Financial Markets This Week

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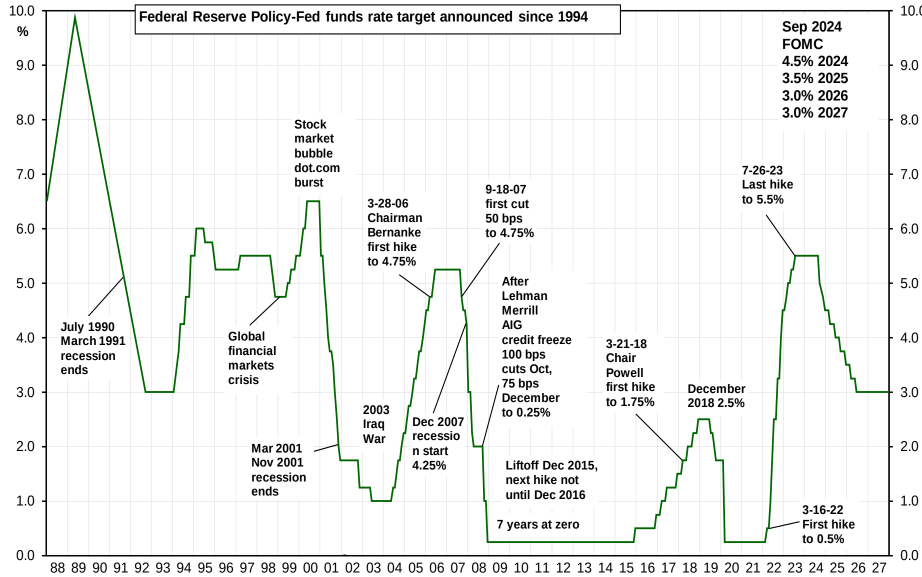
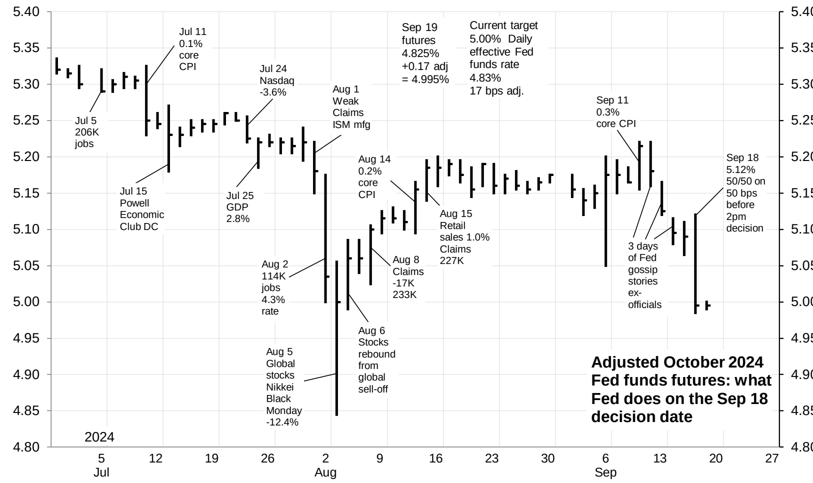
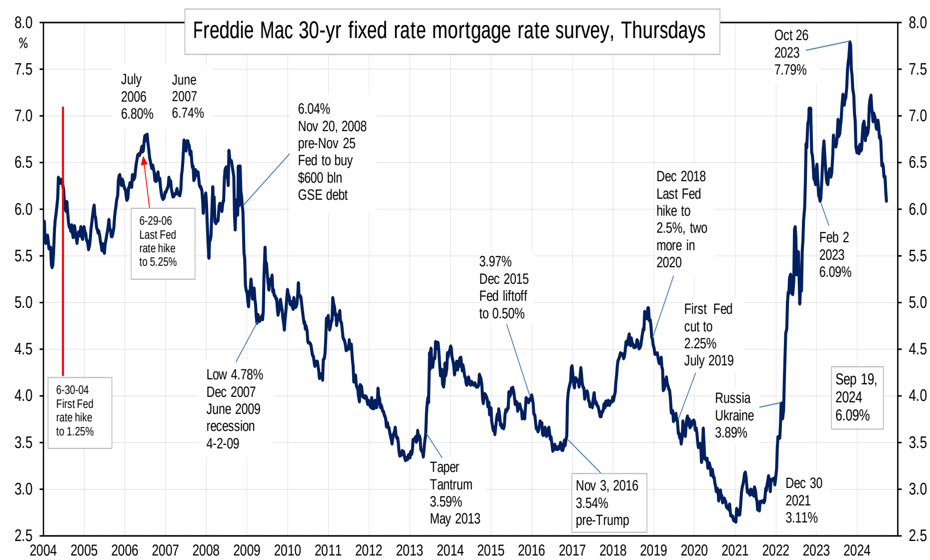
50 BASIS POINTS



