Danny Robushi, APEX MACRO Founder

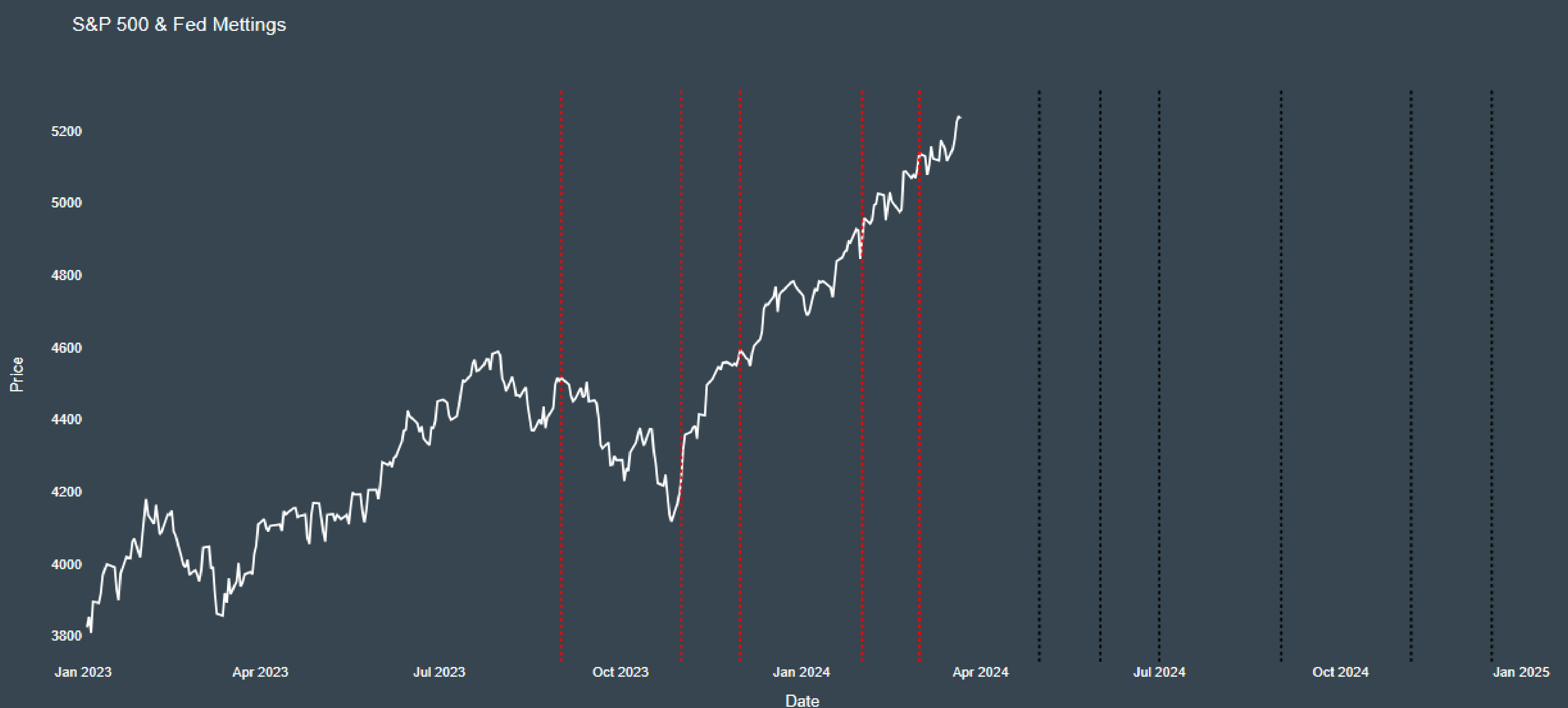
The Market Loves What It Hears

March 23, 2024

Heading into the FOMC meeting on Wednesday of this past week, market expectations for a Federal Reserve rate cut were minimal, under 3%. A combination of robust financial data and inflation persisting above expectations has pushed the likelihood of an initial rate cut further into 2024 (Projected for June). This backdrop explains the market's muted response just before Chairman Jerome Powell's speech on Wednesday when they announced rates would remain unchanged at this meeting. However, the scenario shifted significantly once Powell began his address at 2 PM; bond yields dipped, and stock market indices across the board experienced an upturn. Powell's remarks further solidified the anticipation of a dovish shift in monetary policy, explicitly indicating a trajectory towards three rate cuts. Despite prior speculation suggesting a lean towards just two cuts, given the stronger recent economic indicators, the Summary of Economic Projections (SEP) reinforced the commitment to a triad of cuts. This SEP release offered updated forecasts on GDP growth, the unemployment rate, inflation as measured by the PCE index, and the Federal Funds Rate. The notable changes were:

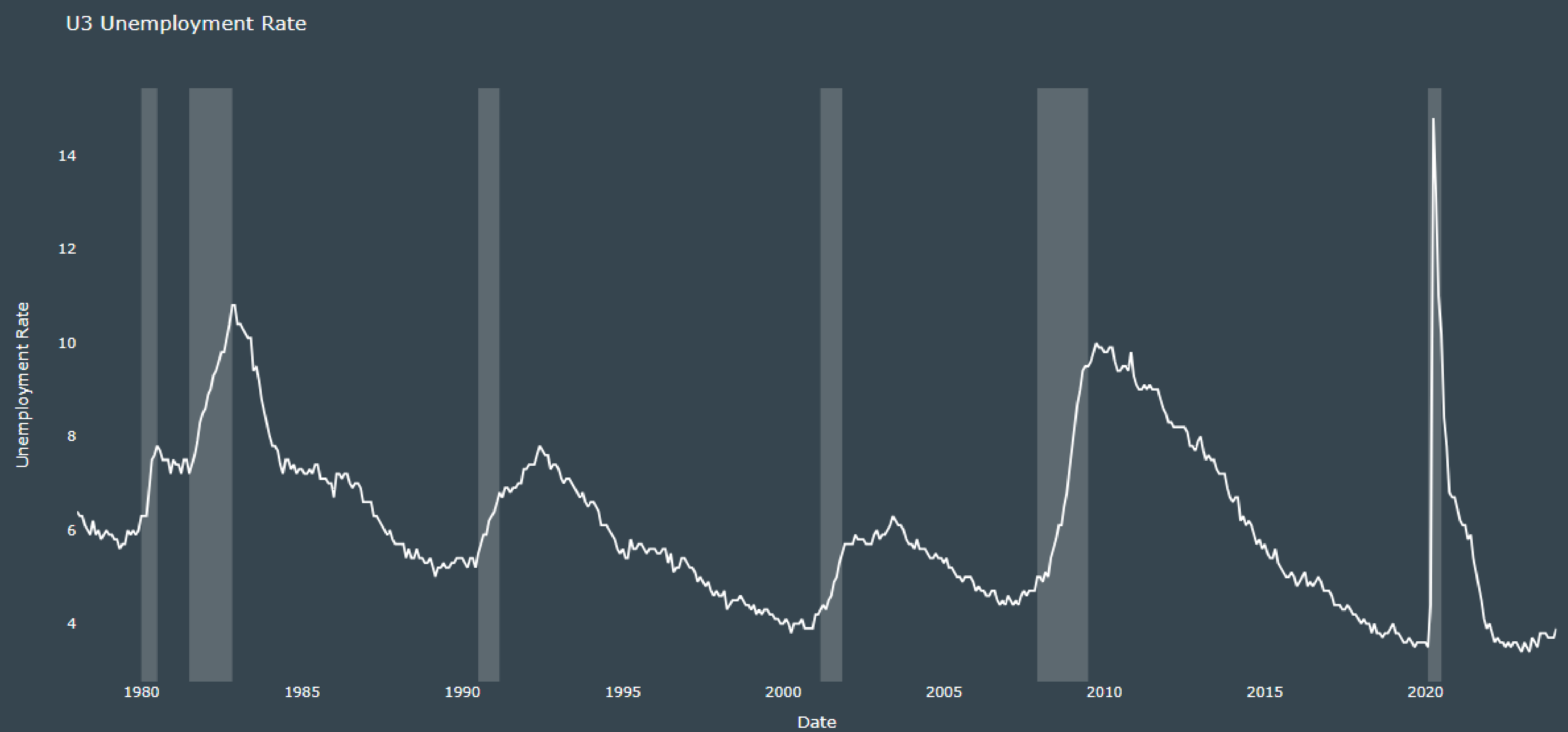
- 2024 GDP projections revised up to 2.1% from 1.4% in December
- 2024 Unemployment rate revised down to 4.0% from 4.1% in December
- 2024 Core PCE revised higher to 2.6% from 2.4% in December
- Unchanged at 3 rate cuts

The FOMC's projections anticipate stronger growth, sustained elevated inflation, and a tighter labor market, yet they still plan to implement rate cuts. This stance seems counterintuitive given their emphasis on the 2% inflation target. The expectation for higher growth alongside persistent inflation suggests a potential for inflationary pressures to intensify, which traditionally would warrant maintaining or even raising interest rates. Coupled with these projections the Stock market is at all time highs and continues to move higher unabated. FOMC meetings going back to 2020-2022 were a high risk event for market prices but since the verbal pivot back in November-December of 2023 stocks have loved everything they have heard from the Fed.



