Financial Markets This Week

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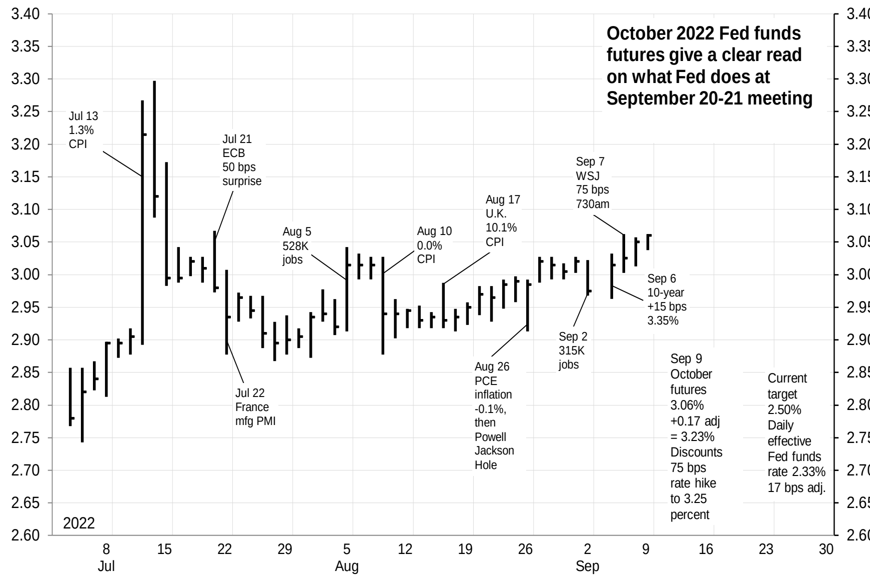
SIMON SAYS 75 BPS



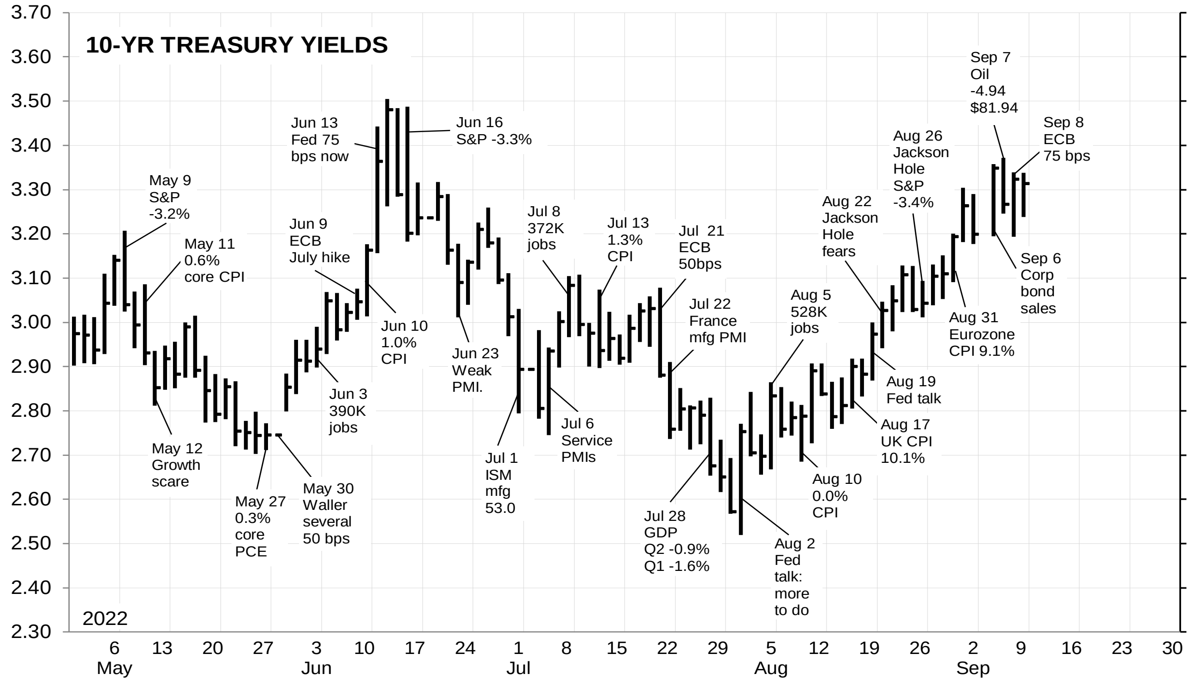
Sounds good to us, gung ho, get on with it, the job isn't done stuff. Powell spoke again on Thursday shortly after 9am ET, a discussion, no prepared remarks. October Fed funds futures didn't give a green light last Friday, but now they have. Up, up and away. 75 bps to 3.25% on September 21 is now just about discounted. Sounds attractive to us, if it isn't wrecking the economy, these front-loaded rate hikes, and we will eagerly wait to check our financial statements to see what rate of interest our financial institution is paying on our savings accounts. It probably won't be 3.25%, but at least it is starting to move upward. Beats the stock market.