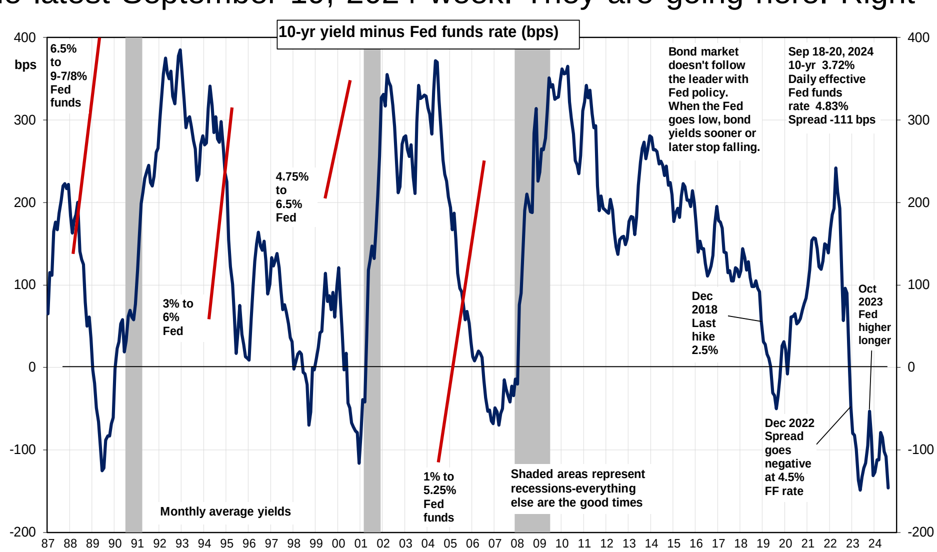
We were shocked. Fed cut rates 50 bps to 5.0%. If GDP growth is close to 3% in the third quarter, the 5.5% level of Fed rates since July 2023 does not appear to be restrictive. Maybe things are good and Powell wants to keep it that way as he said. Or maybe something more like the two tenths rise in the unemployment rate to 4.3% two days after the prior meeting's July 31 press conference made him more concerned about the downside risks to employment. He did say in the press conference on Wednesday they may well have cut interest rates in July if they had known the July employment report. There is some thinking Fed funds futures "told them what to do" when the contract turned around more to the side of favoring 50 bps at times late last week on Fed 50 bps gossip news stories, after virtually ruling it out following last week's higher-inflation 0.3% CPI report to 3.2% year-on-year. Powell said we do what we think is right for the economy, not what Fed funds futures tell them to do. The Fed individual forecasts were probably mostly set by late last week where the median says the Fed rate will be 4.5% by December: 19 votes where 9 said 4.5% and 7 said 4.75%. Quite a few, 9 participants, don't want to cut more than 25 bps more with two FOMC meetings left this year with votes on November 7 (election Tuesday, November 5) and December 18. Powell said 50 bps was a strong start but did not necessarily expect cuts at that pace to continue. It depends on the data as usual and there are two more monthly employment reports before the November meeting. That's good because the forecast looks split between 25 bps or 50 bps more at one or both of the final two meetings of the year. Strong start indeed. The S&P 500 was up as much as 1.0% to record highs on the Wednesday Fed news in the first couple of minutes before closing down 0.3% on the day. Thursday's rebound started early; Europe stocks up 0.9% at their opening.

Fed Individual Forecasts					
Fed funds rate at year-end					Longer
Votes	2024 End	2025 End	2026 End	2027 End	run
1	4.125	2.875	2.375	2.375	2.375
2	4.375	2.875	2.625	2.375	2.500
3	4.375	3.125	2.625	2.625	2.500
4	4.375	3.125	2.625	2.625	2.500
5	4.375	3.125	2.875	2.625	2.625
6	4.375	3.125	2.875	2.875	2.750
7	4.375	3.125	2.875	2.875	2.750
8	4.375	3.125	2.875	2.875	2.750
9	4.375	3.375	2.875	2.875	2.875
10	4.375	3.375	2.875	2.875	2.875
11	4.625	3.375	3.125	3.125	3.000
12	4.625	3.375	3.125	3.125	3.000
13	4.625	3.375	3.375	3.375	3.250
14	4.625	3.375	3.375	3.375	3.375
15	4.625	3.625	3.375	3.375	3.375
16	4.625	3.625	3.625	3.625	3.500
17	4.625	3.625	3.625	3.625	3.500
18	4.875	3.875	3.625	3.625	3.625
19	4.875	4.125	3.875	3.875	3.750
Median	4.375	3.375	2.875	2.875	2.875
Meeting	Sep 24	Sep 24	Sep 24	Sep 24	Sep 24



