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The Fed Made a Mistake

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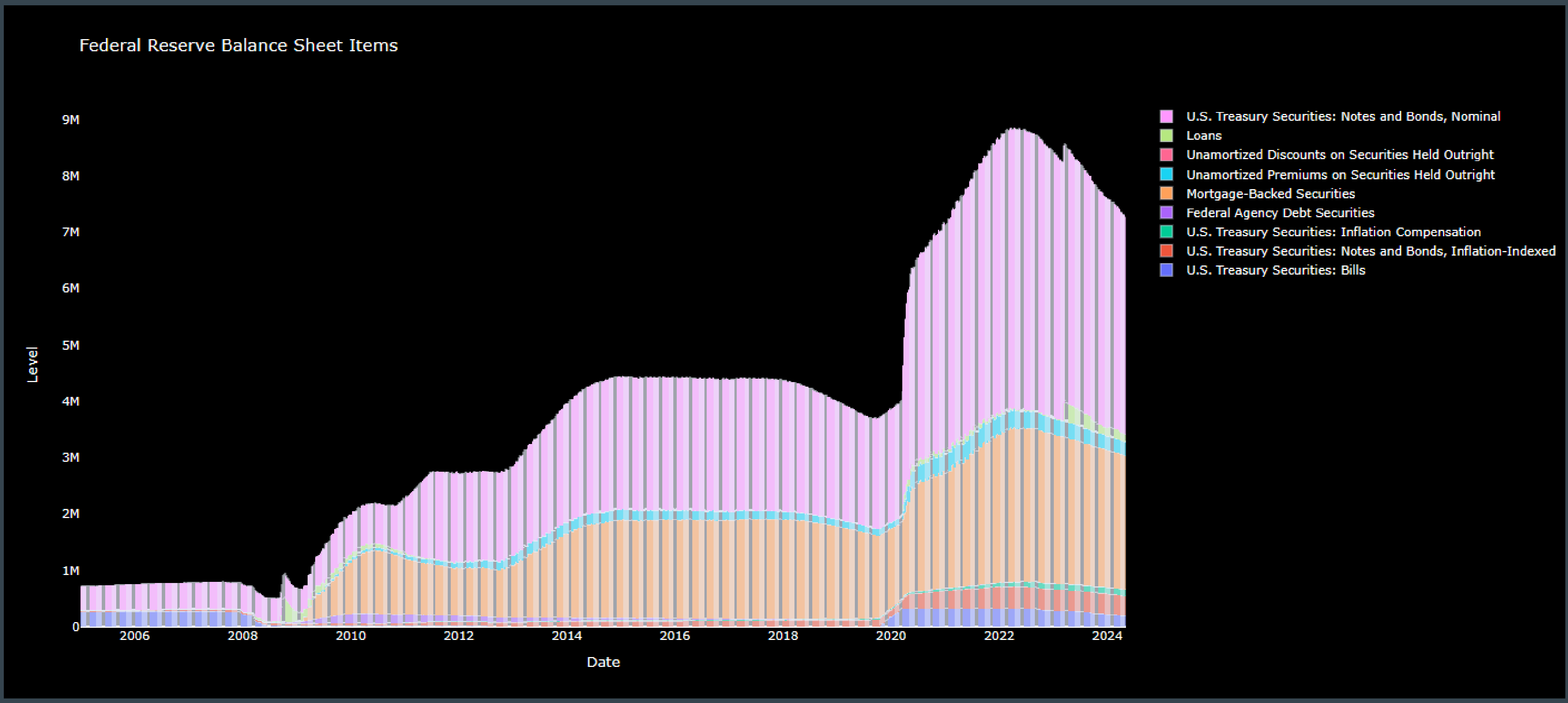
The Federal Reserve held interest rates steady at 5.50% during their recent two-day meeting, a decision that was widely anticipated and had already been priced into the market. However, the focal point of the meeting was not the rate decision but rather Chair Jerome Powell's comments regarding the future of monetary policy. Importantly, the Fed announced plans to begin tapering QT in June. Currently, the Fed allows $95 billion per month to roll off its balance sheet ($60 billion in Treasuries and $35 billion in mortgage-backed securities, or MBS), which is refinanced to the broader market. The significant takeaway from the announcement was the planned reduction in the amount of Treasuries rolling off, to be adjusted down to $25 billion a month, while the offload of MBS will remain unchanged. This is being done to preserve bank reserves and accommodate continued government debt issuance without additional pressure from the Fed. Scaling back QT will mitigate the upward pressure on interest rates caused by large-scale issuances and addresses the drain on bank reserves, particularly evident by the draining of the Reverse Repo. This change has been telegraphed by multiple Fed speakers and forced upon the Fed by Janet Yellen's strategy of shifting debt issuance to the shorter end of the curve. This past Monday was also the Quarterly Refunding Announcement, and it indicated that the Treasury plans to issue $234 billion in debt for Q2 of 2024 and over $800 billion for Q3. Given this substantial upcoming debt issuance, the Fed's decision to taper its balance sheet reduction is aimed at preventing liquidity shortages in the banking system. Alongside these adjustments, Jerome Powell's commentary on the future direction of the Fed Funds Rate was critical. He indicated that the Fed does not see sufficient progress to justify a rate cut and later stated that the next move would likely not be a rate hike. I think this comment was a mistake by the Fed as they took one of their pieces off the board and I will comment further on it later. To round out the week, the Nonfarm Payrolls report was released, showing a gain of 175,000 jobs versus the 240,000 expected. This weaker-than-expected result led to a drop in yields, and the market responded positively, rallying on the news. The market will continue to cheer soft data until it looks recessionary. It wants cuts but not the emergency cuts that would need to bail out the economy in the event of a recession.

