Financial Markets This Week

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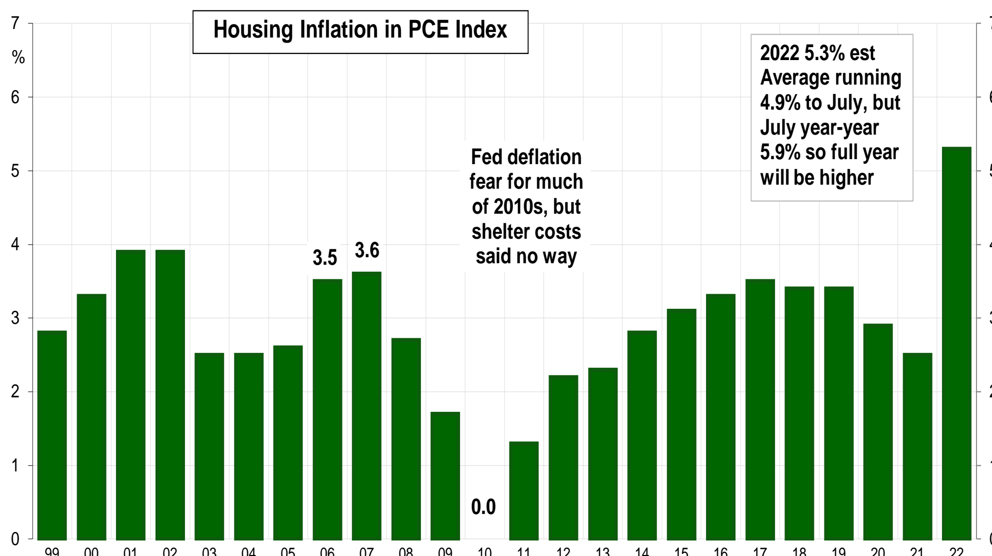
CONSUMERS HAVE TWO INFLATION INDEXES

Some thoughts on inflation this week as it remains key to how high Powell thinks he wants to push interest rates, the latest peak Fed funds rate being 4.75% next year where it was 3-7/8% in the Fed's June meeting forecasts for 2023. Interest rates are supposed to be above inflation to be "restrictive," but the public's understanding of inflation is still muddied by the Fed's preferred inflation measure that is the personal consumption expenditures deflator (PCE) versus the longstanding CPI inflation measure that is used to index social security benefits among other uses, like how much HR will allow managers to increase your paycheck next year after your annual review. It's not just the general public, the stock and bond markets tend to rally and plunge more on the CPI inflation statistics. Powell thinks interest rates should be above core PCE inflation of 4.6% year-year in July which is some comfort perhaps given core CPI inflation was even higher at 6.3% year-year in August.

	July 2022	Aug 2022
CPI inflation		8.3
Core CPI		6.3
PCE inflation	6.3	
Core PCE	4.6	