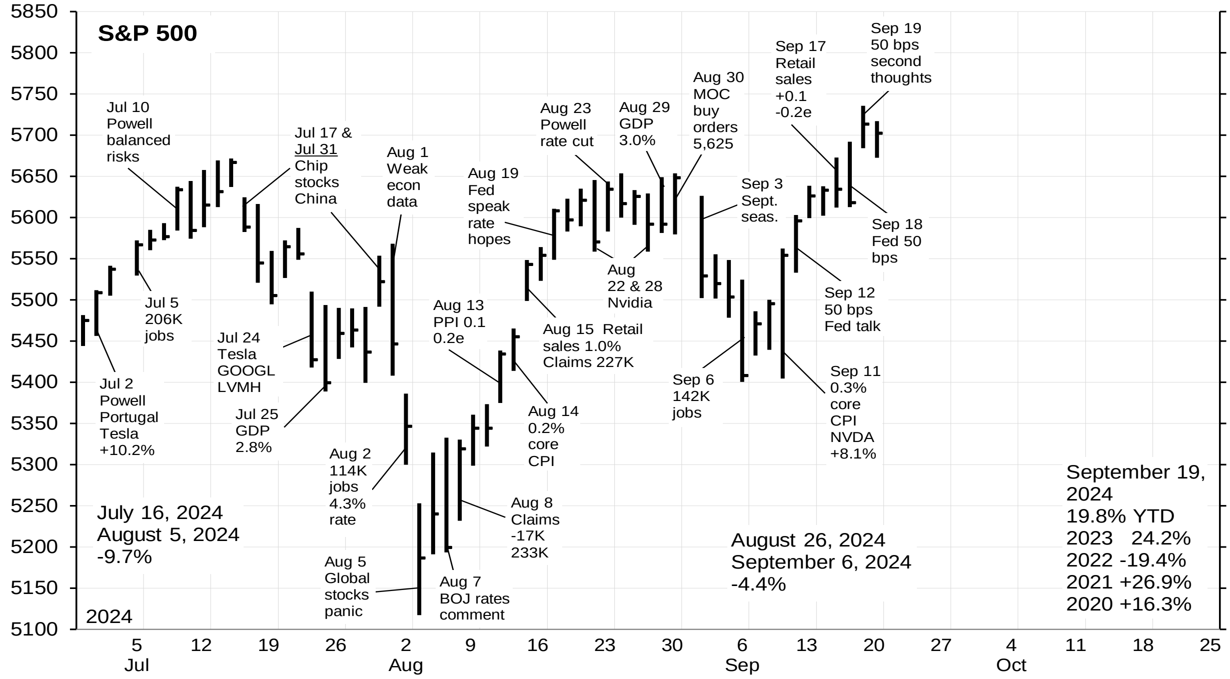


Where are rates heading? We mean besides the 3.0% rate the FOMC forecasts ("which we don't vote on") say for 2026. The problem with going 50 bps (besides confusing Wall Street Fed Watchers and causing one Fed Governor dissent) is you tell markets you are a long way from normal or a long way from where you need to be so that higher interest rates are not a headwind for economic growth. We are not even sure 3.0% is neutral. In [last week's letter]() we looked at the real rates model estimate at the New York Fed which is 0.7% in Q2 2024. If you add 2.6% core PCE inflation to that, normal is 3.3%. If you add 3.2% core CPI to the 0.7% (which looks a little low btw-just eye-balling the graph) real rate, normal is 3.9%. The FOMC forecasts have moved their longer term estimate of rates up from 2.5% to 3.0% which is progress of a sort. But it seems like 3.5% is as low as they should communicate to the public on where they might be going on this new rate cut "the time has come" trend. What else? How about where are mortgage rates going which are 6.09% in the latest September 19, 2024 week. They are going here. Right where they are now unless bond traders push the Fed to lower short-term rates to recession-fighting levels again.



If you are trapped in your home unable to move because of your low pre-pandemic 3% mortgage rate, relax, you are not going anywhere. Banks are charging you more for your mortgage rate than their cost of funds, or in this case, 10-year Treasury yields. Credit spreads have widened. Before the inflation-outbreak at the end of 2021, mortgage rates of 3.11% were 160 bps more than 10-yr Treasury yields. The 6.09% mortgage rate this week is 243 bps above 10-yr Treasury yields. Where are 10-yr Treasury yields going when the dust clears and the Fed has their overnight funds rate target back to where it wants it? Well, probably right around here or maybe higher we had been thinking. It is not impossible for the 10-yr Treasury to Fed funds rate target spread to normalize back to a positive 125 bps or so. Stay tuned. The Fed's first rate cut was a shot heard round the world, and fortunate that it was as the European market rallied at their opening even if the S&P 500 faltered, and closed down 0.3% the same day as the Fed announcement. Time to call up our 401K and check on the current valuation. Unfortunately we have significant cash investments and that 5.5% Fed funds rate is going down to 3.0% the Fed says. Full disclosure. We own cash and don't want them to push it all the way down there to 3% especially as there is no science behind what they are saying they need to do on interest rates. Don't forget these are the people down in Washington who used to steer monetary policy off of money supply growth target cones on paper-drawn graphs with pencils and erasers. It was one strong first step by Powell this week in adjusting rates. Here's hoping there won't be all that many more. The Fed in 2012 thought 4.25% was neutral. Why not?

INTEREST RATES



Stocks closed up 19.6% YTD, after increasing 24.2% in 2023. We keep waiting for stocks to forget why they wanted a 50 bps cut. Fed Governor Waller said Friday he voted for 50 bps because of low inflation not because of weakness in the labor market or recession worries. He expects PCE inflation will be a good number on September 27 after CPI/PPI inputs. Powell said in his press conference statement that 2.7% core PCE inflation year-year is expected. Does not look all that low, but Waller explained the last four months of monthly changes have been low, and almost too low if you take away housing inflation. There is the annual GDP benchmark revision coming Thursday which could change the pattern of quarterly growth and monthly PCE inflation as well. Stay tuned. Fed funds futures see the Fed funds rate at 4% by February which includes the next three Fed meetings. 25, 25, 50 anyone?