The Federal Reserve has cut its balance sheet from just under $9 Trillion to ~$7.3 trillion over the course of 2 years. It was largely expected that the "Temporary" program enacted by Ben Bernanke back during the GFC would become permanent. Many also predicted that the best the Fed could do was bring its balance sheet back to $4 Trillion, which is where it sat for 6 years. It does not look like we will even get close to there.



It's well understood that higher rates at the long end of the yield curve have exerted downward pressure on asset prices. The relationship going back to 2021 shows a clear pattern: whenever rate volatility spikes and yields on the long end rise sharply, the S&P 500 typically starts to correct, particularly when rates have approached the 5% mark. In the Feds latest Financial Stability Report they talked about asset prices and highlighted that equity valuations are stretched by historical measures, credit spreads are unusually tight, and housing valuations remain at elevated levels. Given these conditions, one might expect the Federal Reserve to favor a reversion of these valuations towards historical averages. Moreover, there's substantial evidence supporting the correlation between asset prices and consumer spending. Meaning as long as asset prices stay elevated you have the demand driven side of inflation supported.

Some quotes from that report are below:

Equities

"Valuations rose further to levels that were high relative to fundamentals across major asset classes. Equity prices grew faster than expected earnings, pushing the forward price-to-earnings ratio to the upper end of its historical distribution."

"The ratio of prices to expected 12-month earnings, or the P/E ratio, increased since the October report and currently sits in the upper end of its historical distribution since 1989 […]."

"The difference between the forward P/E ratio and the real 10-year Treasury yield—a measure of the additional return that investors require for holding stocks relative to risk-free bonds (the equity premium)—declined, on net, since the October report and currently stands well below its historical median […]."

Corporate Credit

"Valuations in corporate bond markets also appeared stretched as corporate credit spreads, the difference in yields on corporate bond and yields on similar-maturity Treasury securities, narrowed since the previous report, falling to levels in the lower range of their historical distributions."