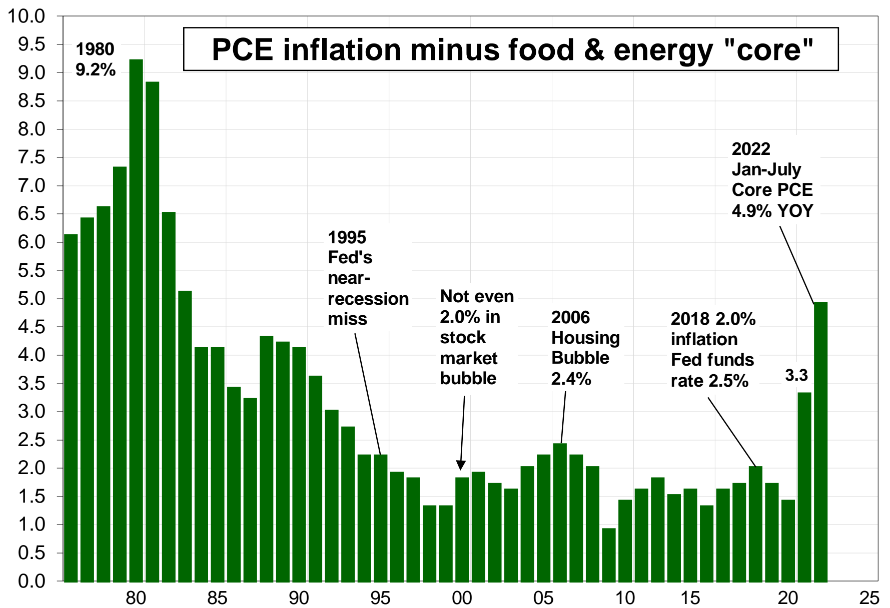
Year-year percent % changes

Shelter costs, the price of a roof over our heads, is one reason for the difference between the two measures. The July PCE shelter weight was 15.1% of core PCE, where the shelter weight in CPI is much higher at 41.5%. There's some talk that shelter costs will keep inflation high even when economic growth falters, although for PCE anyway, shelter came down from 3.6% in 2007 during the housing bubble to 0.0% in 2010 following the end of the recession. Seems reasonable, although it was quite a deep housing recession.

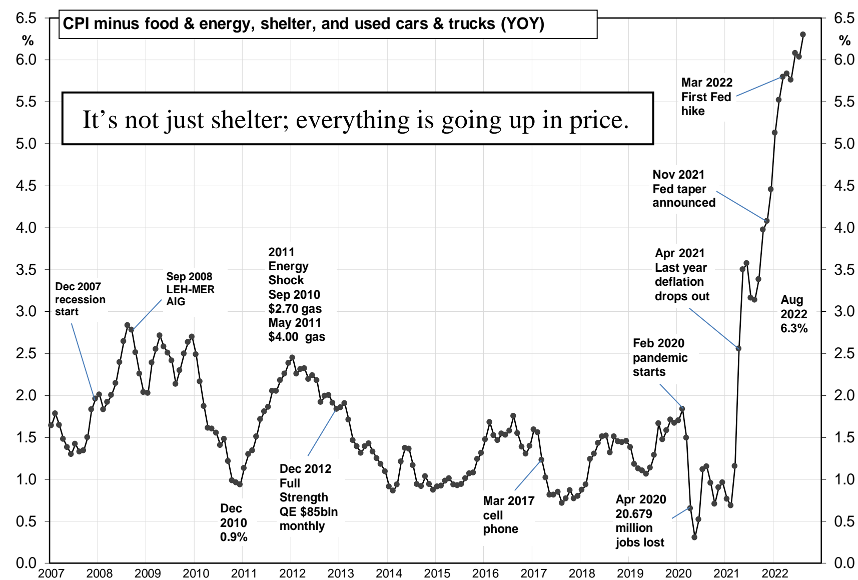


Some things to consider about this inflation. First off this inflation is not like the late 1970s. That inflation for PCE core consumer prices was over 6.0% starting in 1976 (the recession ended March 1975) and rose steadily to the peak of 9.2% in 1980. This isn't the 70s because that inflation outbreak was over a decade in the making. Core PCE had been relatively quiet in hindsight, so you can see why the Fed turned their attention to putting people back to work after the pandemic with low rates.

Core PCE inflation was calm even during the strong stock market bubble economy in the late 90s, and the housing bubble peak of core inflation at just 2.4% in 2006. If the Fed's massive rate hikes under Volcker with two recessions (the second recession ended November 1982) did the trick, core PCE inflation was still over 4% in 1985.



The 80s experience to us suggests it will be hard for the Powell Fed to win the war on inflation. Once the inflation fire has been lit, from some outside demand shock maybe, or easy money from the Federal Reserve, but triggered most often by soaring energy or food prices, it is difficult to put out. Everyone tries to play catchup to runaway prices by asking for higher wages, or businesses who have to raise prices because their costs are going up. Everyone tries to index themselves to current inflation and in doing so, inflation tends to persist. Everyone tries to index themselves, except in this cycle, savers are losing out because banks won't pay anywhere near market rates on their savings deposits. The Fed can raise rates fast like today, or at a measured pace like under Greenspan/Bernanke in the mid-2000s, but the effect on bringing down inflation is hard to forecast. Economists used to think the central bank could easily stop inflation in its tracks, it was trying to get the economy out of recession that was most difficult. We may have to rethink this depending on the path of inflation in the next few years.

