Financial Markets This Week

17 MAY 2024

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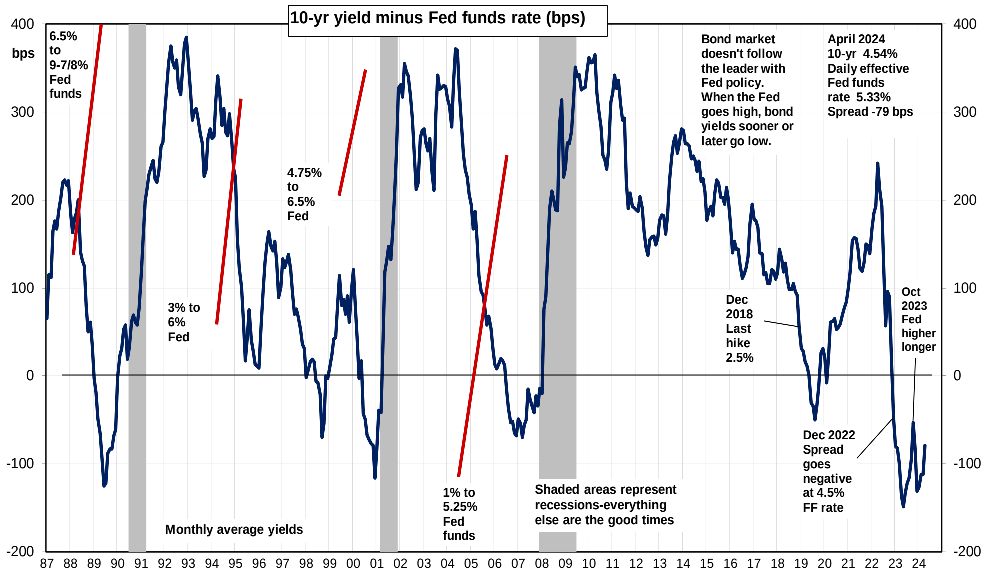
BOND YIELD PEAK



The peak in bond yields for this cycle was in October 2023 and the Fed's last rate hike to 5.5% was in July 2023. The sudden inflation outbreak in the first quarter this year did not send Treasury yields higher than the 4.80% October 2023 peak (average, see graph in Interest Rates section on page 3). Powell this week said policymakers needed to be patient on those three rate cuts they forecast this year at the March 2024 meeting. Interesting. Lots of bad news that should mean higher bond yields and yet it is not happening. 10-year yields did drop 10 bps to 4.34% on Wednesday after the good news of a slower 0.3% core CPI print and 0.0% retail sales in April.

One can make the case that 10-year yields will still trade a little above 4% even if the Fed ever does get rates down to the lower levels they have forecast: 4.0% at the end of 2025 and 3.25% at the end of 2026. Bond yields in recent decades never got much higher than the Fed funds rate peak, why bother if yields are going to come back down when the Fed eases policy back down. And bond yields do not follow the Fed rate all the way back down either: the Fed funds-10-yr Treasury curve normalizes and goes positive again after being inverted during the monetary restraint and peak Fed rates.

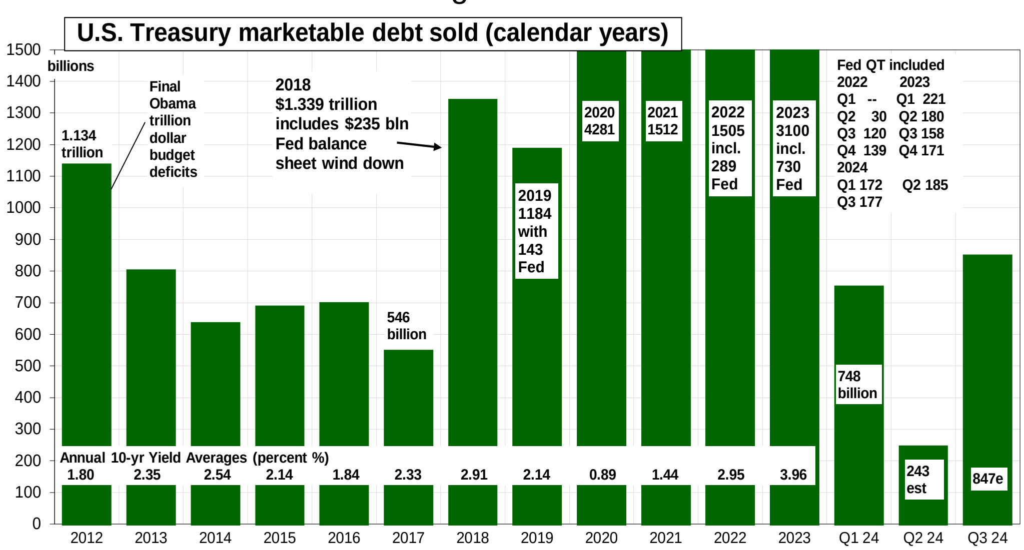
Fed rates, the backbone holding up 10-year yields, inflation, and supply/demand all go into forecasting 10-year yields. Good news on the supply. On inflation, Fed officials keep talking up the 2.0% inflation target, but 10-year yields have not cared if it goes all the way to 2.0%. Trying to figure out what inflation rate to use to price Treasuries is one unresolved problem. Powell thinks core inflation shows the way to the future. One would think bond investors would want 10-year yields to be above headline inflation of core + food + energy. April CPI headline inflation was 3.4% and core was 3.6%, so investors are getting modest real yields. March PCE headline inflation was 2.7% and core was 2.8%, so they get more real yield if they think consumer inflation is measured best by PCE. Greenspan moved the