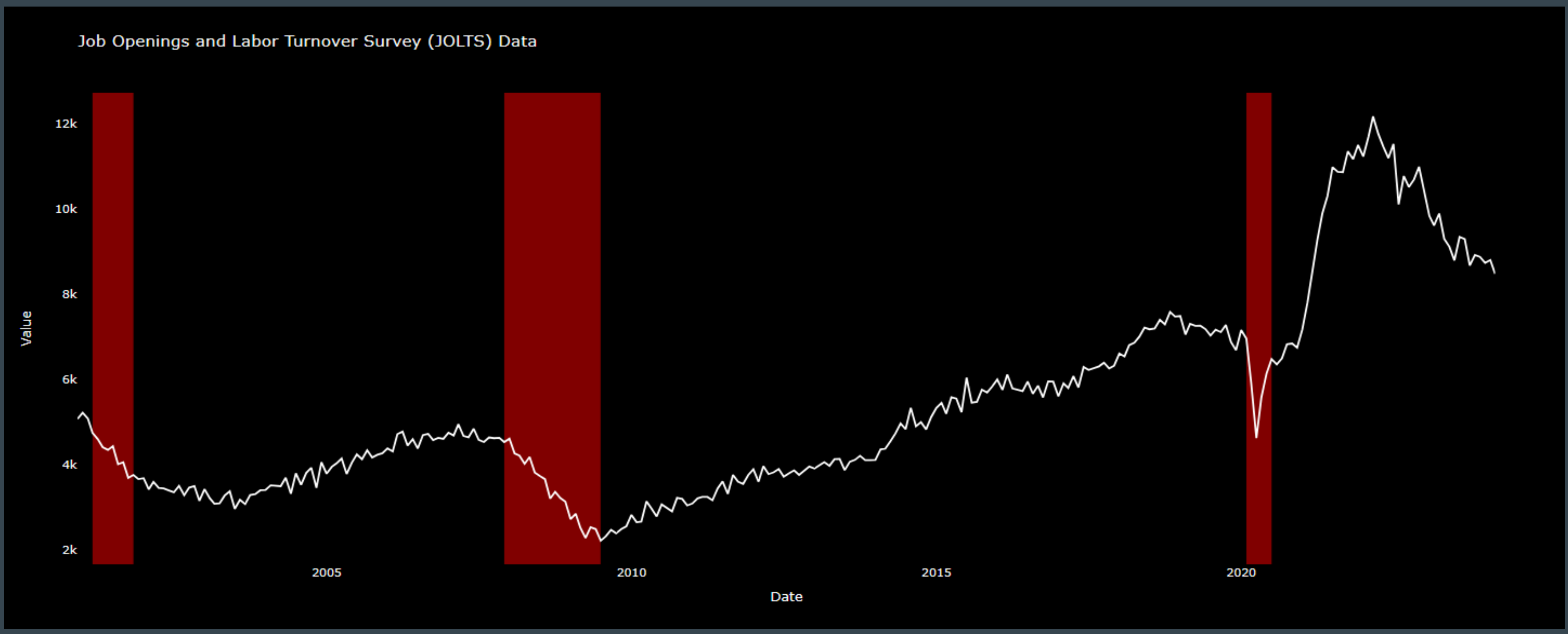
Housing

"Valuations in the residential real estate sector remained at elevated levels relative to historical standards and moved higher since the October report."