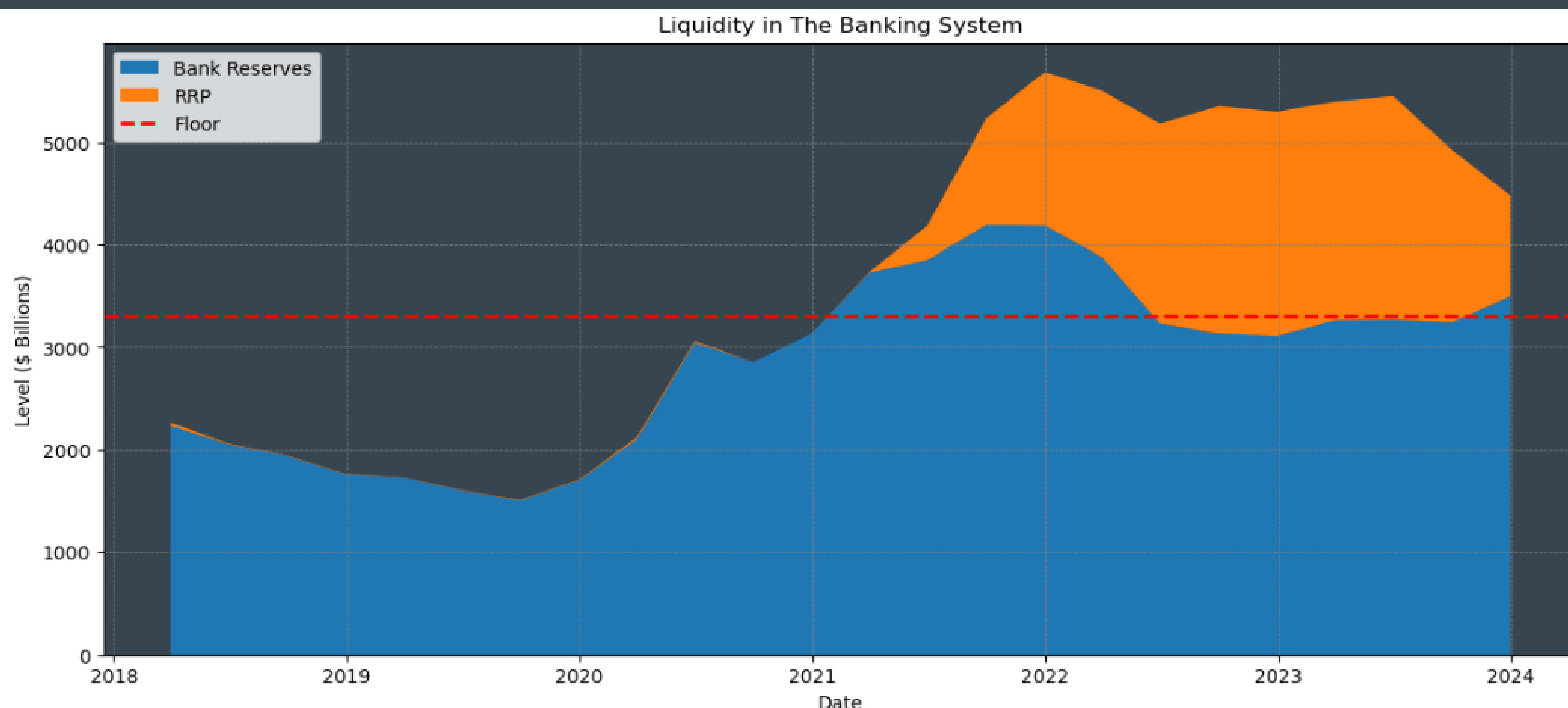
The red lines above represent meetings that have past, and the black lines are the meetings left in 2024. There are 4 left prior to the election and 2 more after. Given the Federal Reserve's objective to avoid political bias, initiating three rate cuts implies starting no later than the mid-year meetings. With the market largely driven by anticipation of these cuts, apart from a potential short-to-medium term correction due to overvaluation, significant risks include a substantial rise in CPI to upwards of 3.6-3.7% or an unemployment rate exceeding 4%. Absent such developments, the momentum suggests a continued upward trend, potentially reaching mid-5000 levels.