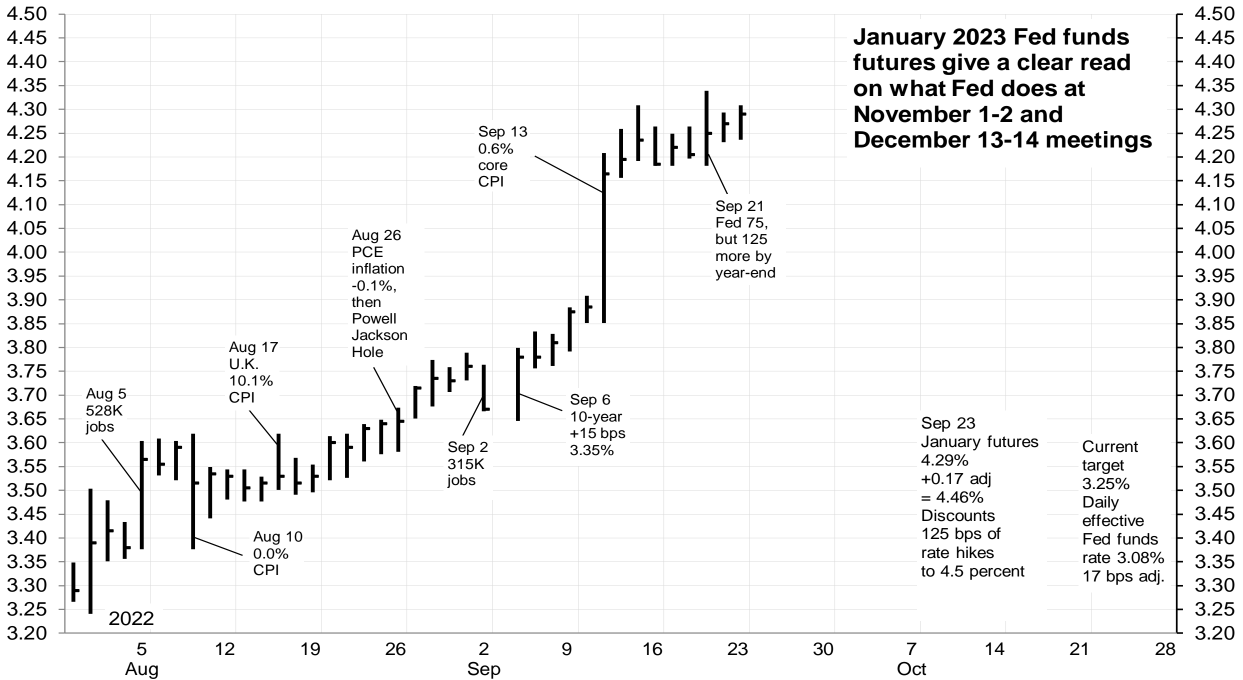


The best hope is that inflation comes back down in a surprise as quickly as it appeared out of nowhere. At the moment, all market observers can do is watch inflation like a hawk to see whether price pressures are lessening. If not, interest rates under the Powell Fed are going up across the yield curve to at least the level of core PCE inflation which was 4.6% in July. The August PCE inflation data are due out 830am ET on Friday, September 30, 2022. Wait for it.