Fed funds futures call Fed policy

Current target: September 20 -- 5.00%

Rate+0.17	Contract	Fed decision dates
4.230	Jan 2025	Nov 7, Dec 18*
3.920	Feb 2025	Adds Jan 29

Last trade, not settlement price

* Not strictly true, Jan 2025 has Jan 29 Fed date, so 2 days could be a new interest rate

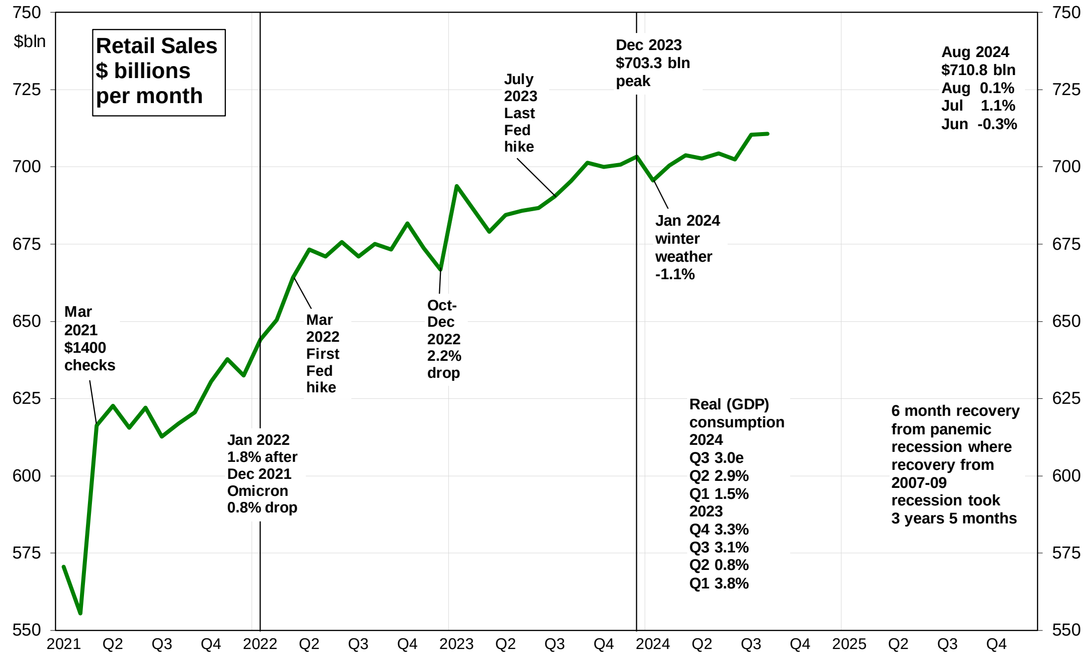
Next up: August PCE inflation report Friday, September 27

Monthly % Changes	Aug	Jul	Jun	May	Apr	Mar	Feb	2024 Jan	2023 Dec	Nov	Oct	Sep	Aug	Jul	2023 Jun
Core CPI inflation	0.3	0.2	0.1	0.2	0.3	0.4	0.4	0.4	0.3	0.3	0.2	0.3	0.2	0.2	0.2
Core PCE inflation	0.2e	0.2	0.2	0.1	0.3	0.3	0.3	0.5	0.2	0.1	0.1	0.3	0.1	0.1	0.2
Core PCE YOY	2.7e	2.6	2.6	2.6	2.8	2.8	2.8	2.9	2.9	3.2	3.4	3.6	3.7	4.2	4.3
Core CPI YOY	3.2	3.2	3.3	3.4	3.6	3.8	3.8	3.9	3.9	4.0	4.0	4.1	4.3	4.7	4.8

OTHER ECONOMIC NEWS

Retail sales say no to 50 bps (Tuesday)

Breaking economy news. Retail sales rose 0.1% in August with just minor revisions to June and July. Does not sound like much even if it beat the -0.2% consensus. Let the record show that Q3 2024 retail sales are running 4.4% versus 3.7% at the time of July's retail sales report a month ago. Not much change. The consumer is steady as a rock despite some upcreep in joblessness (workers without paychecks to spend) which is hard to assess and probably wrongly ascribed to migrants who are blamed for many other things as well lately.



Net, net, the economy's engines continue to drive forward with brisk consumer spending this quarter seemingly without a care in the world and there is certainly no sign that shoppers are staying away from the shops and malls because of the Federal Reserve's setting on interest rates. There does not appear to be any reason for Fed officials to start out with a larger 50 bps rate cut to bring interest rates down to neutral more quickly because whatever stress there is in the labor market, it isn't translating into weaker economic demand. The consumer is alive despite all reports to the contrary. If this is an economy on the brink of recession, consumers certainly don't see it.