Committee to a PCE inflation focus away from the tried-and-true CPI index over twenty years ago, but not everyone buys it. Might as well stick with CPI which is higher than PCE mostly due to the greater weight of housing. Neither CPI or PCE inflation reflects the full increase in home prices since the pandemic. There are theoretical economist kind of reasons for this, trying to figure out how people consume housing month-to-month even as the lucky ones sometimes buy just one or two homes in a lifetime. But it seems like a 40% more expensive home should somehow be reflected better in the cost-of-living, inflation data. Doesn't seem to be the case because since the pandemic recession ended in April 2020, FHFA home prices are up 47.3% (through Feb 2024), the cockamamie imputed rent-of-your-house in the PCE inflation index rose 21.7% from April 2020 through March 2024, and the same concept owners-equivalent-rent in the CPI inflation index rose 22.3% from April 2020 through April 2024. Next time there is a pandemic, buy a house. Well, the S&P 500 is up 82.1% from the end of April 2020 through Friday, May 17, 2024. Buy stocks instead.

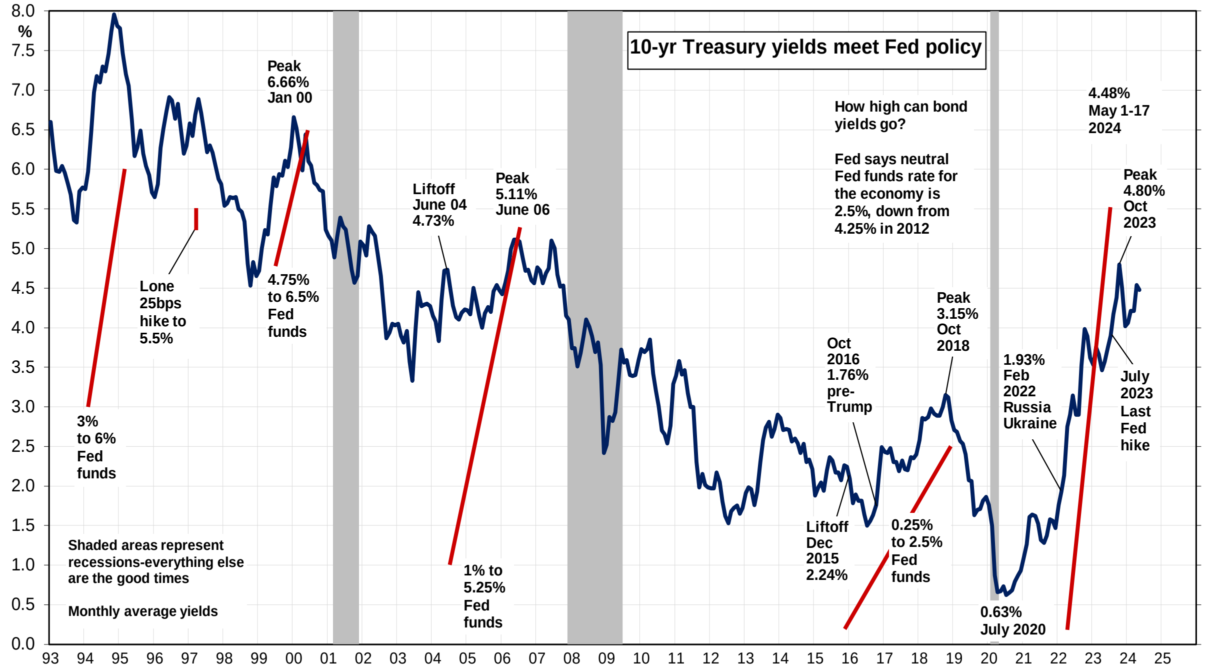
%	Core CPI	Core PCE	Diff
2002	2.4	1.7	0.7
2003	1.4	1.6	-0.2
2004	1.8	2.0	-0.2
2005	2.2	2.2	0.0
2006	2.5	2.4	0.1
2007	2.3	2.2	0.1
2008	2.3	2.0	0.3
2009	1.7	0.9	0.8
2010	1.0	1.4	-0.4
2011	1.7	1.6	0.1
2012	2.1	1.9	0.2
2013	1.8	1.5	0.3
2014	1.7	1.5	0.2
2015	1.8	1.2	0.6
2016	2.2	1.6	0.6
2017	1.8	1.6	0.2
2018	2.1	1.9	0.2
2019	2.2	1.6	0.6
2020	1.7	1.3	0.4
2021	3.6	3.6	0.0
2022	6.2	5.2	1.0
2023	4.8	4.1	0.7
2023	3.8	2.9	0.9
	2024-to March		