Selected Fed assets and liabilities Fed H.4.1 statistical release billions, Wednesday data	7-Sep	31-Aug	24-Aug	17-Aug	3/11/20*	Change from 3/11/20 to Sep 7
Factors adding reserves						
U.S. Treasury securities	5690.760	5694.997	5700.628	5699.175	2523.031	3167.729
Federal agency debt securities	2.347	2.347	2.347	2.347	2.347	0.000
Mortgage-backed securities (MBS)	2709.291	2709.288	2725.906	2727.473	1371.846	1337.445
Repurchase agreements	0.005	0.000	0.000	0.000	242.375	-242.370
Primary credit (Discount Window)	3.677	5.251	3.570	2.657	0.011	3.666
Paycheck Protection Facility	14.744	14.969	15.188	15.469		
Main Street Lending Program	25.950	25.933	25.917	25.902		
Municipal Liquidity Facility	5.558	5.556	5.554	5.552		
Term Asset-Backed Facility (TALF II)	2.145	2.144	2.160	2.159		
Central bank liquidity swaps	0.197	0.171	0.166	0.189	0.058	0.139
Federal Reserve Total Assets	8872.2	8874.9	8901.2	8899.5	4360.0	4512.145
~~3 month Libor %~~ SOFR %	2.28	2.29	2.27	2.29	1.15	1.130
Factors draining reserves						
Currency in circulation	2284.279	2278.728	2276.186	2276.370	1818.957	465.322
Term Deposit Facility	0.000	0.000	0.000	0.000	0.000	0.000
U.S. Treasury Account at Fed	582.921	669.911	530.196	539.278	372.337	210.584
Treasury credit facilities contribution	17.940	17.940	17.940	17.940		
Reverse repurchases w/others	2206.987	2251.025	2237.072	2199.631	1.325	2205.662
Federal Reserve Liabilities	5600.835	5759.087	5630.283	5565.800	2580.036	3020.799
Reserve Balances (Net Liquidity)	3271.336	3115.846	3270.912	3333.695	1779.990	1491.346
Treasuries within 15 days	48.969	59.696	78.233	78.277	21.427	27.542
Treasuries 16 to 90 days	366.228	317.001	324.425	323.810	221.961	144.267
Treasuries 91 days to 1 year	809.289	852.012	819.487	819.992	378.403	430.886
Treasuries over 1-yr to 5 years	2010.475	2010.480	2017.728	2017.163	915.101	1095.374
Treasuries over 5-yrs to 10 years	1000.932	1000.936	1009.321	986.738	327.906	673.026
Treasuries over 10-years	1454.868	1454.871	1451.434	1473.195	658.232	796.636
Note: QT starts June 1	Change	7-Sep	1-Jun			
U.S. Treasury securities	-80.019	5690.760	5770.779			
Mortgage-backed securities (MBS)	1.845	2709.291	2707.446			
**March 11, 2020 start of coronavirus lockdown of country						