Core Consumer Inflation and stickier services prices ex-energy

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

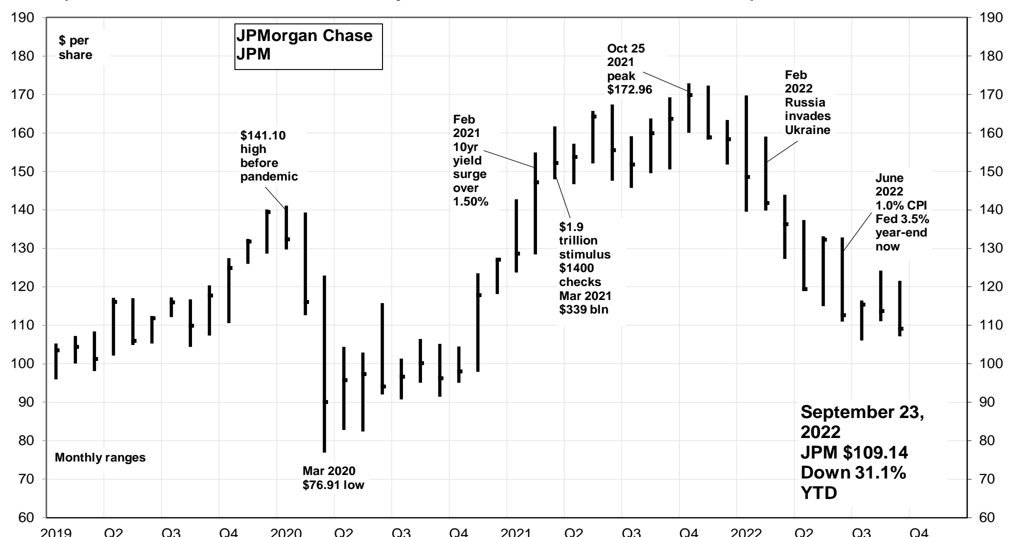
INTEREST RATES



This is the second time the market sold off on a "hawkish" Powell. First was Jackson Hole, and now this week the Fed meeting. January Fed funds futures were pricing in 75 bps and 100 bps more to end the year at 4.25%. Fed forecasts ended up being 75 bps, and 125 bps more. Not that much of a difference. Still the markets fell. Stocks partly didn't like Powell at the press conference around 310pm ET saying the housing market needs to go through a correction to get back to normal price growth. Not sure why the Fed Chair is talking about the value of Americans' homes. At the end of the week, stocks continued to crash at a speed and total decline that we used to call a financial crisis. Financial crisis that the Federal Reserve is supposed to steer the economy through. Instead, they are going to continue to raise rates rapidly. The Friday S&P 500 YTD loss 22.5% versus -23.1% worst on June 16.

JPMorgan down 31.1% YTD to $109.14 with $4 dividend

The stock traded $115.78 at 230pm ET Wednesday when Powell started the press conference. Rates are going up globally to fight inflation which will cause a worldwide recession and increase credit costs seems to be the story. After the earnings release on July 14, the stock fell almost 5% (for one day), and Dimon warned of dire consequences for the economy down the road. In that quarter, net income fell 28% to $8.6 billion from last year with a net credit reserve build of $428 million versus a $3 billion release last year. Stock buybacks were suspended. Q3 earnings are October 14 at 830am ET.



FEDERAL RESERVE POLICY

Fed Individual Forecasts					
Fed funds rate at year-end					Longer
Votes	2022 End	2023 End	2024 End	2025 End	run
1	3.875	3.875	2.625	2.375	2.250
2	4.125	4.375	2.875	2.375	2.250
3	4.125	4.375	3.125	2.375	2.250
4	4.125	4.375	3.375	2.375	2.250
5	4.125	4.375	3.375	2.625	2.250
6	4.125	4.375	3.375	2.625	2.250
7	4.125	4.375	3.625	2.625	2.375
8	4.125	4.625	3.625	2.875	2.500
9	4.125	4.625	3.625	2.875	2.500
10	4.375	4.625	3.875	2.875	2.500
11	4.375	4.625	3.875	3.125	2.500
12	4.375	4.625	3.875	3.125	2.500
13	4.375	4.625	3.875	3.125	2.500
14	4.375	4.875	4.125	3.125	2.500
15	4.375	4.875	4.125	3.375	2.500
16	4.375	4.875	4.375	3.375	2.625
17	4.375	4.875	4.375	3.625	3.000
18	4.375	4.875	4,625	3.625	3.000
19	4,625	4.875	4.625	3.625	
Median	4.375	4.625	3.875	2.875	2.500
Meeting	Sep 22	Sep 22	Sep 22	Sep 22	Sep 22

The Fed met on September 20-21, 2022 to consider its monetary policy. No 100 bps surprise on Wednesday, but 100 bps is in the pipeline. More than that actually. By the end of the year. We guess they tried to beat market expectations. The Fed raised rates 75 bps to 3.25% and it looks like a consensus for 75 bps in November and 50 bps more in December ending the year at 4.5%. Wow. 0.25 percent last December and 4.5% this December. 4.5%, even if it is not a done deal with 9 out of 19 participants seeing a Fed funds rate no higher than 4.25% at the end of this year. 4.25, 4.5 what's the difference.

They loaded up the gun and shot all the lights out. No hesitation, no delay for the most front-loaded Fed policy since the 1980s. They brought out a big gun today and if today's announcement doesn't start to slow aggregate demand and bring the rate of inflation back down, nothing will.