Retail spending, actual dollars, each month

	$million Aug	% to Total	Percent Changes % Aug	Jul	Year/year
Total Retail Sales	710,773	100.0	0.1	1.1	2.1
Motor vehicles/parts	134,295	18.9	-0.1	4.4	1.3
Furniture/furnishings	11,217	1.6	-0.7	1.7	-0.7
Electronics/appliances	7,819	1.1	-1.1	1.1	1.9
Building materials/garden	41,170	5.8	0.1	0.8	-0.1
Food & beverage	83,110	11.7	-0.7	0.9	1.6
Health/personal care	37,797	5.3	0.7	1.7	3.5
Gasoline stations	51,983	7.3	-1.2	0.5	-6.8
Clothing/accessories	26,097	3.7	-0.7	0.1	1.0
Sporting goods, books	8,169	1.1	0.3	-0.9	-3.6
General merchandise	75,655	10.6	-0.3	0.8	2.1
Department stores	10,834	1.5	-1.1	-0.3	-2.1
Miscellaneous retailers	15,362	2.2	1.7	-0.8	10.7
Nonstore retailers (internet)	123,589	17.4	1.4	-0.4	7.8
Eating & drinking places	94,510	13.3	0.0	0.2	2.7
[Total ex-autos/gas]	524,495	73.8	0.2	0.4	3.3

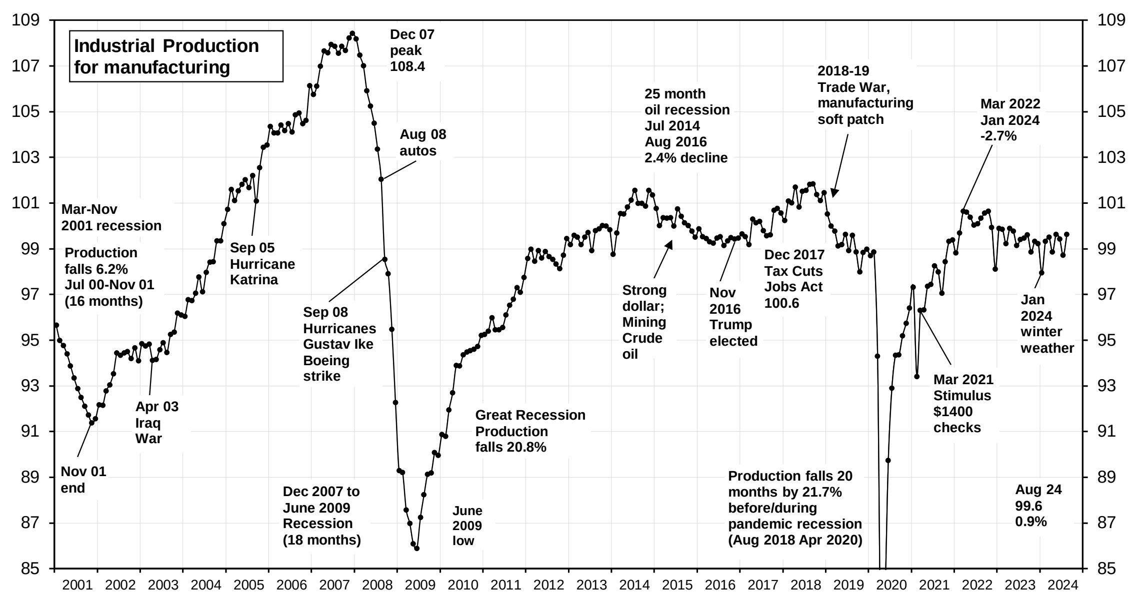
Inflation is no longer a problem for Fed officials, but the million dollar question is whether joblessness and unemployment is going to be a problem because it makes a difference whether policymakers set off with a bigger 50 bps rate cut or a regular 25 bps move in rates. Retail sales would vote no on a bigger rate cut if sitting at the table today. Fed funds futures are 8 or 9 bps away from discounting a full 50 bps move, which is more than 50/50 after jawboning by ex-Fed officials (thanks a lot!) no longer sitting at the table. This vote is going to be a close one. Bet on it.

Industrial production says no to 50 bps rate cut (Tuesday)

Breaking economy news. The Federal Reserve's Industrial production index rose 0.8% to 103.1 in August which is actually slightly above the 102.9 level where it had been reported a month ago (now revised). It looks like Hurricane Beryl in Texas shut down more than just petrochemical production.

Percent changes			Industrial Production August 2024		
Jun	Jul	Aug	YOY		Weight
0.1	-0.9	0.8	0.0	Total Index	100.0
-0.2	-0.7	0.9	0.2	Manufacturing	75.1
0.3	-0.4	0.8	0.1	Mining	14.2
1.6	-3.0	0.0	-0.9	Utilities	10.7
			Manufacturing payroll jobs 12.9 million -14K YOY 9.5% of Private Payroll Jobs		

Net, net, industrial output falls sharply in economic recessions and while it will be a struggle to bring factories back to America after being sent overseas for cost reasons two decades ago, there is no sign currently that manufacturing is throttling back despite the highest Fed rates seen since the late 90s. About the only thing the Fed's recession-magnitude rates policy has done is put the kibosh on home sales. Whether Powell starts off the new trend with a larger 50 bps rate cut or a regular-sized 25 bps move, America's factories are indifferent. Manufacturing industrial production jumped back 0.9% in August after July's drop was revised to 0.7% from the prior -0.3% reading in last month's report. The change is all from volatility in motor vehicles and parts that dropped about 9 percent in July and rebounded almost 10 percent in August. The economy is not going down for the count looking at factory output. While it is true that the peak in manufacturing industrial production was 100.6 in March 2022, the month of the first Fed rate hike to fight the inflation outbreak, there is little evidence that lowering the boom on interest rates is going to bring back factory production any faster. The manufacturing index was 99.6 in August just slightly below that 100.6 peak almost two-and-a-half years ago. Stay tuned.