Lots of cross currents this week, but when you think about it, October Fed funds futures only rose 8.5 bps this week, but that is enough to discount a 75 bps move in two weeks at the September 20-21 meeting. The odds came down last Friday after the softer monthly employment situation report, but started rising immediately on Tuesday after the Labor Day weekend. On Tuesday, conviction was growing for a 75 bps ECB rate hike on Thursday, and 10-yr Treasury yields rose sharply, in part due to the heavy corporate bond calendar with hedge sales after the August "summer break." Friday Fed speak was heavy with plenty of ex-Fed speakers pounding the table for 4% rates as well. October Fed funds futures closed up just slightly higher on Friday, and actually ended up at the level hit on a Wall Street Journal story at 730am ET on Wednesday, a level that didn't hold on the day.

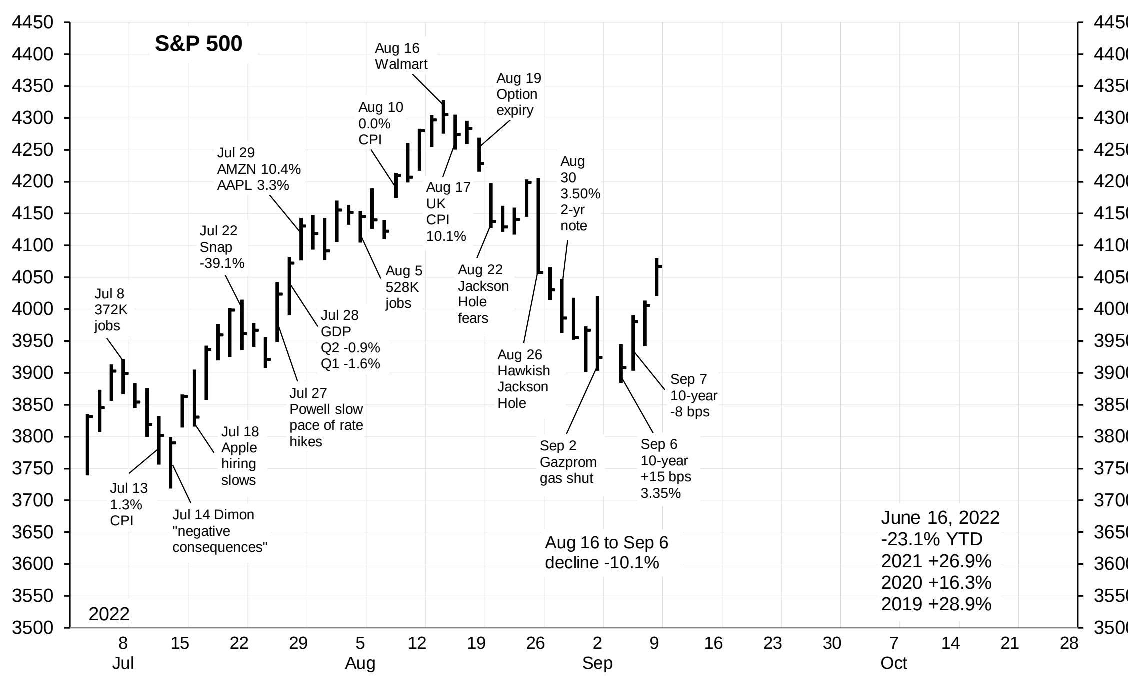
75 bps is this week's consensus. Let's see if it sticks after another zero monthly CPI inflation report on Tuesday, September 13. As far as the final two Fed meetings, rates are now in line with the view that the Fed lifts rates 50 bps in November, and 25 bps in December ending the year at 4%. Fed Governor Waller headlines at 12noon Friday, "may need to lift rates well above 4%," sent January Fed funds futures down sharply to end the week at 4.045% (adjusted). Stay tuned.

