ALPINEMACRO
A Unique Mind On The Markets

GLOBAL STRATEGY

September 16, 2024

Debating Federal Reserve Policy

In This Report

Financial markets are currently discounting 100 basis points in Federal Reserve rate cuts by the end of this year, plus an additional 125 basis points in 2025. In other words, investors are betting that the Fed will take its policy rate all the way down to around 2.5-3% by the end of 2025.

There is no guarantee that the Fed will follow market expectations. More often than not, it doesn't. The relevant question for investors is, which side will the Fed surprise the market? Will it cut more and faster, or less and slower, than what is being discounted?

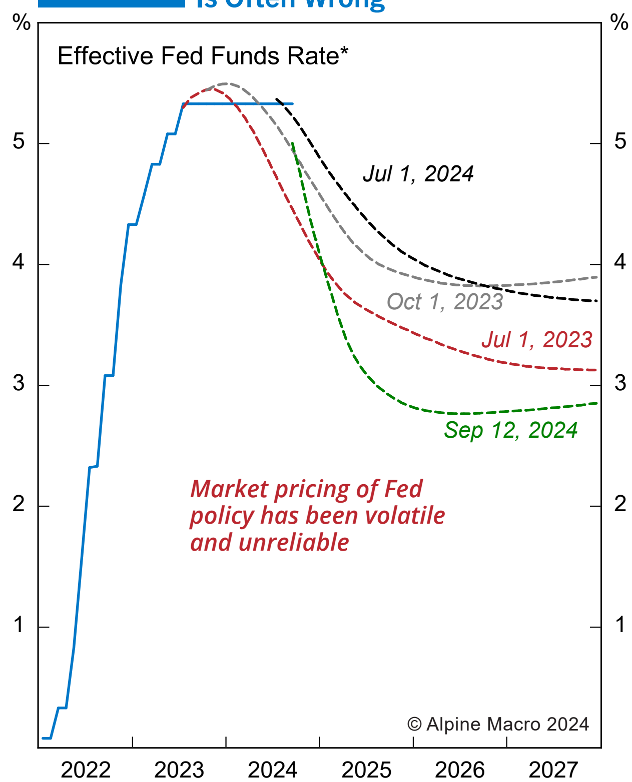
Markets Are Often Wrong

Chart 1 shows that market anticipations of Fed policy are highly unreliable and often change. For example, in July 2023, the forward market priced in a "terminal rate" at 3.1% by 2027; it was revised up by 75 basis points three months later. In July of this year, the market expected the fed funds rate to drop to 3.7%, which has since melted to 2.8% currently.

The stock market shakeout since early August on a weakening labor market has clearly spooked investors, raising fears of a possible recession. This has caused rate expectations to melt, bringing down the long end of the curve as well. Now, the 10-year/2-year Treasury yield curve is already disinverted, for the first time since 2022.

It is interesting to note that historically, financial markets have often, albeit not always, under-estimated both the speed and magnitude of rate

Chart 1 The Forward Market Is Often Wrong



*Dashed lines are forward curves as of indicated dates cuts (Chart 2). This is probably because Fed rate hikes have almost always caused financial crises, followed by recessions, which, in turn, have forced the central bank to ease aggressively to compensate for policy mistakes.

This time around, however, the market seems to be very quick to discount deep cuts, which is unusual from a historical perspective. With current expectations of a 3% fed funds rate by the end of 2025, financial markets are looking at a 1% real rate and 2% inflation. This projected policy rate is consistent with a "soft landing" outcome of sub-trend but non-recessionary growth.