There's even some light at the end of the tunnel in these interest rate forecasts in that they see just one more rate hike to 4.75% for all of 2023 and after some more pain with the unemployment rate going up to 4.4% from 3.7% currently, which is a recession in our book, they will cut rates back down to 4% by the end of 2024 and another 100 bps down to 3.0% at the end of 2025. Let's see if the bond market will trade on that. It is a 30-yr Treasury bond.

	Fed Policy-key variables					Long
Meeting		2022	2023	2024	2025	Term
Sep	Fed funds	4.4	4.6	3.9	2.9	2.5
June	Fed funds	3.4	3.8	3.4		2.5
Sep	PCE inflation	5.4	2.8	2.3	2.0	2.0
June	PCE inflation	5.2	2.6	2.2		2.0
Sep	Core inflation	4.5	3.1	2.3	2.1	
June	Core inflation	4.3	2.7	2.3		
Sep	Unemployed	3.8	4.4	4.4	4.3	4.0
June	Unemployed	3.7	3.9	4.1		4.0
Sep	GDP	0.2	1.2	1.7	1.8	1.8
June	GDP	1.7	1.7	1.9		1.8

Net, net, Fed officials upped the ante today and while there may be some light coming at the end of the tunnel, there is a lot of pain to be felt by all before we get there. They are forecasting an economic recession in all but name with unemployment at 4.4% next year. And it isn't just jobless workers that will feel the Fed's heat. The Fed's tighter policies have crushed the stock market and retirement dreams of millions, and now Fed officials are coming for your homes. The last housing price bubble was popped by the subprime mortgage crisis, the blame for this one will lie at the foot of the Federal Reserve. Mortgage rates at 7% anyone, anyone?

If you think it can't possibly be public policy to fight inflation by deflating Americans' wealth in stocks and bonds and real estate with higher interest rates, think again. Elections have consequences as do the actions of central banks. The Federal Reserve unleashed the worst inflation in modern economic history, and time will tell if this changes the fortunes of elected officials down in Washington. President Ford was the first to be blamed for an inflation outbreak, we all know how that turned out, and he is unlikely to be the last.

OTHER ECONOMIC NEWS

Housing starts rebound sort of (Tuesday)

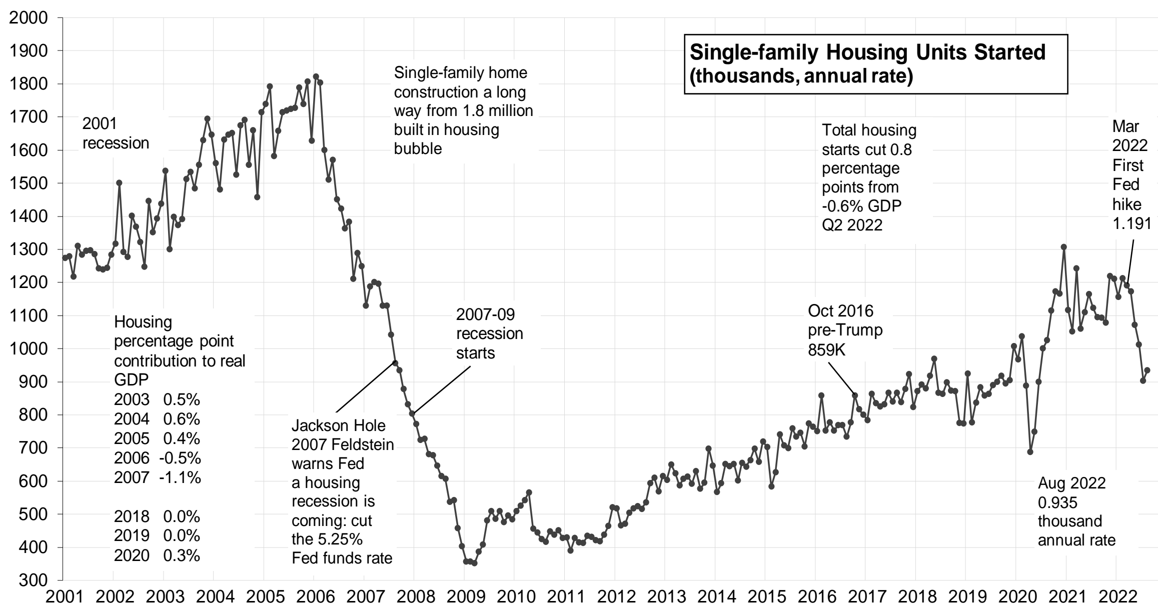
Breaking economy news. Housing starts jumped 12.2% in August, rebounding from the plunge in July, exactly back to June's level of activity. The driving force between the swing in residential construction is multi-family starts of 5 or more units. Homebuilder sentiment may be down in the dumps, but they weren't born yesterday. If homes are too expensive and buyers cannot qualify with mortgage rates over 6%, then shift to building housing for renters. Rents are still soaring and the Fed's rate hikes have left them untouched. Homebuilders are all in with units of 5 or more surging 28.6% to new record levels. No wonder housing construction employment isn't declining.

