong Kong (-2.9).

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 400 MidCap Value index was the best performer, with a gain of 4.7%, ahead of Russell MidCap Value (4.6%), S&P 400 MidCap Pure Value (4.5), S&P MidCap 400 (4.5), and Russell MidCap (4.5). The Russell 1000 Growth and Russell 300 Growth indexes, with gains of 2.2%, were the worst performers, followed by S&P Industrial Composite (2.3), S&P 100 (2.4), and Nasdaq Composite (2.4). All 48 of the indexes are now positive so far in 2025, up from just four of the 48 indexes positive a week earlier and 46 rising in 2024. The S&P 500 LargeCap Pure Growth index is in the top spot as the best performer so far in 2025, with a gain of 5.3%, ahead of S&P 400 MidCap Pure Growth (4.6), S&P 500 Transportation (4.5), S&P 400 MidCap Pure Value (4.3), and S&P 400 MidCap Growth (4.1). The worst performing major US stock indexes ytd: Russell 1000 Growth (0.4), Russell 3000 Growth (0.5), S&P Industrial Composite (1.0), S&P 600 SmallCap Pure Value (1.1), and S&P 100 (1.2).

S&P 500 Sectors Performance (*link*): All 11 S&P 500 sectors rose last week, and seven were ahead of the S&P 500's 2.9% gain. The outperformers last week: Energy (6.1%), Financials (6.1), Materials (6.0), Real Estate (4.8), Industrials (4.8), Utilities (4.3), and Consumer Discretionary (4.0). The underperformers last week: Health Care (0.3%), Consumer Staples (1.3), Communication Services (1.3), and Information Technology (1.6). The S&P 500 is up 2.0% ytd, with nine sectors in positive territory and seven sectors ahead of the index. Energy wears the crown as the best ytd performer, with a gain of 9.2%, ahead of Materials (5.0%), Industrials (4.5), Utilities (4.1), Financials (3.8), Consumer Discretionary (2.7), and Communication Services (2.0). These sectors are lagging the S&P 500 so far in 2025: Consumer Staples (-1.0), Information Technology (-0.2), Real Estate (0.9), and

Health Care (1.8).

US Economic Indicators

Retail Sales (*link*): Retail sales exited 2024 on an up note, climbing the final four months of the year. *Headline retail sales* increased 0.4% in December, slightly below the consensus estimate of 0.6%, though November's gain was revised upward from 0.6% to 0.8%. Sales were up 3.9% y/y. Autos sales advanced 0.7% in December, slowing from November's 3.1% jump. Sales *ex autos* increased 0.4%. Sales in the *control group*—which excludes autos, gasoline, building materials, and food services—jumped 0.7% in December, topping consensus forecasts of a 0.4% gain. This measure correlates closely with the consumer spending component of GDP. *Of the 13 nominal retail sales categories*, ten rose in December while three fell, with stores that gain from discretionary spending having a solid month. *December sales performance versus that of a year ago:* miscellaneous store retailers (4.3% m/m & 3.7% y/y), sporting goods & hobby stores (2.6 & 1.8), furniture & home furnishings (2.3 & 8.4), clothing & accessories stores (1.5 & 2.4), gasoline stations (1.5 & -1.2), motor vehicles & parts (0.7 & 8.4), food & beverage stores (0.8 & 3.1), electronics & appliance stores (0.4 & 5.8), general merchandise stores (0.3 & 2.6), non-store retailers (0.2 & 6.0), building materials & garden equipment (-2.0 & -1.8), food services & drinking places (-0.3 & 2.4), and health & personal care stores (-0.2 & 3.4).

Industrial Production (*link*): Industrial production surprised on the upside in December, boosted by the end of the Boeing strike. *Headline* production rose a larger-than-expected 0.9% last month—triple the consensus estimate—accelerating sharply from November's 0.2% increase. *Manufacturing* output increased 0.6% last month, triple the consensus forecast of 0.2% and above the upwardly revised increase of 0.4% in November—which was double the initial estimate. *Durable goods* manufacturing production increased 0.4% in December, led by a big gain in output of aerospace & miscellaneous transportation (6.3%), with primary metals (1.7) also posting a solid gain. Meanwhile, *nondurable manufacturing* production increased 0.7%, with gains recorded in all its subcomponents, led by petroleum & coal products (1.6%), printing & support (1.5), and apparel & leather (1.2). *By market group*, *consumer goods* output increased 0.5% for the second month, led by a 0.7% increase in consumer nondurable goods production, while consumer durable goods output slipped 0.4% during December. *Business equipment* production climbed 1.4% for the second straight month in December, following declines of 3.1% and 3.4% the prior two months—with production of *transit equipment* soaring 16.4% over the two-month period, after tanking 31.2% during the two months through October. Meanwhile, *industrial* *equipment* advanced 1.0% over the two months ending December, after sliding 2.5% over the three months ending October. Information processing equipment dropped for the fourth time in five months, by 1.6% in December and 2.0% over the period. *Defense & space equipment* output has shown little change over the past four months, but December production was 4.1% above a year ago.

Capacity Utilization (*link*): The *headline* capacity utilization rate rose to 77.6% in December after falling from 77.9% in August to 77.0% in both October and November. December's 77.6% rate was 2.1ppts below its long-run (1972-2023) average. The *manufacturing* utilization rate rose for the second month to 76.6% in December, after falling from 77.0% in August to 76.0% in October. December's rate was 1.7ppts below its long-run average. The utilization rate for mining increased from 89.5% to in 90.8% in December, 4.3ppts above its long-run average; the utilities rate edged up to 71.1% in December from 69.8% in November, well below its long-run average.

Housing Starts & Building Permits (*link*): Housing starts soared in December on a surge in multi-family starts, though single-family starts also moved higher. *Total housing starts* jumped 15.8% to 1.50mu (saar) above market expectations of 1.32mu, hitting the highest number of starts since February 2024. *Multi-family* starts skyrocketed 58.9% to 418,000 units (saar) in December, while *single-family* starts rose 3.3% to 1.05mu. Despite these gains, headline (-4.4% y/y), single-family (-2.6), and multi-family (-11.3) starts all were below their readings in December 2023. *Regionally*, total housing starts in the Northeast (40.2% m/m & 22.7% y/y) posted the biggest gains for the month of December and versus a year ago, followed by the Midwest (20.0 & 1.0) and South (17.7 & 0.1), while starts out West (-0.7 & -26.2) fell in December and versus a year ago. Meanwhile, *building permits* slipped 0.7% in December to 1.48mu (saar), with both *multi-family* (-5.8% to 437,000) and *single-family* (-2.1% to 141,000) units posting declines. *Versus a year ago*, total permits were down 3.1%, led by a 5.4% in multi-family permits, while single-family permits were 2.5% lower.

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