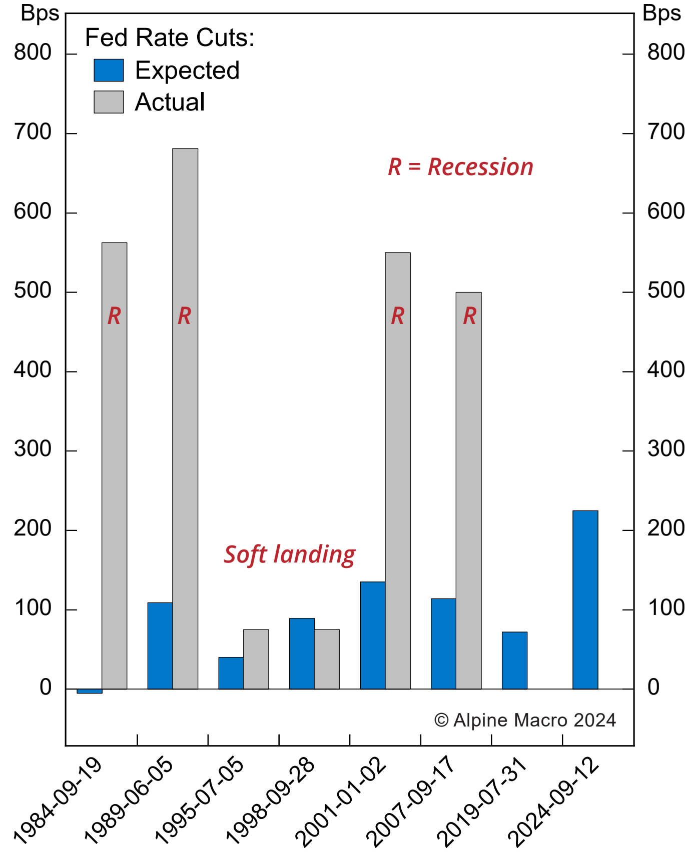
At Alpine Macro, we have had a few debates and brainstorming sessions lately. The subject of discussion is on which side the Fed could surprise the bond market: are they cutting more than anticipated or less? Getting a proper handle on this issue is consequential: if the Fed needs to ease much more than what is already priced in, bonds could still rally more while stocks could fall further. And *vice versa*.

Arguments For Faster And Deeper Cuts

Some of our strategists argue that the Fed needs to cut faster than what has been discounted by markets. They predict that U.S. economic growth will fall somewhere between zero and 1% in the next few months, which requires faster rate cuts to break the downward momentum. Otherwise, the risk of recession would rise exponentially.

They are concerned that the Fed could miss both of its mandates, with inflation undershooting the 2% target and the unemployment rate overshooting

Chart 2 Expected Versus Actual Rate Cuts

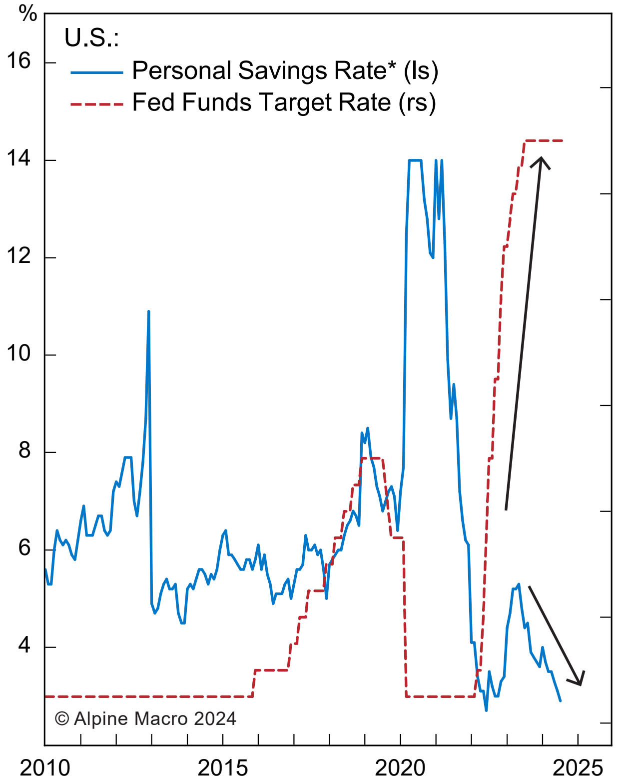


on the upside. The main arguments for faster and probably deeper rate cuts include:

First, the personal savings rate in the U.S. has experienced an unexpected drop in 2024, a highly unusual occurrence against the background of rising interest rates and a key reason that has propped up U.S. private consumption (Chart 3). Nevertheless, with the savings rate having already fallen to 2.9%, a 16-year low, it is unlikely to drop further.