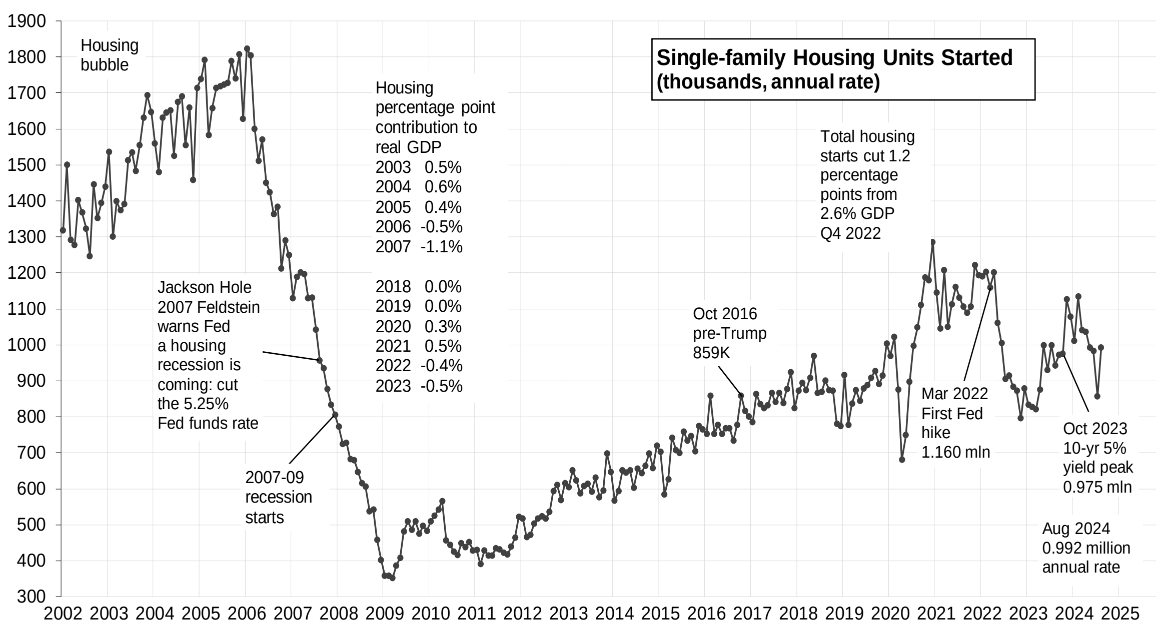
Housing starts say no 50 bps (Wednesday)

Breaking economy news. Housing starts weathered Hurricane Beryl and rebounded 9.6% to 1.356 million at an annual rate in August. Starts had been above 1.5 million in the final months of 2023. Housing permits are more resilient at 1.475 million in August and may mean starts will move up to that level. Residential housing construction was a slight 0.1 percentage point drag in Q2 2024's 3.0% real GDP report.

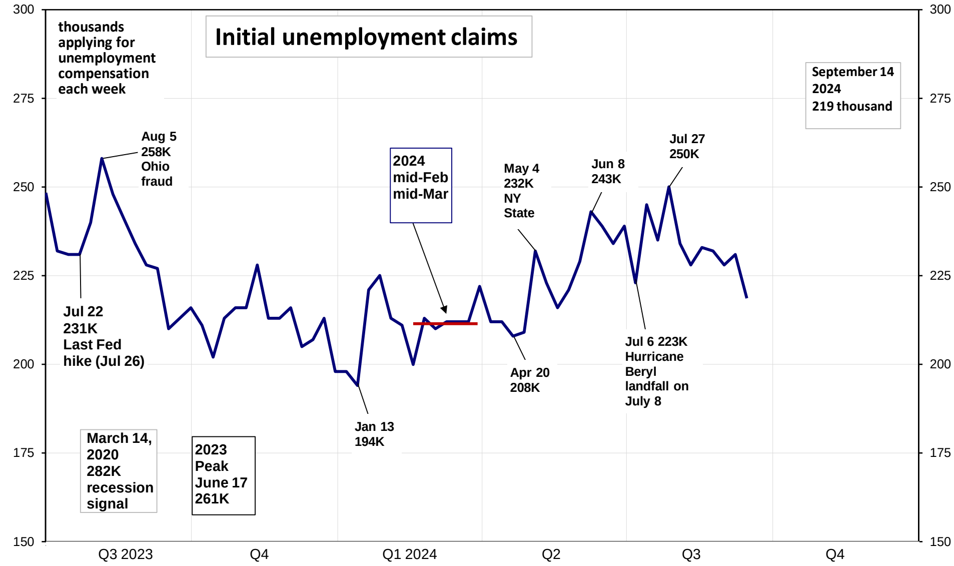
Net, net, single-family housing starts did not fall off a cliff last month as the damage was all storm related down South after Hurricane Beryl struck Texas. Single-family housing starts rose 15.8% to 992 thousand at an annual rate in August after tumbling 12.8% during the hurricane last month. The highest interest rates in over a decade are not depressing residential housing construction as much as feared so the Fed can move at a moderate pace when it comes to unwinding its monetary policy restraint. Mortgage rates are coming down which will help with the cost of financing a new home, but those 3% mortgage yields prior to the pandemic are unlikely to return unless there is a hard landing for the economy that requires zero Fed rates and trillions of dollars quantitative easing purchases of securities. Stay tuned.