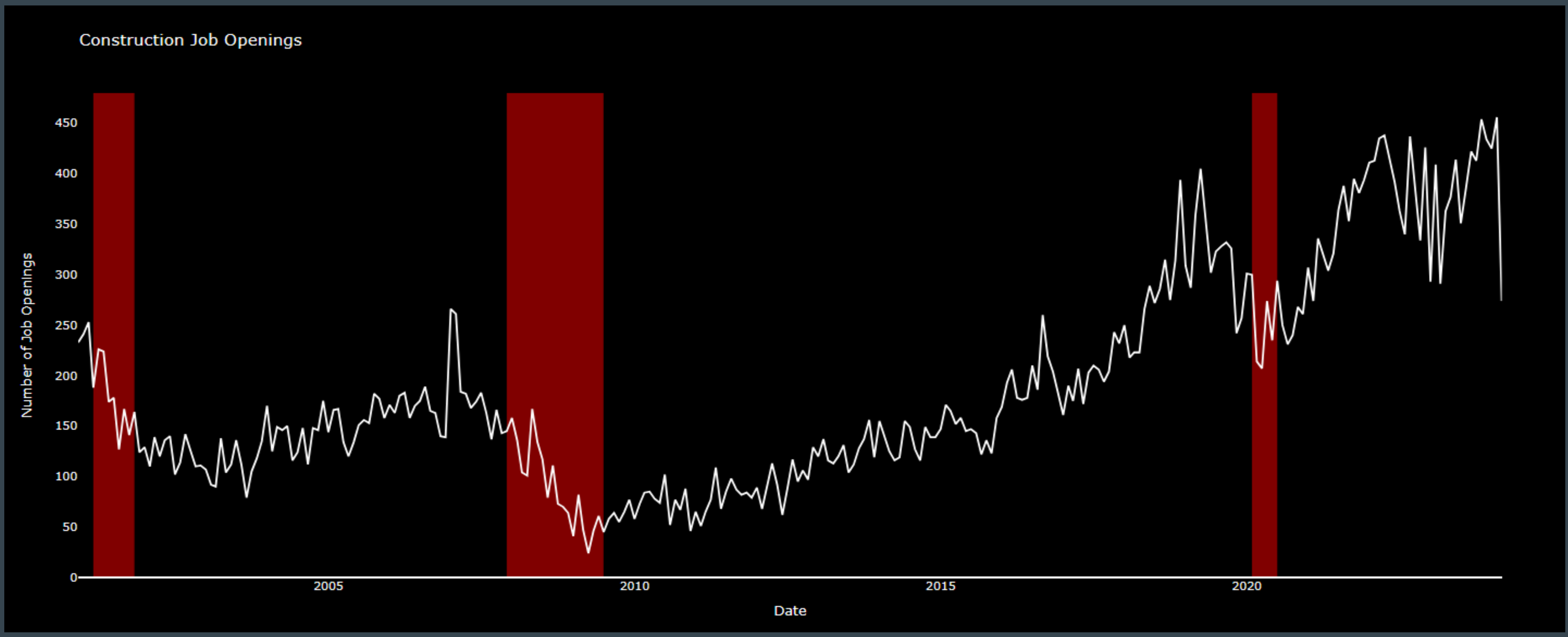
"A model of house price valuation based on prices relative to market rents and the real 10-year Treasury yield suggests that valuations in housing markets were increasingly stretched. Moreover, an alternative measure of valuation pressures (which uses owners' equivalent rent instead of market rents and, therefore, has a longer history) also suggested elevated valuations (figure 1.18). Moreover, the median price-to-rent ratio measured across a wide distribution of geographic areas remained close to its previous peak in the mid-2000s."

With these comments in mind, it brings me back to the mistake I think Jerome Powell made in his comments. He took rate hikes off the board when saying that he doesn't see the next move being a hike. If you have inflation across every metric, you look at heading higher and you clearly acknowledge asset prices are elevated, why would you take the one thing you know can bring down asset prices off table? I am not saying that they should hike but the threat to the market that there is the possibility of a hike would be enough to keep prices at bay. It sets the Fed up going into the end of the year to get data that is soft enough to justify a cut and create a scenario where asset prices to take off again. You will then be looking at inflation not back to target fueled by a higher market with the higher end consumer still spending and an underlying economy that is slowing into a recession. It seems like a dangerous scenario for the Fed, and they continue to put themselves into a corner.