INTEREST RATES



Treasury yields rose this week. More talk of the Fed funds rate going to 4.0% this year, but yields still don't know how to price this or won't. In other Fed tightening cycles, 10-year yields have tended to stop around the same level as the Fed's final rate hike. Maybe bonds think inflation has peaked, or perhaps traders are weighing the risk of a sharper economic slowdown. Canada isn't too far north of us and we were surprised to see employment has dropped 3 months in a row: a recession sign.

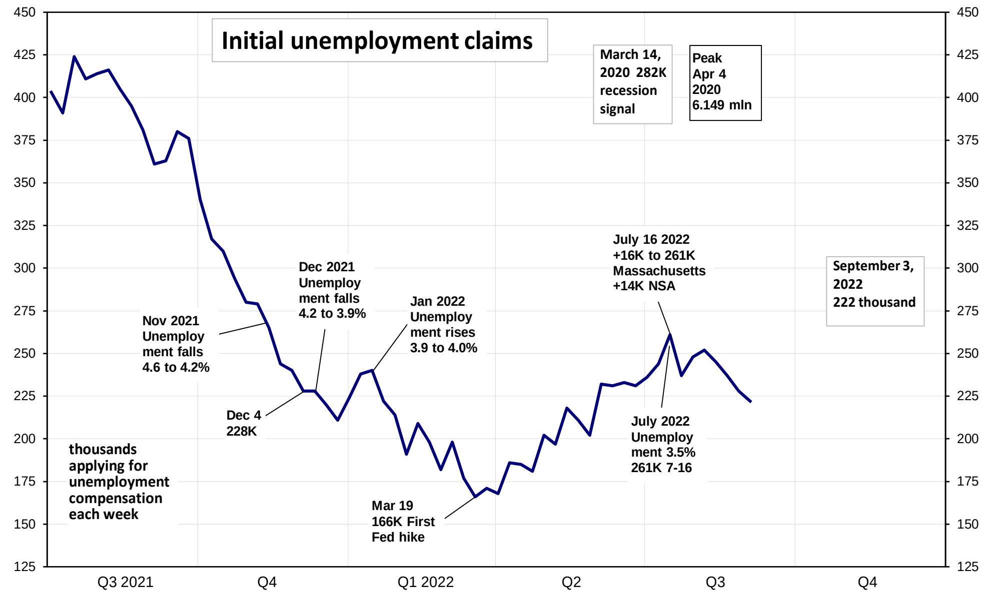
STOCK MARKET



Stocks rallied back after falling 10% since mid-August. Far enough. The low was Tuesday with 10-year yields jumping 15 bps and the dollar hitting new highs. Most of the move looks technical, the downtrend line from August broke on Friday's close. Wonder what the Minneapolis Fed President thinks after being happy to see stocks fall 3.4% after Jackson Hole. Probably not a good policy for the Fed to hope for a weak stock market. Stocks do tend to look a year or two down the road.