	10-yr Treasury Yield	Core CPI	Real Yield bps
2002	4.61	2.4	221
2003	4.01	1.4	261
2004	4.27	1.8	247
2005	4.29	2.2	209
2006	4.80	2.5	230
2007	4.63	2.3	233
2008	3.66	2.3	136
2009	3.26	1.7	156
2010	3.22	1.0	222
2011	2.78	1.7	108
2012	1.80	2.1	-30
2013	2.35	1.8	55
2014	2.54	1.7	84
2015	2.14	1.8	34
2016	1.84	2.2	-36
2017	2.33	1.8	53
2018	2.91	2.1	81
2019	2.14	2.2	-6
2020	0.89	1.7	-81
2021	1.44	3.6	-216
2022	2.95	6.2	-325
2023	3.96	4.8	-84
2024	4.36	3.8	56
	2024-to April		

This leaves supply. The national debt is rising and the trend is unsustainable, the famous people say, but you would think it is just a number on a piece of paper, the way bond investors keep buying at Treasury auctions. The Fed threw the market a bone and cut the amount of quantitative tightening at its last meeting even if they were not thinking about bond investors. Fed QT was $60 billion monthly or $720 billion a year that was tacked onto the Federal budget deficit that needed to be financed in the markets; they announced in the May 1 press statement the amount goes down to $25 billion monthly ($300 billion annual) starting June 1. That will cut a lot of the borrowing requirement this year where in 2023 Treasury raised an incredible $3.1 trillion new cash from the markets that included $730 billion of Fed QT. It wasn't in these borrowing requirements announced Monday, April 29 before the terms of the quarterly refunding on Wednesday, May 1 along with the Fed meeting press statement and press conference with Fed Chair Powell. In the first three quarters of 2024, the estimate is for $1.838 trillion, but we can subtract out $140 billion with the reduction in Fed QT. In conclusion, 10-yr yields should stay above 4% as long as the Fed does not cut rates below 3%.



INTEREST RATES



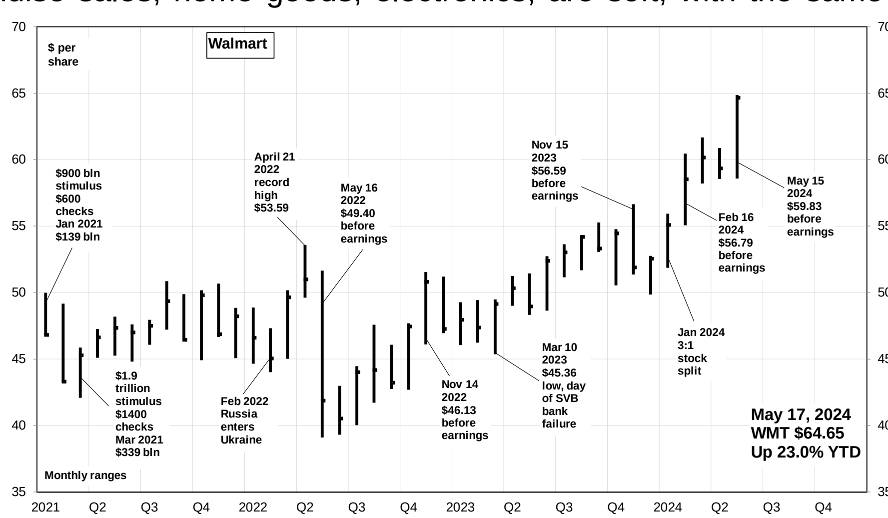
Rational markets have come down to this: Core CPI monthly percent changes Jan 0.392, Feb 0.358, Mar 3.59, Apr 0.292. Barely a tenth, 0.67 lower, but okay, it made all the difference in literally the world, enough for us to check our 401K online on Wednesday (who among us would not) after CPI and the S&P 500 1.2% advance to a record high. That was about it for the week. Jobless claims fell back 10K to 222K on Thursday disappointing those looking for recession; claims did not seem to hurt stocks as much as it helped a week ago. Finally, on Friday, the Dow industrials closed above 40,000 for the first time, and is up 6.1% YTD, while the S&P 500 closed up 11.2% YTD. Only two more inflation reports before the Fed's June 12 decision date. April core CPI that is expected to be 0.2% on Friday, May 31, and May CPI the same morning of the Fed decision later at 2pm ET.