Admittedly, it is a complicated story this month for single-family home construction. Construction of homes rose 3.4% to 935 thousand in August, a modest rise which may have characterized activity out West and down South, but there were wild swings in the Northeast down 17.3% offset by a 20.8% surge in the Midwest.

Housing Starts Total, Single-Family, Multi-Family

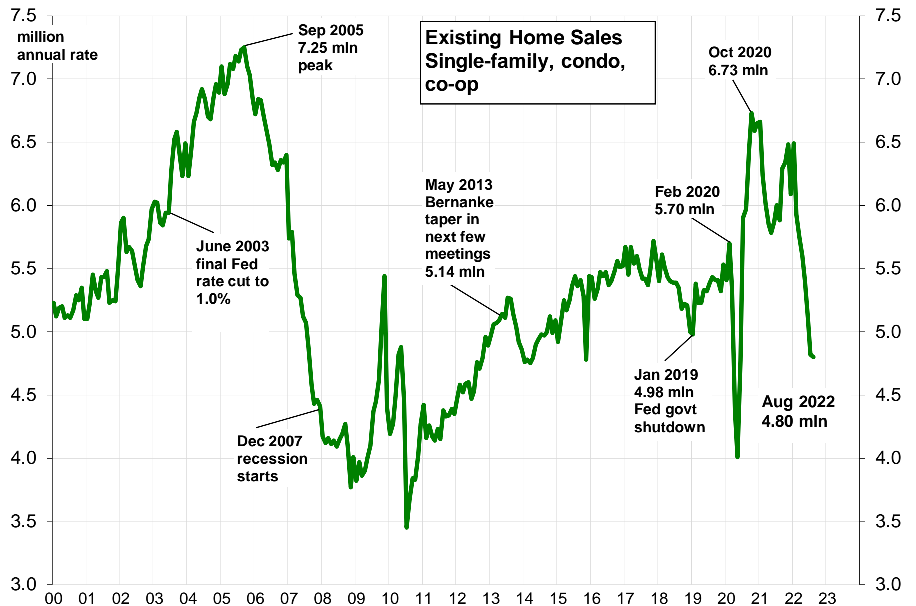
	United States			Northeast		Midwest		South		West	
000s	Total	1 unit	Multi	Total	1 unit	Total	1 unit	Total	1 unit	Total	1 unit
Aug 2022	1575	935	621	162	60	167	122	885	530	361	223
Jul 2022	1404	904	483	196	70	140	101	711	519	357	214
Aug 2021	1576	1095	474	166	68	196	130	888	679	326	218
% Chgs											
Aug/Jul	12.2	3.4	…	-17.3	-14.3	19.3	20.8	24.5	2.1	1.1	4.2
Aug/Aug	-0.1	-14.6	…	-2.4	-11.8	-14.8	-6.2	-0.3	-21.9	10.7	2.3

Net, net, who would have thought a rebound in housing starts is a bad thing. The jump in residential housing construction in August clearly won't be music to Fed officials' ears when they sit down at the table today. Housing is the most interest-rate sensitive sector of the economy, and if housing construction is shrugging off the Fed's front-loaded rate hikes then that means Fed officials will have to try even harder to slow demand in the economy. Stay tuned. Story developing. Here's hoping the Fed can find a way to drive down the stock market even further.