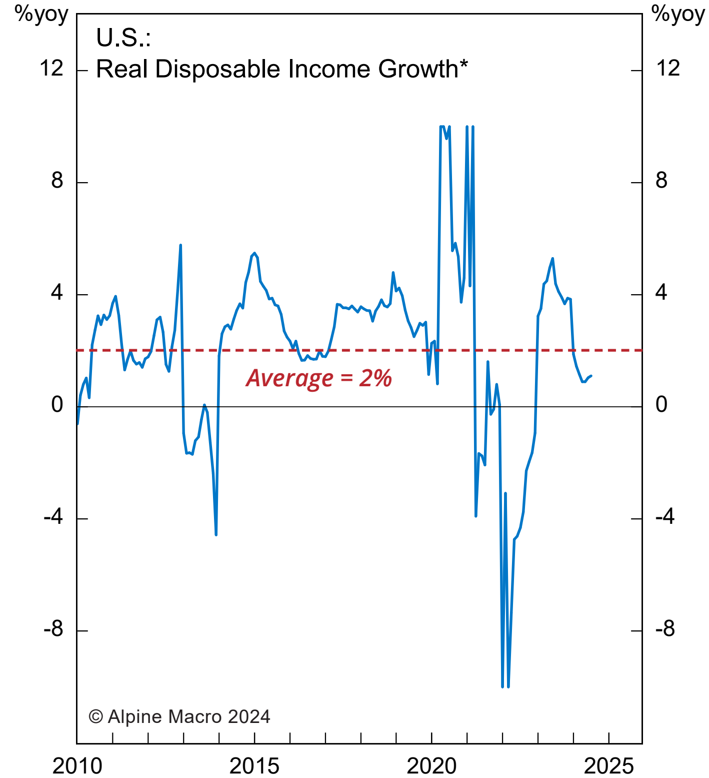
This means private consumption will inevitably soften to converge to real disposable income growth, which is 1.1%. With private consumption taking up more than 70% of the U.S. economy, a sharp slowdown in private consumption means a sharp downshift in overall economic growth.

Chart 3 Falling Savings Rate On Rising Interest Rates Is Unusual



*Truncated at 14

Chart 4 U.S. Real Disposable Income Growth



*Truncated at +/- 10

Second, the labor market is weakening rapidly. While increasing labor supply may have contributed to the recent rise in unemployment, labor demand seems to be softening as well. This can be seen from the rapid decline in the job vacancy rate as well as the fall in the quits rate. The job vacancy-to-unemployment ratio has also fallen to low levels.

Besides, average hourly earnings growth has fallen to 4.1% and, in real terms, stands at 0.77%. All of this suggests that the path of least resistance for income growth is down (**Chart 4**), unless the Fed cuts rates quickly to prop up private sector spending.

Third, the external environment is highly deflationary. China is veering towards full-blown deflation and even recession (**Chart 5**, top panel), which has been dragging down tradeable goods prices.

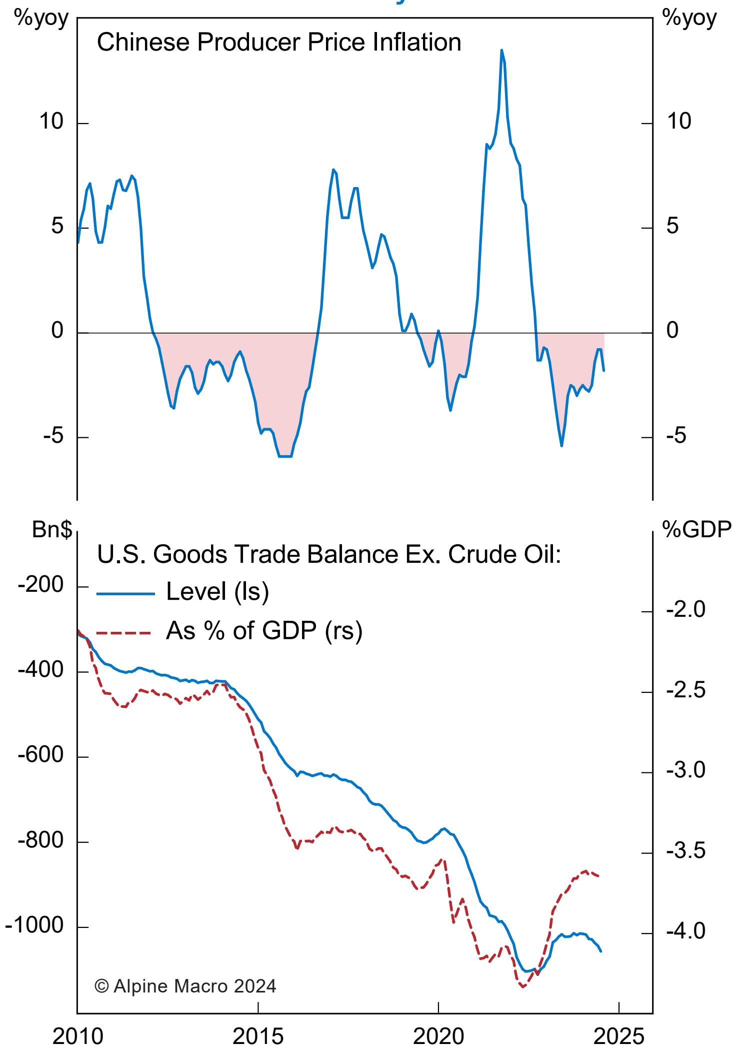
A faltering Chinese economy is removing a key source of economic growth and adding deflationary pressures. Europe has not fared much better, with the German economy having been contracting since 2021.