The current unemployment rate has risen to 3.7% from a low of 3.4%. The Summary of Economic Projections anticipates it will reach 4% in 2024 and peak at 4.1% in 2025. Historically, such minor increases following a trough are uncommon; typically, the unemployment rate experiences a more substantial rise before peaking. This forecast indicates a departure from the historical trend of significant post-trough increases in unemployment seen since the 1970s.



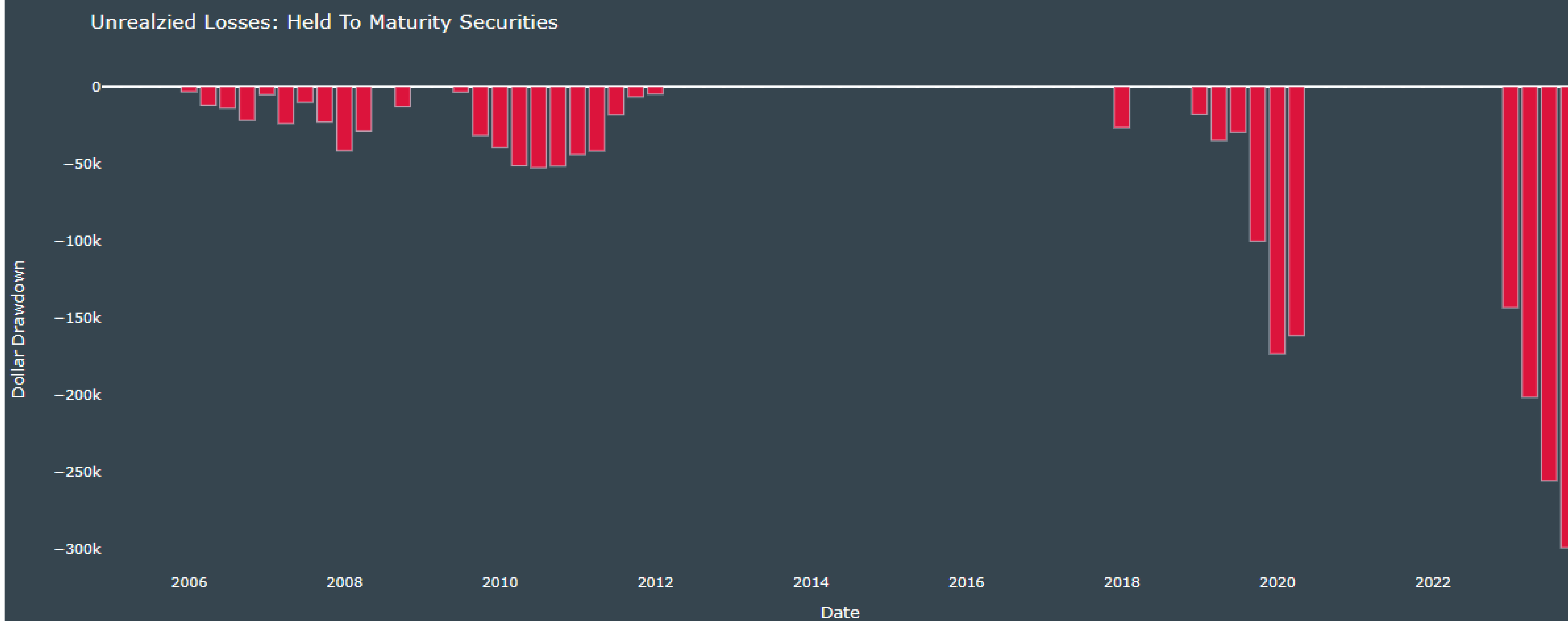
A topic that usually gets overlooked by the market in favor of rates is the Federal Reserves Balance Sheet. Albeit a more complicated topic, it does have a material impact on liquidity, which is a major driver of asset prices. Powell mentioned that the Federal Reserve has continued the process of reducing their securities holdings, but they also discussed slowing the pace of runoff. They also cited that slowing the pace of run off would help avoid liquidity problems within the banking system. As noted in previous articles, the issuance of Government debt at the short end of the curve is causing excess reserves (Reverse Repo) to leave the banking system in search of higher yield in Bills. The Fed is letting $60 billion a month of Treasuries roll off their balance sheet which needs to be issued into the market. This process had drained the RRP to ~$400 billion.

When excess reserves leave the banking system, there's a risk of liquidity shortages, potentially hampering banks' ability to secure overnight funds. The precise threshold for reserve levels before such issues arise is unknown. However, a liquidity crunch could sharply drive-up interest rates, leading to significant repercussions across financial markets. Below shows Bank Reserves + RRP and the red dotted line is an estimation of the floor. As reserves reach that level QT is likely to be adjusted.