Walmart Inc. (WMT) up 23.0% YTD

Wall Street has liked the last two earnings reports. The stock closed Friday up 8.1% after earnings reported before the open Thursday, May 16. The stock split announced in January did not hurt. Results were better than expected and the company raised the forecast for this year slightly. Revenue is up 6.0% from last year, and eCommerce is up 21%. Grocery business is picking up as the cost of dining out goes up. General merchandise sales, home goods, electronics, are soft, with the same trend of more spending on health, personal care and groceries.

Bln $	Revenue	Operating Income	Same-store Sales YOY *	13-weeks ending *
Q1 2021	138.3	6.9	6.2%	4/30/2021
Q2 2021	141.0	7.4	5.5%	7/30/2021
Q3 2021	140.5	5.8	9.9%	10/29/2021
Q4 2021	152.9	5.9	6.3%	1/29/2022
Q1 2022	141.6	5.3	4.0%	4/29/2022
Q2 2022	152.9	6.9	7.0%	7/29/2022
Q3 2022	152.8	2.7	8.5%	10/28/2022
Q4 2022	164.0	5.6	8.8%	1/27/2023
Q1 2023	152.3	6.2	7.3%	4/28/2023
Q2 2023	161.6	7.3	6.3%	7/28/2023
Q3 2023	160.8	6.2	4.7%	10/27/2023
Q4 2023	173.4	7.3	3.9%	1/26/2024
Q1 2024	161.5	6.8	3.9%	4/26/2024

* US comparable sales, incl. Sam's Club, ex-fuel

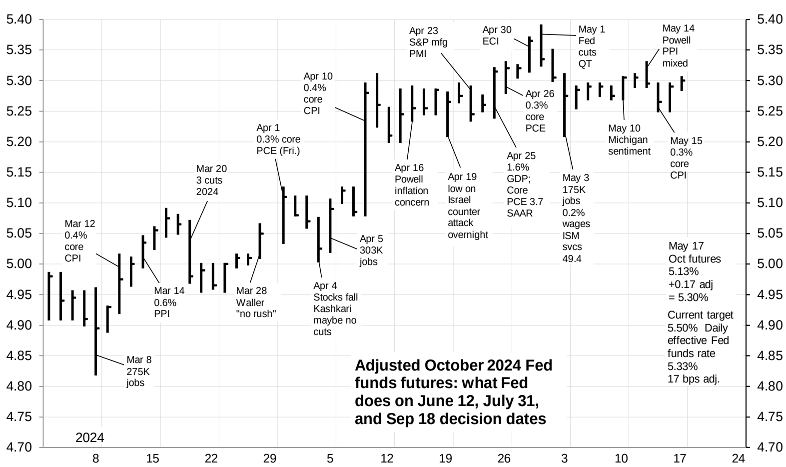


FEDERAL RESERVE POLICY

Selected Fed assets and liabilities						Change
Fed H.4.1 statistical release						from
billions, Wednesday data	15-May	8-May	1-May	24-Apr	3/11/20*	3/11/20
Factors adding reserves						to May 15
U.S. Treasury securities	4488.090	4518.691	4517.906	4539.799	2523.031	1965.059
Federal agency debt securities	2.347	2.347	2.347	2.347	2.347	0.000
Mortgage-backed securities (MBS)	2371.983	2372.049	2372.049	2384.720	1371.846	1000.137
Repurchase agreements	0.000	0.001	0.000	0.005	242.375	-242.375
Primary credit (Discount Window)	6.364	6.198	6.791	7.018	0.011	6.353
Bank Term Funding Program	109.595	112.663	124.117	125.492		
FDIC Loans to banks via Fed	0.000	0.000	0.000	0.000		
Paycheck Protection Facility	2.938	2.949	2.962	2.975		
Main Street Lending Program	13.773	14.130	14.114	14.518		
Municipal Liquidity Facility	0.000	0.000	0.000	0.000		
Term Asset-Backed Facility (TALF II)	0.000	0.000	0.000	0.000		
Central bank liquidity swaps	0.130	0.125	0.124	0.137	0.058	0.072
Federal Reserve Total Assets	7355.3	7404.5	7413.0	7453.4	4360.0	2995.245
~~3-month Libor %~~ SOFR %	5.31	5.31	5.32	5.31	1.15	4.160
Factors draining reserves						
Currency in circulation	2348.375	2348.973	2346.816	2344.784	1818.957	529.418
Term Deposit Facility	0.000	0.000	0.000	0.000	0.000	0.000
U.S. Treasury Account at Fed	706.108	816.809	890.442	929.379	372.337	333.771
Treasury credit facilities contribution	7.438	7.438	7.438	7.438		
Reverse repurchases w/others	443.779	493.427	438.148	441.215	1.325	442.454
Federal Reserve Liabilities	3938.885	4073.790	4096.104	4181.725	2580.036	1358.849
Reserve Balances (Net Liquidity)	3416.386	3330.687	3316.943	3271.706	1779.990	1636.396
Treasuries within 15 days	41.744	89.940	94.329	61.251	21.427	20.317
Treasuries 16 to 90 days	216.735	212.031	184.358	241.502	221.961	-5.226
Treasuries 91 days to 1 year	565.935	522.131	545.252	525.436	378.403	187.532
Treasuries over 1-yr to 5 years	1501.723	1506.100	1505.775	1517.921	915.101	586.622
Treasuries over 5-yrs to 10 years	643.410	678.562	678.459	684.209	327.906	315.504
Treasuries over 10-years	1518.543	1509.928	1509.733	1509.480	658.232	860.311
Note: QT starts June 1, 2022	Change	5/15/2024	6/1/2022			
U.S. Treasury securities	-1282.689	4488.090	5770.779			
Mortgage-backed securities (MBS)	-335.463	2371.983	2707.446			
**March 11, 2020 start of coronavirus lockdown of country						