Existing home sales slow their descent (Wednesday)

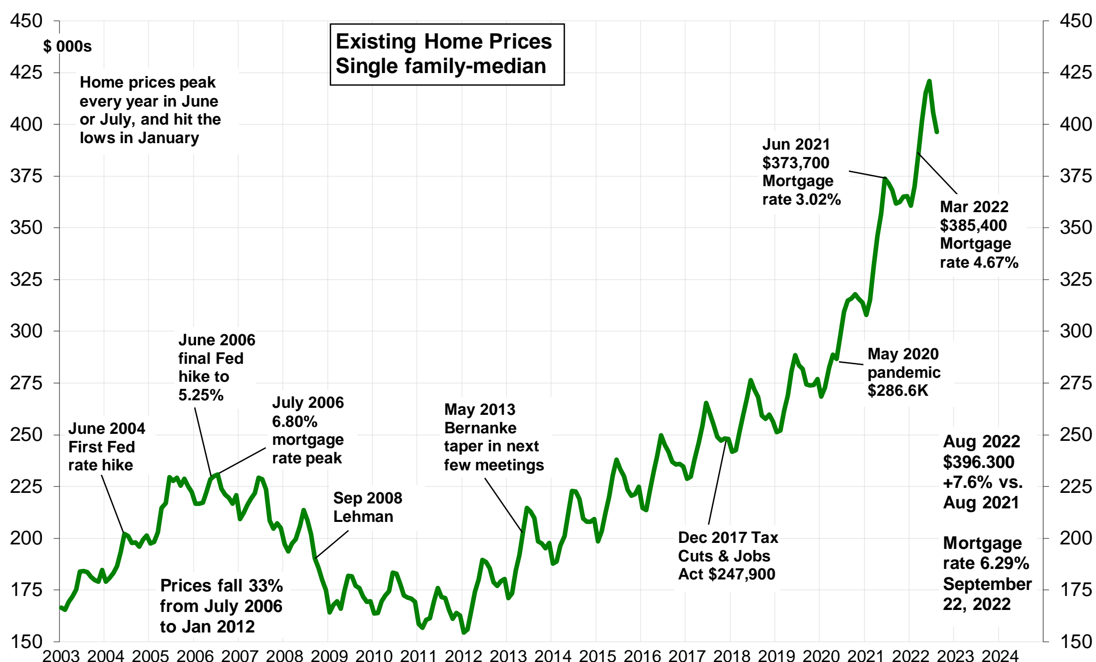
Breaking economy news. The steepest descent in existing home sales seen since the housing bubble crash over a decade ago slowed its decline this month and was barely changed in August at a 4.80 million annual rate of sales versus 4.82 million in July. There is plenty of anecdotal evidence from real estate industry professionals that activity slowed further in September with mortgage rates above 6%, but that data will have to wait for next month's report.



The year-on-year changes show where the hurt is across the regions of the country. The West is the worst with sales down 29.0% year-year, followed by the South -19.3%, the Midwest -15.9%, and the Northeast down 13.7%. It seems odd that the Northeast sales of 630K are so close to the West with 880K in sales turnover even with a much bigger market out West.

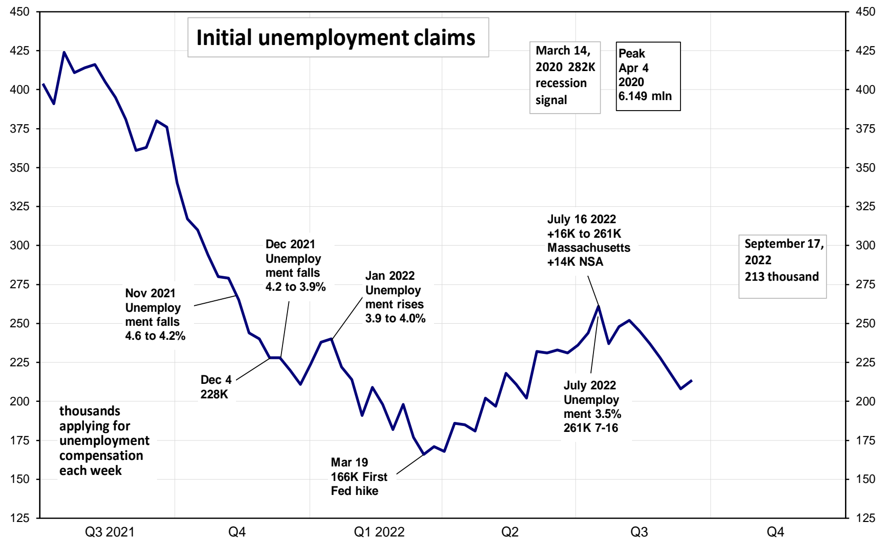
Wall Street won't be happy with Northeast single-family home prices tumbling 7.2% in August and up just 0.6% from last year now. Prices in the Northeast averaged $301,900 in 2019 for the full year, and were $419,700 in August 2022.