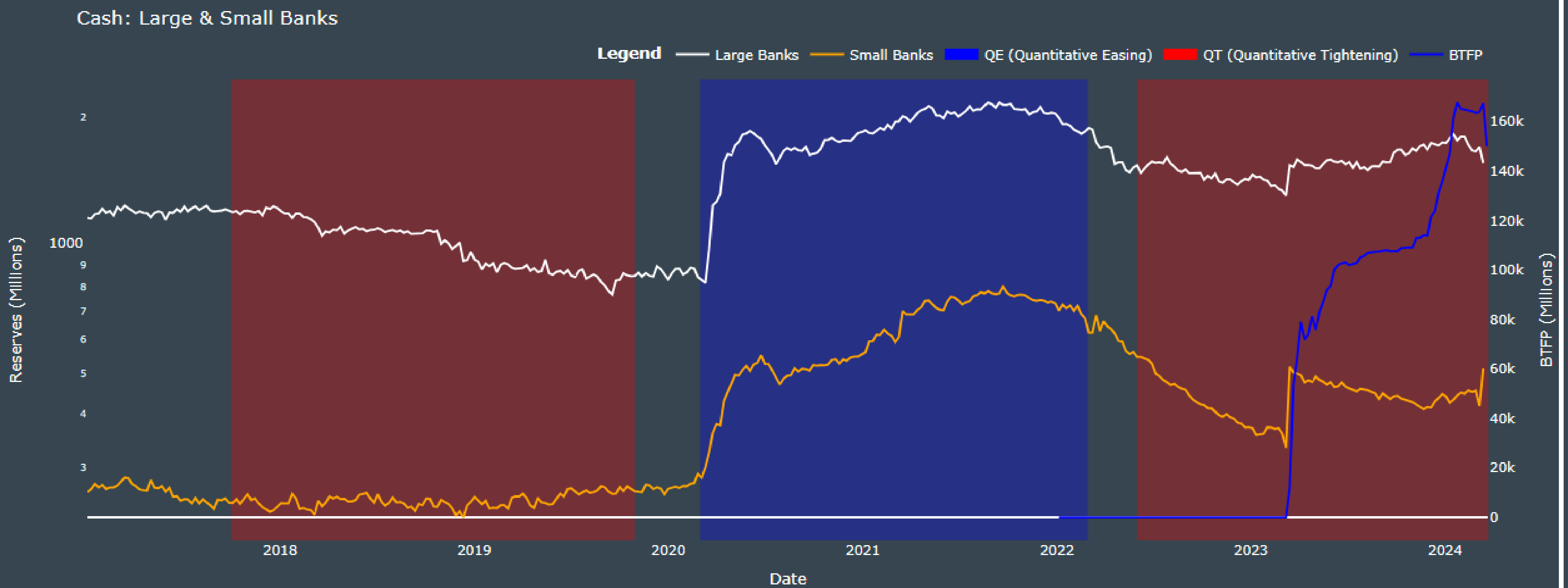


Several strategies are being considered to facilitate the Federal Reserve's balance sheet reduction without unsettling the market. One suggestion involves allowing banks to increase their Treasury holdings to support government deficit and stabilize short-term rates, deterring cash outflows from the banking system. Another strategy could involve the Fed altering the mix of securities that roll off, such as repurchasing short-term Bills while letting longer-term Notes and Bonds be refinanced into the market, which could place upward pressure on long-term rates instead. The lack of supply that has been issued at the long end has kept rates 10-year rates range bound between 3.8% and 4.3%. Getting rates out 10 and 30 years to rise likely needs to happen to get inflation from 3% to 2%.

As for the Banks as a whole, they have not fully recovered from the stress of rate fluctuations experienced since the banking crisis in March 2023. While there was a period for balance sheet restructuring and the availability of the Bank Term Funding Program (BTFP) providing cash loans, the program's conclusion leaves substantial unrealized losses. The $300 Billion in losses has not disappeared, it was papered over by the Fed.



Small banks were the primary beneficiaries of the BTFP. They face challenges post-program, particularly with potential increases in withdrawals. Without such support, they may need to recognize losses, issue shares, or utilize the discount window—all indicators of financial strain that could spark concern among stakeholders and depositors.



The Financial Sector overall has more than recovered from the drawdown seen last year but this recovery was in large part driven by the Larger Banks and the Insurance Industry.

Financials are up 35% from their bottom on March 24, 2023

Reginal Banks still haven't fully recovered their losses

The latest in the regional bank saga to sell off is New York Community Bank

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