The Fed meets June 11-12, 2024 to consider its monetary policy. Plenty of Fedspeak, PPI, CPI, jobless claims, but the chance of a rate cut in September remains the same. The problem is that inflation is down, but no one knows how to get it down to 2.0. It's not in a textbook. Fed Governor Bowman keeps talking about a hike, or willingness to hike rates if necessary. It may be too much to expect inflation to return to exactly 2.0. It did not fall that quickly after the early 80s inflation fight, the double-digit interest rates that threw millions out of work. Other Fed members have said they can cut rates before inflation gets to 2.0, as indeed, the March Fed forecasts show. Hard to know who will win this argument on rates. In March, the rate forecasts did show some of the 19 members were not onboard for significant rate cuts this year: two saw no rate cuts this year, two others saw one rate cut, and 5 more saw two rate cuts this year, the median was three cuts of course. Since the March meeting inflation got worse; Kashkari wondered aloud about whether there should be no cuts on April 4, Powell noted his inflation concern on April 16. It is hard to know what the right thing to do is, maybe that is why Powell is sticking with leaving interest rates where they are for now, "Let's give monetary policy more time to work." 5.5% Fed rates sure need more time to stop the housing price bubble from inflating.

Fed Policy-key variables				Long
	2024	2025	2026	Term
Fed funds	4.6	3.9	3.1	2.6
PCE inflation	2.4	2.2	2.0	2.0
Core inflation	2.6	2.2	2.0	
Unemployed	4.0	4.1	4.0	4.1
GDP	2.1	2.0	2.0	1.8
March 2024 median Fed forecasts				



August Fed funds futures say it is not looking good on a rate cut by July 31. The last trade on the day Friday for October futures discount 20 bps of one 25 bps rate cut before the election, meaning September really. 80% chance.

Fed funds futures call Fed policy	
Current target: May 17 -- 5.50%	
Rate+0.17 Contract	Fed decision dates
5.425 Aug 2024	June 12, July 31
5.300 Oct 2024	Adds Sep 18
Last trade, not settlement price	

Next up: April PCE inflation report Friday, May 31														
Monthly				2024	2023									2023
% Changes	Apr	Mar	Feb	Jan	Dec	Nov	Oct	Sep	Aug	Jul	Jun	May	Apr	Mar	Feb
Core CPI inflation	0.3	0.4	0.4	0.4	0.3	0.3	0.2	0.3	0.2	0.2	0.2	0.4	0.5	0.3	0.5
Core PCE inflation		0.3	0.3	0.5	0.2	0.1	0.1	0.3	0.1	0.1	0.2	0.3	0.3	0.3	0.4
Core PCE YOY		2.8	2.8	2.9	2.9	3.2	3.4	3.6	3.7	4.2	4.3	4.7	4.8	4.8	4.8
Core CPI YOY	3.6	3.8	3.8	3.9	3.9	4.0	4.0	4.1	4.3	4.7	4.8	5.3	5.5	5.6	5.5

OTHER ECONOMIC NEWS

PPI is hot (Tuesday)