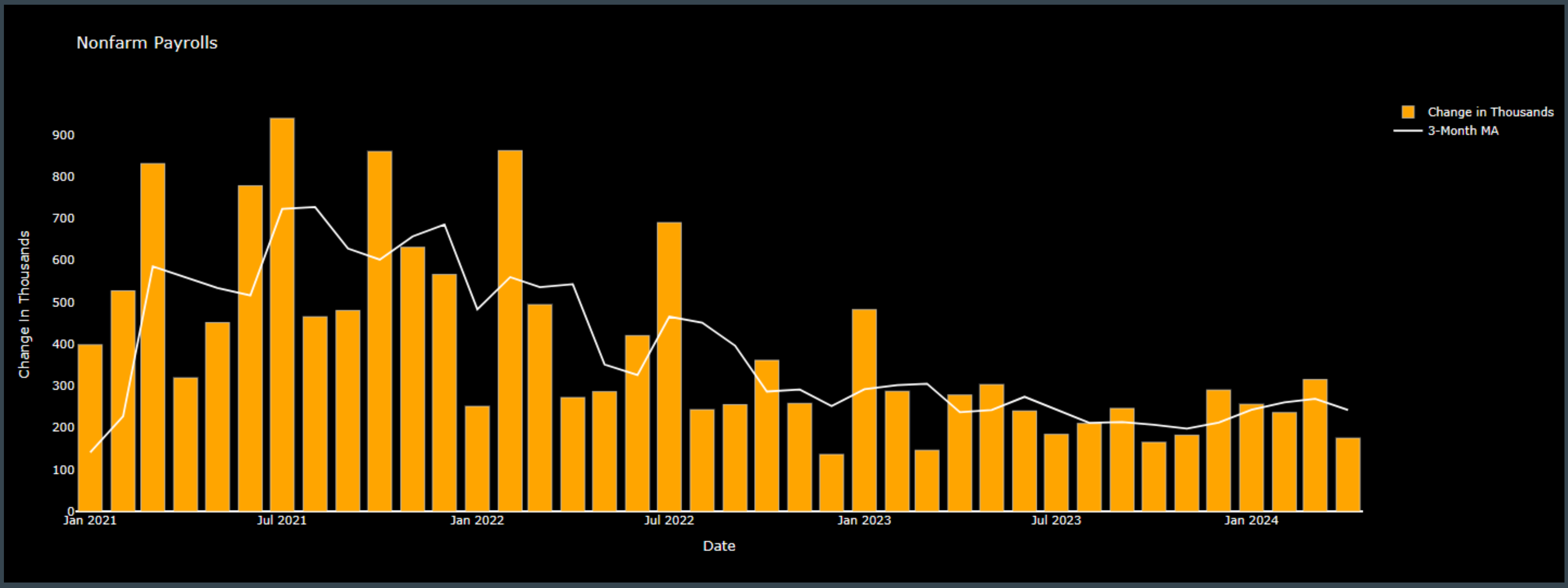
The latest JOLTS report, closely monitored by the Federal Reserve, showed that job openings decreased by 300,000 to 8.48 million from the previous month. Despite its popularity as an indicator, I maintain a degree of skepticism towards the overall credibility of this report. The primary issue lies in the nature of job postings. It's challenging to ascertain whether postings listed across various websites represent unique job opportunities or if they are duplicated. Additionally, it's unclear whether companies are genuinely intent on hiring or if they are merely 'testing the waters' to gauge the availability and quality of candidates in the job market.



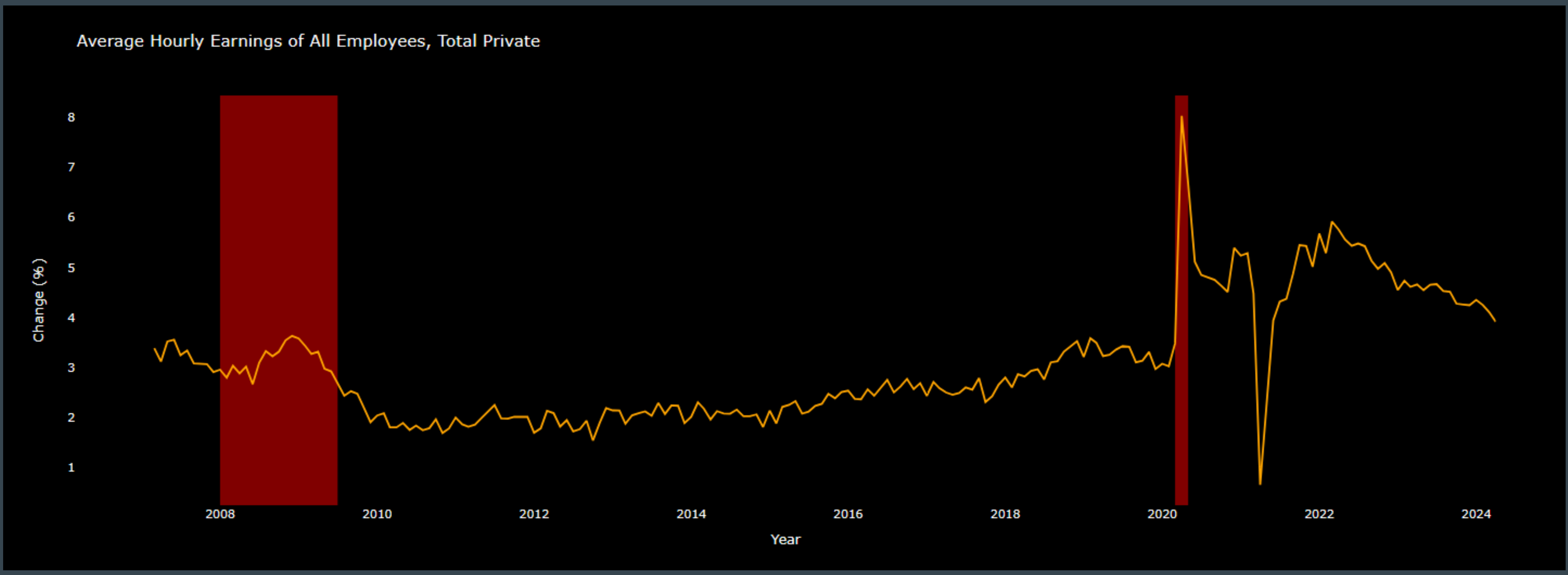
What was notable within the report was Job Openings for Construction, however. We saw the largest drop month-over-month in openings ever. When you have a large distortion in such a critical sector of the economy it is worth paying attention to. Openings fell by 182,000.