Housing Starts Total, Single-Family, Multi-Family

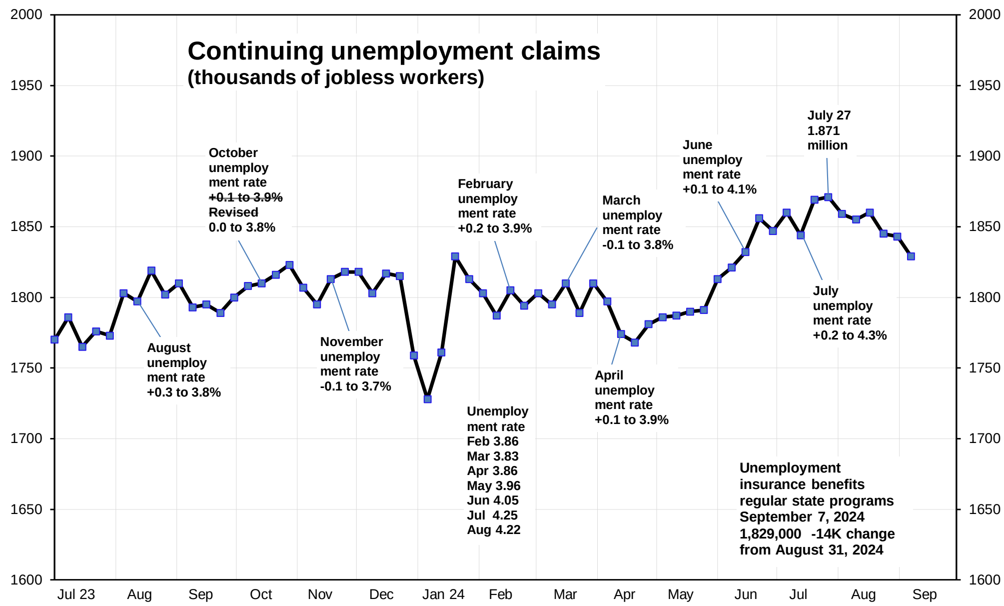
	United States			Northeast		Midwest		South		West	
000s	Total	1 unit	Multi	Total	1 unit	Total	1 unit	Total	1 unit	Total	1 unit
Aug 2024	1356	992	333	117	84	206	144	745	547	288	217
Jul 2024	1237	857	357	161	57	159	129	645	460	272	211
Aug 2023	1305	943	355	127	55	161	108	731	584	286	196
% Chgs											
Aug/Jul	9.6	15.8	…	-27.3	47.4	29.6	11.6	15.5	18.9	5.9	2.8
Aug/Aug	3.9	5.2	…	-7.9	52.7	28.0	33.3	1.9	-6.3	0.7	10.7



Jobless claims plummet (Thursday)



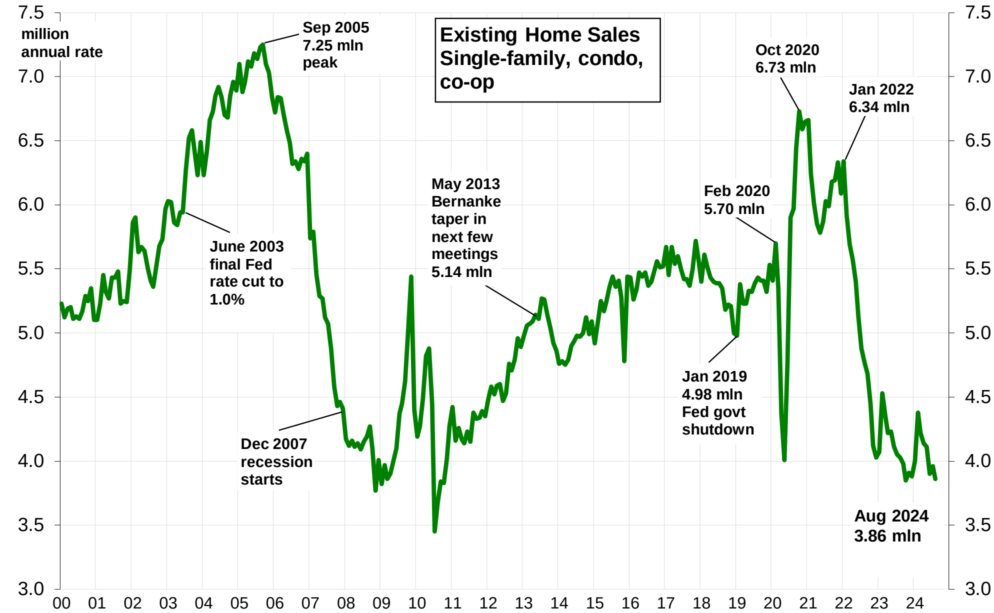
Breaking economy news. Weekly jobless claims fell 12K to 219K in the September 14 week. The case for serious deterioration in the labor market was based on the trend of initial claims rising from about 210K at the end of March to the recent peak of 250K at the end of July, but now the story is unraveling. Sorry. We were wrong, the economy is saying, you can all keep your jobs and put all your savings in the stock market because money market fund yields are coming down 200 bps over the next year. Sorry.