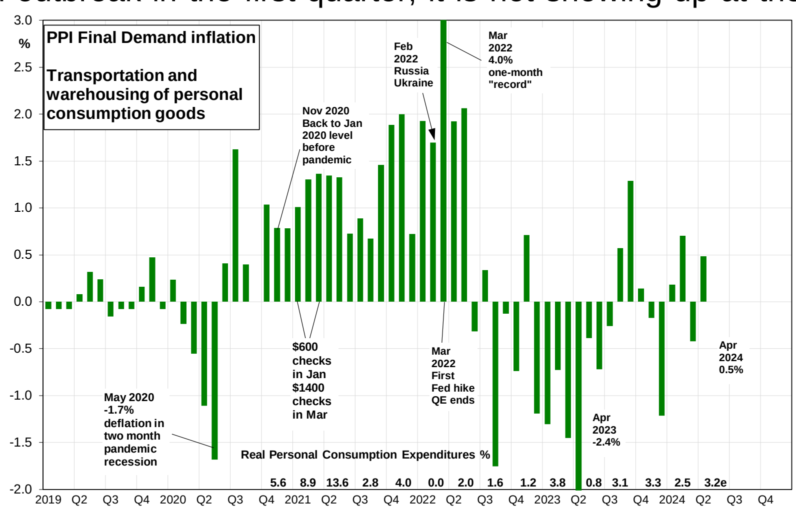
Breaking economy news. PPI jumped 0.5% in April which was a reversal from the 0.1% decline in March. The energy price rebound fueled the reversal of fortune with energy prices dropping 1.3% in March and rising 2.0% in April. Gasoline prices have been stable since mid-April so at least next month's headline PPI report should not come as a shock to markets. It is important to note that this PPI monthly rise of 0.5% in April is only 2.2% higher than a year ago; the peak of the inflation outbreak was 11.6% year-on-year in March 2022.

PPI Final demand goods less foods/energy-- Monthly Percent Changes SA	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
2023	0.6	0.3	0.2	0.1	0.1	-0.1	0.0	0.1	0.3	0.1	0.1	0.1
2024	0.2	0.4	0.0	0.3								
PPI Final demand goods less foods/energy-- Year/Year Percent Changes NSA	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
2023	5.6	5.1	4.3	3.3	2.7	2.0	1.9	1.8	2.1	2.1	2.0	1.9
2024	1.5	1.6	1.4	1.6								

PPI Final demand goods less foods and energy is like the old fashioned PPI. It did rise 0.3% in April where iron and steel scrap was 4.6%, industrial chemicals 2.6%, and industrial material handling equipment rose 2.4%. Mobile homes prices fell 0.8% if you're looking.

Net, net, inflation at the producer level is back on the front burner this month and consumers are sure to feel the heat as higher production costs will feed into the inflation they see in the goods and services they buy. The cost-of-living crisis is still a worry for Americans although the news was not all bad with much of the PPI services inflation kicked up by a massive 3.9% jump in portfolio management services that is a cost that will not be borne by those without savings or investments. Good news if you fly this summer on holiday you will be able to enjoy the lower air fares that crashed 3.8% in April. Property and casualty insurance slowed to just 0.1% in April and are 7.0% higher than a year ago. All of these category prices here go into the calculation of April PCE inflation due to be released Friday, May 31.

Not all of the PPI inflation can be explained away however because final demand goods prices less foods and energy reared its ugly head this month with a sharp 0.3% advance. If Fed officials were seeking some moderation from the inflation outbreak in the first quarter, it is not showing up at the start of the second quarter for core final demand goods. If today's report is any indication of Wednesday's consumer price index report, the bad news on inflation may completely rule out a Fed rate cut for at least the next couple of meetings. Producers see more inflation and that spells bad news for the consumer. Bet on it. The Fed will need more time than ever to wait for its monetary policy to work and cool down inflation.

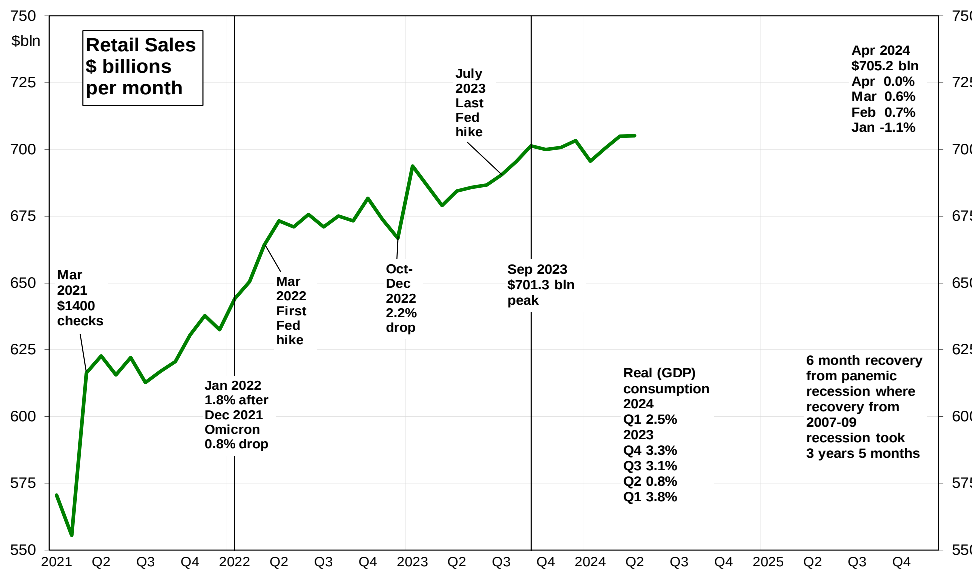


CPI and retail sales not hot (Wednesday)