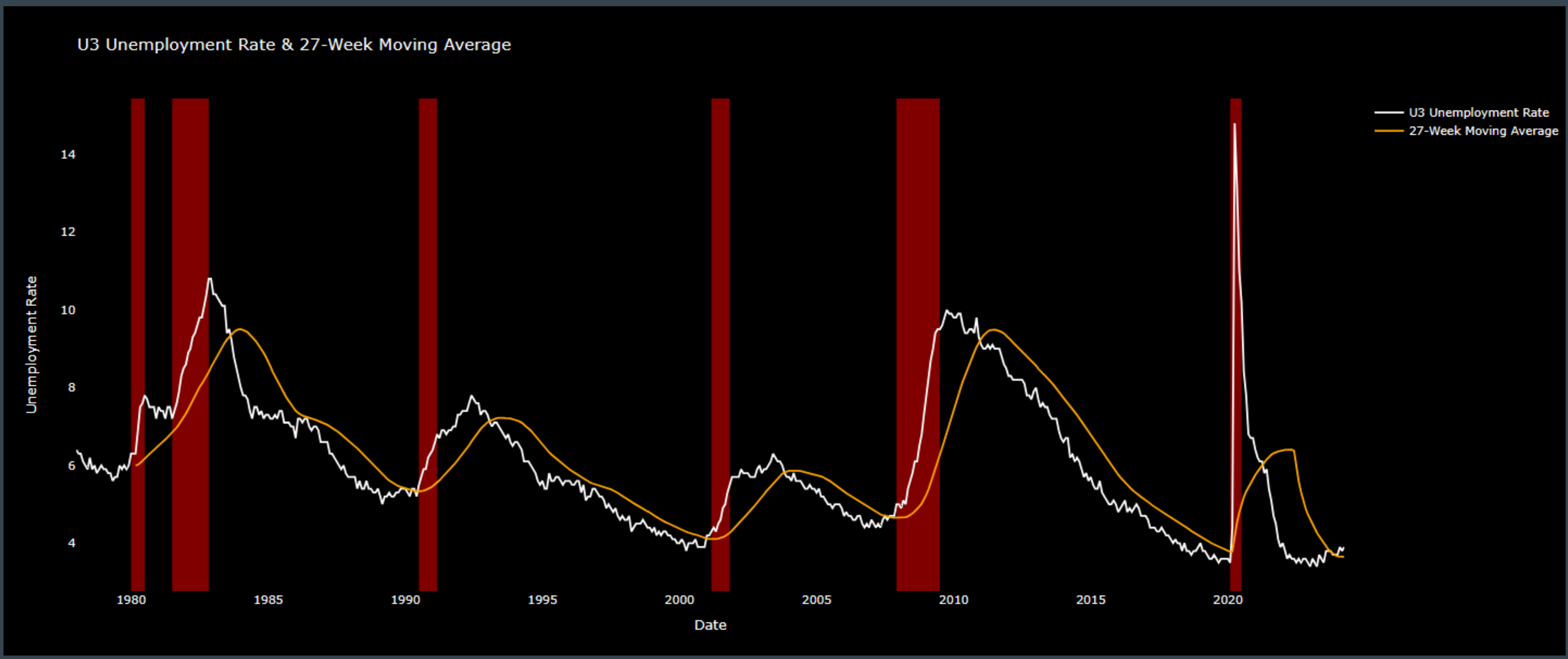
Nonfarm Payrolls were expected to come in at 240,000 and every print since late last year has beaten expectations. April came in at 175,000. While it is a weak print, it is not weak to the point where it is alarming, the market also rallied on it. Over 50% of the jobs were Government-related and this trend has persisted for 2 years now. The long-term average of less than 30%.