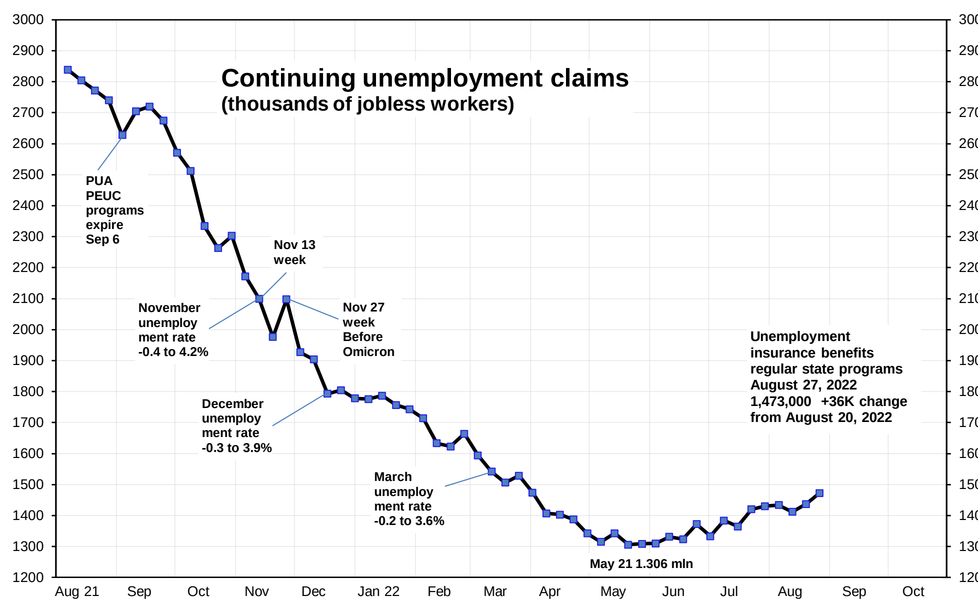
OTHER ECONOMIC NEWS

Claims down, recession warning falls flat (Thursday)



Breaking economy news. First-time jobless claims are 222K in the September 3 week ahead of the Labor Day weekend. Another downward revision to the week before where 232K in the August 27 week is now 228K. How low can they go after being over 260 thousand in the middle of July which means there is much less stress in the labor market than there was in the middle of the summer. The recession warning lights flashing red are barely caution yellow at the moment unless the Fed raises interest rates higher and faster to slow the economy down.

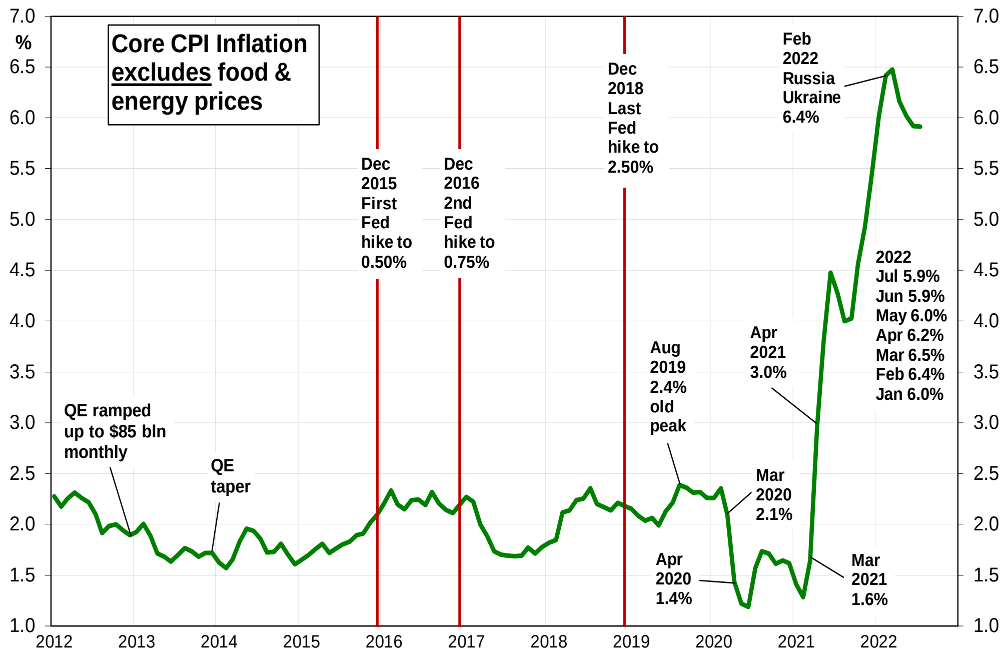
The only good news for recession buffs in the report is the 36K jump in the total unemployment rolls to 1.473 million in the August 27 week. The rise in the total pool of jobless receiving benefits means the jump in the unemployment rate in August to 3.7% from 3.5% in July was not a fluke. Maybe there isn't a lot of firing going on, or at least the job losers cannot apply for unemployment benefits, but the rise in the jobless pool may indicate it isn't as easy to find a new job which supports the anecdotal reports of CEOs telling managers not to fill their posted job openings.