Dec 23		Monthly Percent Changes			YOY %
Weight	CPI inflation	Feb 2024	Mar 2024	Apr 2024	Apr 2024
100.0	Total	0.4	0.4	0.3	3.4
13.555	Food	0.0	0.1	0.0	2.2
5.388	Food away from home	0.1	0.3	0.3	4.1
6.655	Energy	2.3	1.1	1.1	2.6
79.790	Ex-food & energy	0.4	0.4	0.3	3.6
3.684	New vehicles	-0.1	-0.2	-0.4	-0.4
2.012	Used cars/trucks	0.5	-1.1	-1.4	-6.9
2.512	Clothing	0.6	0.7	1.2	1.3
1.489	Medical care goods	0.1	0.2	0.4	2.5
36.191	Shelter	0.4	0.4	0.4	5.5
26.769	Owner equiv. rent	0.4	0.4	0.4	5.8
6.294	Transportation	1.4	1.5	0.9	11.2
6.515	Medical care services	-0.1	0.6	0.4	2.7
	Special: Where inflation might come back down to				
60.899	Services ex-energy	0.5	0.5	0.4	5.3
18.891	Commodities (core)	0.1	-0.2	-0.1	-1.3

Breaking economy news. April CPI rose 0.3% for the month and 3.4% from a year ago. April core CPI rose 0.3% and is 3.6% higher than last year. Shelter costs have slowed to 0.4% monthly changes in February, March and April which is a 4.8% annual rate, slightly slower than the April 5.5% year-on-year rate. Clothing prices are higher for some reason recently, up 1.2% in April. Motor vehicle insurance is up 1.8% this month after rising 2.6% in March and is 22.6% higher than a year ago. On a year-year basis, car repair is up 7.6%, and you smokers saw 6.7% higher prices; weakness from used cars and trucks -6.9% and air fares -5.8%.

Retail sales were unchanged in April, but there were revisions to prior months. Q1 2024 was 0.2% and is now -0.5% SAAR, and the second quarter of 2024 was looking like 3.2% and now is running 2.8% with today's report for April. Consumer spending is still firm as consumers focus their spending on services which is not really in the retail sales report besides dining out.



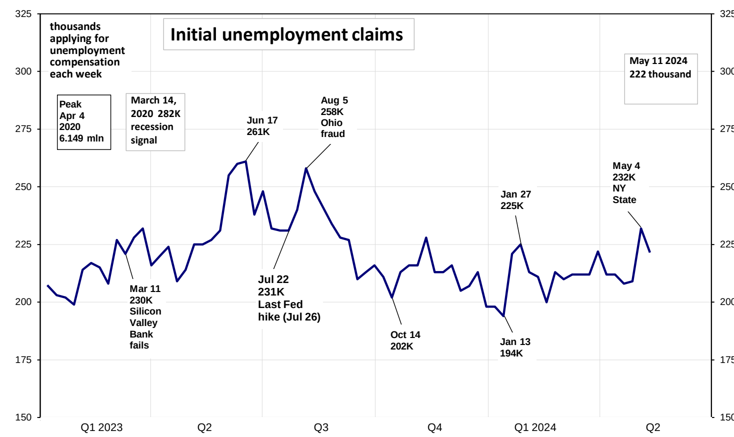
Net, net, a great sigh of relief is heard in markets around the world as core CPI inflation that Powell follows closely slowed to 0.3% in April after a hot first quarter. It was a solid 0.3% as well with the three-decimal change at 0.292 following March's 0.359% reading that was barely 0.4% to begin with. Maybe not exactly what Fed officials want to see, but inflation is certainly on its way to getting there, especially if April core PCE data slows to 0.2% in a couple of weeks. One tenth makes all the difference in the world, and yesterday's PPI report is now dead and buried in the market's collective consciousness. Stay tuned. The economic data are picture perfect this morning in favor of interest rate cuts with retail sales unchanged and inflation cooling and slowing down from the worrisome first quarter pace. The country is not out of the woods from the threat of inflation, but we can start to see the end of the forest and the better days that surely lie ahead for all Americans, rich and poor alike.