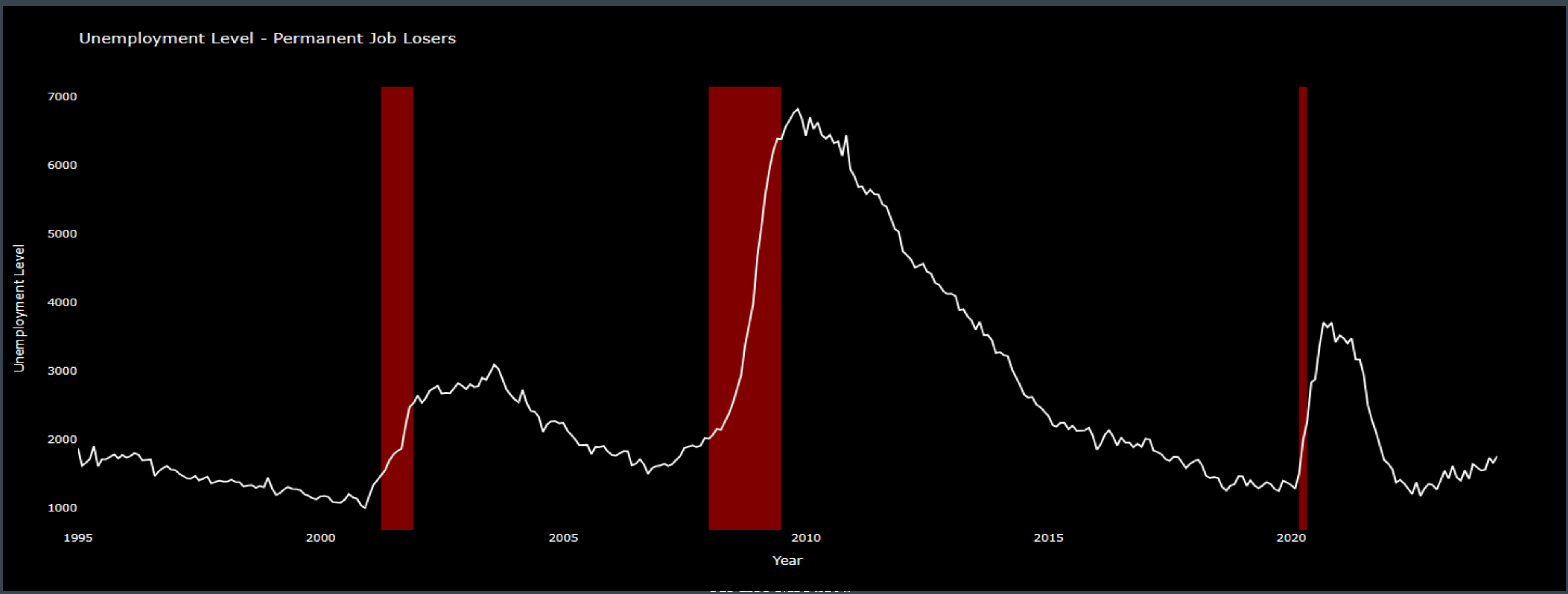
Average hourly earnings year-over-year fell from 4.1% to 3.9% and this is some positive news on the inflation front. Some of the problems with the headline numbers outside of rents is wage growth. Many of the cyclical components are at or below target. It is the non-cyclical components like wages that have been problematic. A loosening of the labor market is needed to fully correct those components.