Net, net, rest assured, just as the Fed has it in for the stock market, now they are coming for American's homes as well and policymakers won't rest until they bring down housing prices, hitting consumers where they hold their wealth in the attempt to rein in excessive spending and aggregate demand. If the Fed is driving the economy to the breaking point, the stabilization of home sales this month means they have more work to do on pushing interest rates higher and faster.



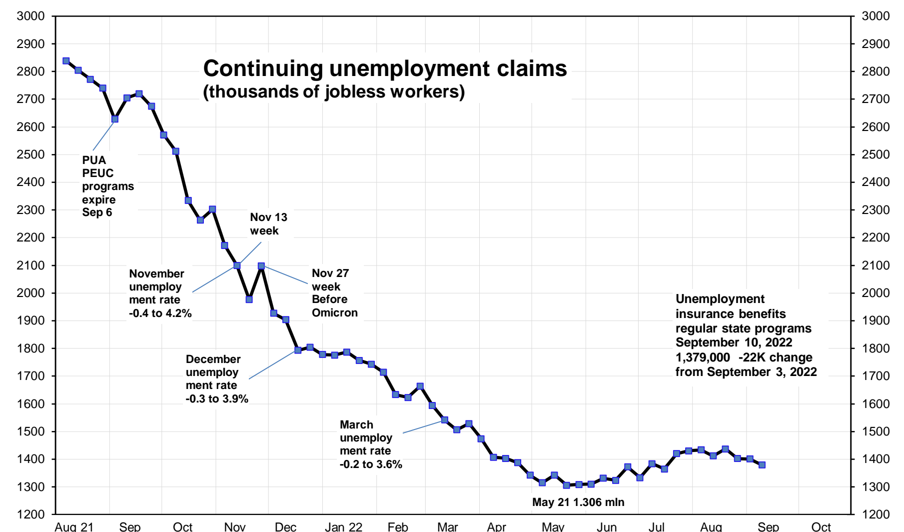
No job losses yet to stop the Fed (Thursday)

Breaking economy news. First time jobless claims were unchanged at 213K in the September 17 week, after initial claims were revised down 5K to 208K for the September 10 week and then rose 5K this week. The Fed's massive too-late rate hikes have wrecked the nation's bond and stock markets, but so far they have little to show for it as the labor market remains strong.



The big news is the total number of Americans receiving unemployment compensation fell 22K to 1.379 million in the September 10 week, a reversal from last month which means the 3.7% unemployment rate could fall back to 3.5% in next month's report if the stars all align. The Fed is forecasting 4.4% unemployment next year, but it looks like the labor market is going the wrong way. Fed officials are hitting the brakes hard but so far employers are just giving this policy a great, big yawn and holding on tight to their workers. It's either that or there is some sort of stealth job losses where those made redundant are not getting unemployment benefits.

Net, net, the labor market continues to shock us with no increase in layoffs after negative economic growth over the first half of the year. We would say the Fed has to try harder to knock the labor market off its feet, but it has done quite enough after yesterday's third consecutive 75 bps rate hike and promise of 125 bps more over the final two meetings this year.



All the talk of Volcker redux misses the point, the rate hikes under Powell are hurting the public much more than under Volcker. There were no 401Ks to speak of and workers were not saving for retirement in the stock market the way they are today. Stocks only fell 21.6% in the 1980 recession brought on by the first round of Volcker rate hikes, and have fallen as much as 24.5% earlier this year from the peak. There are no job losses to stop the Fed, but there sure is a huge loss in the financial markets bordering on crisis for those who own stocks and bonds. If this is what the Fed wanted, they got it. The Fed is supposed to step in during a financial crisis, not wish for one, or try to provoke one. Stocks closed down 0.8% tonight. Sounds like a problem, not something that will stop inflation in its tracks. This is all happening too fast. Volcker speed was to address a 15 year buildup of inflation that had not been addressed. This inflation just started around the time of those $600 and $1400 checks.

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