Net, net, if there is any quiet firing going on out there in the country, the Labor Department statistics can't hear or find it. The market's recession fears will wither and die on the vine if first-time jobless claims don't start picking back up in the weeks ahead as summer turns to fall. The Fed is likely to see these jobs data as signaling they still have more work to do and falling jobless claims are definitely data in the camp arguing for a third 75 bps rate hike in a couple of weeks. The ECB did it. The Bank of Canada did it. Why not? Claims are down, the recession warnings fell flat, giving the green light for the Fed to tighten monetary policy as much as they please.

August CPI due Tuesday, September 13, this is what we said last month

FALLING GASOLINE PRICES REDUCE INFLATION TO ZERO

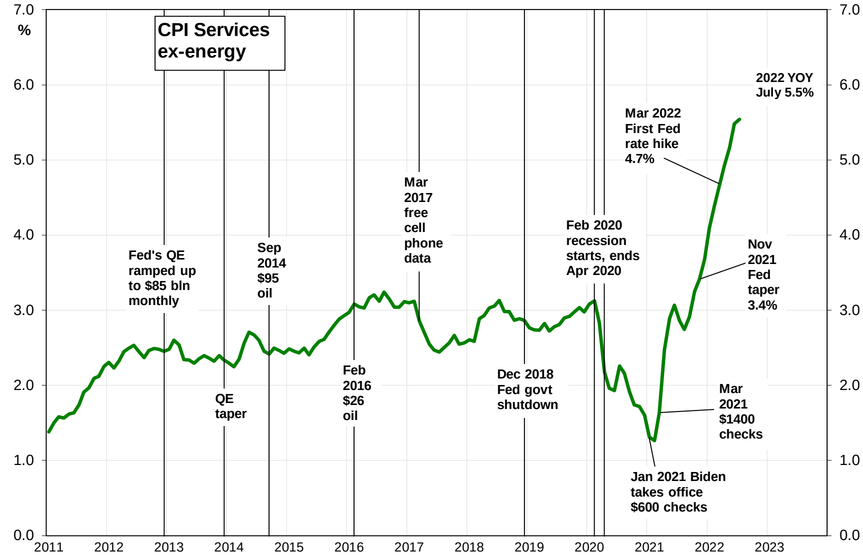


Headline CPI inflation was unchanged this month, 0.0% in July, after a 1.3% jump in June. The stock market was happy even with Fed officials less so. Regulators are never happy, and while they smiled, they also said the Fed funds rate is still on its march upward to near 4% from 2.5% currently. Anyway, for this month, when it comes to inflation, live by the sword, die by the sword, gasoline prices with their 5.227% weight in the CPI basket of goods and services (not mine, I take the train) rose 11.2% in June and fell 7.7% in July. More inflation suppression from gasoline is coming with [AAA gas prices] $3.978 currently, down 20.7% from the June 14 peak of $5.016. A 5.227% gasoline weight on the 7.7% decline this month cuts 0.4 percentage point off headline CPI inflation all on its own. For the August CPI report to be released Tuesday, September 13, it looks like falling gasoline prices will subtract 0.6 percentage point from headline CPI which should produce another 0.0% month assuming core inflation doesn't increase too much more than the relatively modest 0.3% monthly change in July, and food prices don't accelerate from the 1.1% monthly increase in July.