Economy less cool today (Thursday)

Breaking economy news. Housing construction, jobless claims, import prices, industrial production. Residential housing starts rose 5.7% to 1.360 million in April thanks to a 31.4% jump in the construction of 5 units or more. Single-family units dropped modestly by 0.4%, but that was almost entirely due to starts in the Northeast that could be weather-related. Meanwhile, the immediate threat to the labor market went away this week as initial jobless claims fell back to earth. Weekly jobless claims fell from 232K last week to 222K in the May 11 week. New York figured prominently pushing up claims the prior week and bringing down the nationwide layoffs figure this week. Not seasonally adjusted jobless claims fell 13,325 in the May 11 week and New York claims fell 9,442. False alarm so don't get your recession hopes up. Fed officials will not be cutting rates because of a weakening employment market.

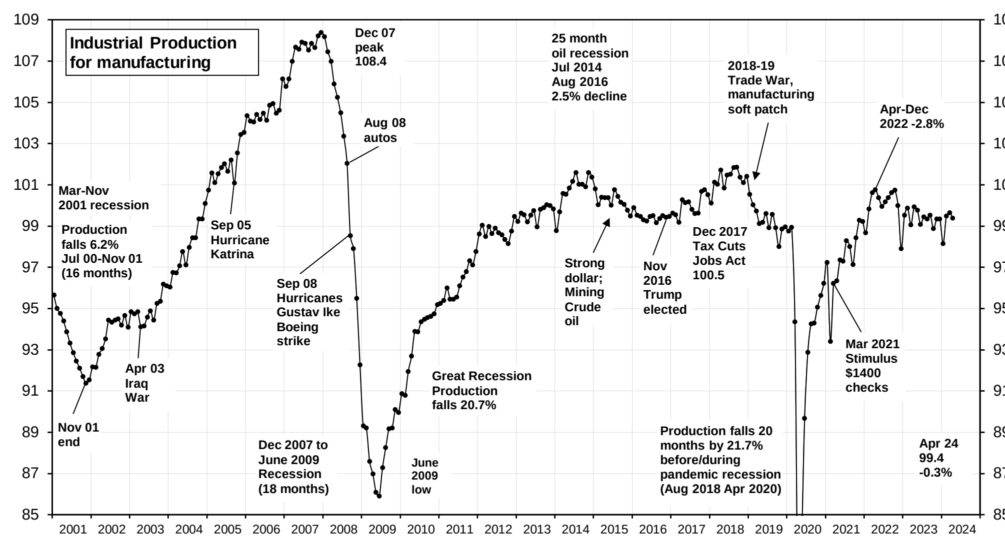
Housing Starts Total, Single-Family, Multi-Family

	United States			Northeast		Midwest		South		West	
000s	Total	1 unit	Multi	Total	1 unit	Total	1 unit	Total	1 unit	Total	1 unit
Apr 2024	1360	1031	322	72	57	181	131	799	611	308	232
Mar 2024	1287	1035	245	93	66	152	132	726	612	316	225
Apr 2023	1368	876	480	128	63	175	93	762	524	303	196
% Chgs											
Apr/Mar	5.7	-0.4	…	-22.6	-13.6	19.1	-0.8	10.1	-0.2	-2.5	3.1
Apr/Apr	-0.6	17.7	…	-43.8	-9.5	3.4	40.9	4.9	16.6	1.7	18.4



Inflation imported from overseas grew worse in April with nonfuel import prices jumping 0.7%. The Fed cannot win its battle with inflation here in this country if higher-priced imports are coming in from overseas. Apr 0.7, Mar 0.2, Feb 0.1, Jan 0.6, Dec 0.1, Nov 0.1, Oct -0.2

Manufacturing industrial production actually fell 0.3% in April, and the increase in March was revised three-tenths lower to 0.2%. If the Inflation Reduction Act signed way back in August 2022 was supposed to be stimulating the economy, US factory output is not seeing it. Same goes for the CHIPS Act.



Industrial production was unchanged in April. Manufacturing industrial production fell 0.3% in April, but would have fallen just 0.1% without the decline in motor vehicle and parts output. Utilities output jumped 2.8% to keep the entire industrial production index unchanged. The production data are stable for the most part, neither adding much to GDP growth or subtracting from it.

Net, net, home builders don’t look overly confident about the outlook as the number of new permits taken out to build single-family homes keeps dropping. One unit housing starts remain near the highs of the year, but the pipeline for new starts is not as full as permits continue to fall back. Whether one looks at starts or permits, there is still not enough affordable housing in the country so the housing price bubble should continue.

The economy may not be cooling down as much as we thought as the labor market is not rebalancing and higher import prices keep consumer prices higher than workers would like. Manufacturing production is down, but it has shown a sideways trend for over a year now. Taking the data as a whole, Fed officials will not rush out to cut rates next month given inflation pressures remain, the labor market is firm, and residential housing starts look healthy. There is no need to cut rates to jumpstart economic growth and there is still a risk of inflation pressures from higher priced imported goods coming into the country. The labor market is not rebalancing and the Fed’s 4.1% unemployment rate forecast in 2025 is looking less likely. Stay tuned. Story developing.

Analyst Certification

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