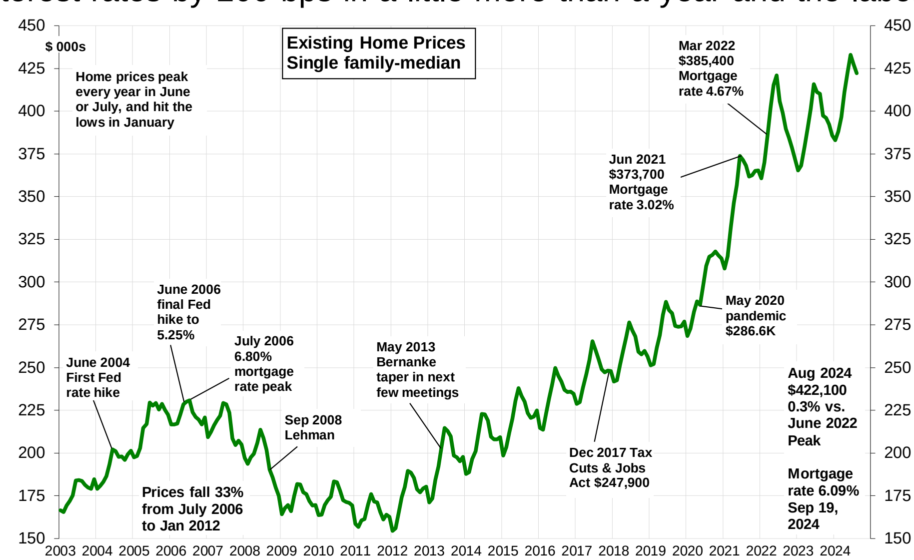
Net, net, the downside risks to the labor market Powell cited yesterday as a reason for a strong start to the interest rate cut cycle with a bigger 50 bps move no longer look to be as worrisome for the overall economic outlook as the number of Americans on the unemployment rolls receiving benefits are sharply lower this week. So-called continuing jobless claims were 1.850 million in the August 31 week and now revised lower to 1.843 million. The latest September 7 week continuing claims fell sharply by 14K to 1.829 million which means the 4.2% unemployment rate in August is unlikely to move higher. If joblessness does move higher, those unemployed workers are not collecting benefits that's for sure. Stay tuned. The Fed's strong start to this interest rate cycle is not likely to need another 50 bps rate cut anytime soon as labor market conditions are not exhibiting the weakness that typically occurs when the economy nears the edge of a downturn. With real GDP running close to 3% this quarter, the latest weekly jobless claims data are consistent with an economy that continues to power ahead and is not being held back by the Fed's monetary policy. One can actually question what the hurry is to return interest rates to normal 3 percent levels when it is not clear what level of rates is normal and what level of interest rates is restrictive. The markets are flying today after the Fed's big 50 bps rate cut yesterday and one wonders if the Fed's move was premature. Time will tell if the abrupt change in monetary policy will light up the inflation fires once again as companies see that it is full speed ahead for the outlook and the roadblocks and downside risks to growth are fading from view.

Fed existing home sales rescue (Thursday)

Breaking economy news. Existing home sales fell 2.5% to 3.86 million at an annual rate in August, very close to the October 2023 low of 3.85 million. The Fed cut interest rates 50 bps yesterday, but bond yields did not fall. Mortgage rates reported for the September 19 week were 6.09%, double where they were before the inflation surge after the end of 2021.



Net, net, we cannot worry too much about the new lows for existing home sales in August because the Fed's lightning bolt out of the blue will bring homebuyers back in a hurry. If policymakers' forecasts are to be believed after cutting interest rates 50 bps yesterday to 5.0%, the committee sees a 3.5% Fed funds rate by the end of next year in one of the fastest reversals for a monetary policy tightening ever seen outside of an emergency recession response. Confidence is likely to return to the housing markets with the cost of financing the purchase of a new home falling and likely to decline further in 2025. The million dollar question remains what will happen to the housing price bubble. Prices never declined while the Fed lifted interest rates from zero to 5.5% from 2022 through 2023. Fed rate cuts could provide the rocket fuel to keep home prices moving higher to ever more unaffordable levels. Home prices of single-family existing homes have fallen from the peak of the summer selling season for purchases at $432,900 in June down to $422,100 in August, but prices are still up 2.9% from year ago levels. It is hard to make the argument that home prices will stop increasing when the Fed is expected to cut interest rates by 200 bps in a little more than a year and the labor markets stabilize with fewer job layoffs in recent weeks. Stay tuned. Story developing. Existing home sales are down, but help is on the way with massive Fed rate cuts riding to the rescue in the year ahead.



Note: this home price index unlike other private and government indexes shows prices looking toppy like they did in the final years of the housing price bubble back in 2005-06. Stay tuned.

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