Jun 22		Monthly Percent Changes			YOY %
Weight	CPI inflation	May 2022	Jun 2022	Jul 2022	Jul 2022
100.0	Total	1.0	1.3	0.0	8.5
13.372	Food	1.2	1.0	1.1	10.9
5.077	Food away from home	0.7	0.9	0.7	7.6
9.200	Energy	3.9	7.5	-4.6	32.9
77.428	Ex-food & energy	0.6	0.7	0.3	5.9
3.999	New vehicles	1.0	0.7	0.6	10.4
4.008	Used cars/trucks	1.8	1.6	-0.4	6.6
2.419	Clothing	0.7	0.8	-0.1	5.1
1.465	Medical care goods	0.3	0.4	0.6	3.7
32.065	Shelter	0.6	0.6	0.5	5.7
23.502	Owner equiv. rent	0.6	0.7	0.6	5.8
5.900	Transportation	1.3	2.1	-0.5	9.2
6.772	Medical care services	0.4	0.7	0.4	5.1
	Special: Where inflation might come back down to				
56.306	Services ex-energy	0.6	0.7	0.4	5.5

The Fed cannot do much about food or energy prices is the thinking, so the focus is on the July 5.9% year-year rise in core CPI if policymakers want to return inflation to their 2% target. Among core prices shelter rose 5.7% year-year which is about 40% of core inflation. Same story. Shelter costs of 5.7%

runs counter to the common sense observation of home prices rising 20 percent the last year. Other notable core price increases year-on-year are new vehicles +10.4%, used cars and trucks +6.6%, motor vehicle insurance +7.4%, and airline fares +27.7%. Only used cars and trucks and airline fares could be slowing with actual declines recorded in July.



Where will inflation settle in at? How entrenched is the problem? Services prices ex-energy (electricity and gas used in your home or apartment) are one measure of how sticky the inflation problem might be. Careful interpretation is required. No twitter quips allowed. CPI services ex-energy are up 5.5% year-year in July, increasing from 3.4% last November when the Fed started tapering and 4.7% in March 2022 with the first Fed rate hike for the cycle. Core services prices were fairly steady at call it 2.5 to 3.0 percent from 2016 up until the 2020 pandemic. The Fed thought they had a too-low inflation problem for much of that time or at least some officials thought that in 2012 to 2015 certainly. Maybe if the Fed wants PCE inflation to return to 2.0%, then perhaps CPI core services should be targeted at 2.5-3.0 percent. Slowing aggregate demand in 2020 brought these prices down close to 1%, but that was the pandemic where demand didn't just slow, it plummeted, and that won't happen again.

To conclude, the inflation story is still spinning. Headline CPI was 0.0%, but other than energy prices, few commodities or services that consumers purchase were zero or down in July. Airline fares fell 7.8%, coming back down finally after all summer holidaymakers already bought their tickets. Clothing fell 0.1% as stores had the wrong merchandise out on the floor and had to discount, especially with millennials refusing to go back to the office/work, office/work, office/work. Used cars and trucks also fell 0.4%. The final thought to remember is the Fed targets PCE inflation not CPI. They chose the measure that always finds less inflation in the economy decades ago under Fed Chairman Greenspan.

Core Consumer Inflation and stickier services prices ex-energy

Monthly	2022						2022	2021									2021
% Changes	Jul	Jun	May	Apr	Mar	Feb	Jan	Dec	Nov	Oct	Sep	Aug	Jul	Jun	May	Apr	Mar
Core CPI inflation	0.3	0.7	0.6	0.6	0.3	0.5	0.6	0.6	0.5	0.6	0.3	0.2	0.3	0.8	0.7	0.9	0.3
Services x-energy	0.4	0.7	0.6	0.7	0.6	0.5	0.4	0.3	0.4	0.4	0.2	0.1	0.3	0.4	0.4	0.5	0.3
Core PCE inflation		0.6	0.3	0.3	0.3	0.3	0.5	0.5	0.5	0.5	0.2	0.3	0.3	0.5	0.6	0.6	0.4
Services x-energy		0.6	0.4	0.4	0.4	0.3	0.3	0.4	0.5	0.3	0.2	0.3	0.4	0.4	0.4	0.4	0.5

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