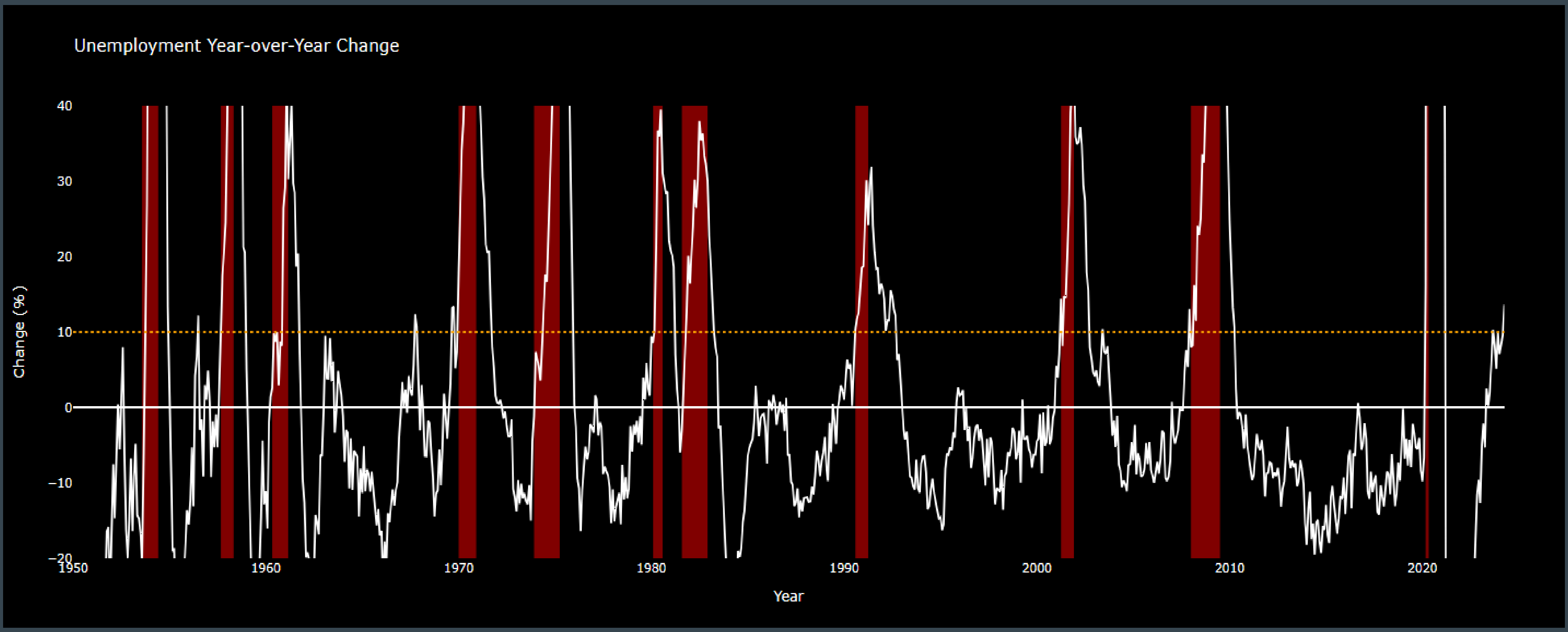
The unemployment rate moved up to 3.9% from 3.8%. It has been below 4% since November of 2021 but has broken above its 27-month moving average. This has been a very accurate recession signal going back to the 80's.



The number of people that have permanently lost their job jumped by 101,000 in April



Another indicator that has been consistent in accurately forecasting recessions is the year-over-year change in the number of people unemployed. Going back to 1950, a 10% change over a 12-month period has been 11 for 13 in signaling a recession. As of April, there are 13% more people unemployed this year than at the same time in 2023.



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