This means that the U.S. economy will shoulder the burden from the weak rest of the world, while importing deflation. The U.S. has already sucked in lots of imports from the rest of the world (**Chart 5**, bottom panel), and inflation could continue to surprise the market on the downside.

The Camp Believing In Less Rate Cuts

While there is a "deeper and faster" camp among our strategists, there are others who disagree. They believe that the Fed may end up easing less than

Chart 5 **External Environment Is Deflationary**



Note: Shading denotes PPI deflation

Chart 6 **GDP Growth Versus 10-Year TIPS Yield**

Note: Shading denotes U.S. recessions

what is discounted. In other words, they are betting on the right side of the probability distribution curve. This is a minority view, and I sympathize with this camp. The main points for this camp include:

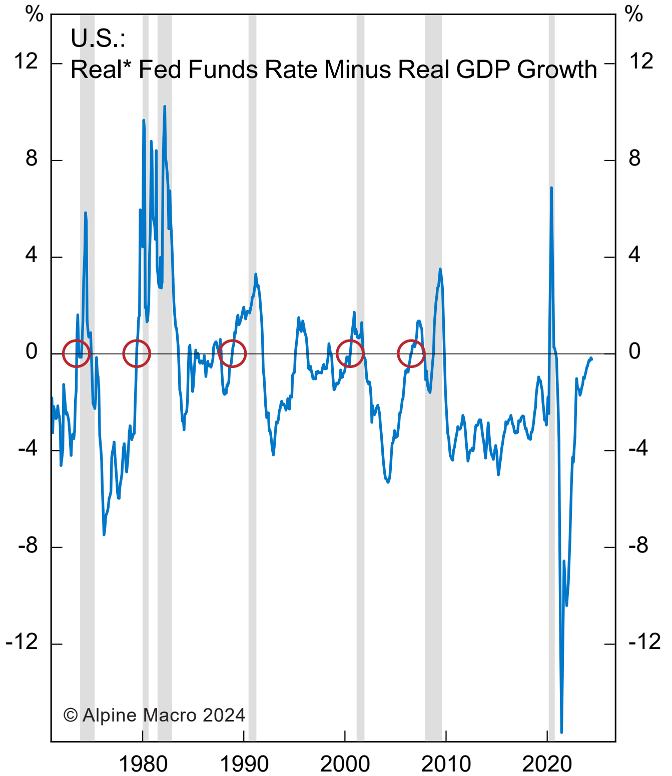
First, from a fundamental viewpoint, steady-state income growth in the U.S. should be at least around 2%, consisting of 1.5% labor productivity growth and 0.5% labor force growth, which could be underestimated if undocumented workers are added.

Short-term, real income is distorted by gyrations in CPI, but over time, the natural tendency is for real personal income to gravitate towards its steady state. Of course, for this adjustment to take place, it requires monetary policy to be neutral.

This camp agrees that Fed policy is too tight but argues that the Fed may not need to cut a full 225 basis points to avoid a recession and restore neutrality. The real policy rate has stood at 2.9% since May and 10-year TIPS yields are 1.6% (Chart 6 & 7). Neither is far above real GDP growth at the moment.

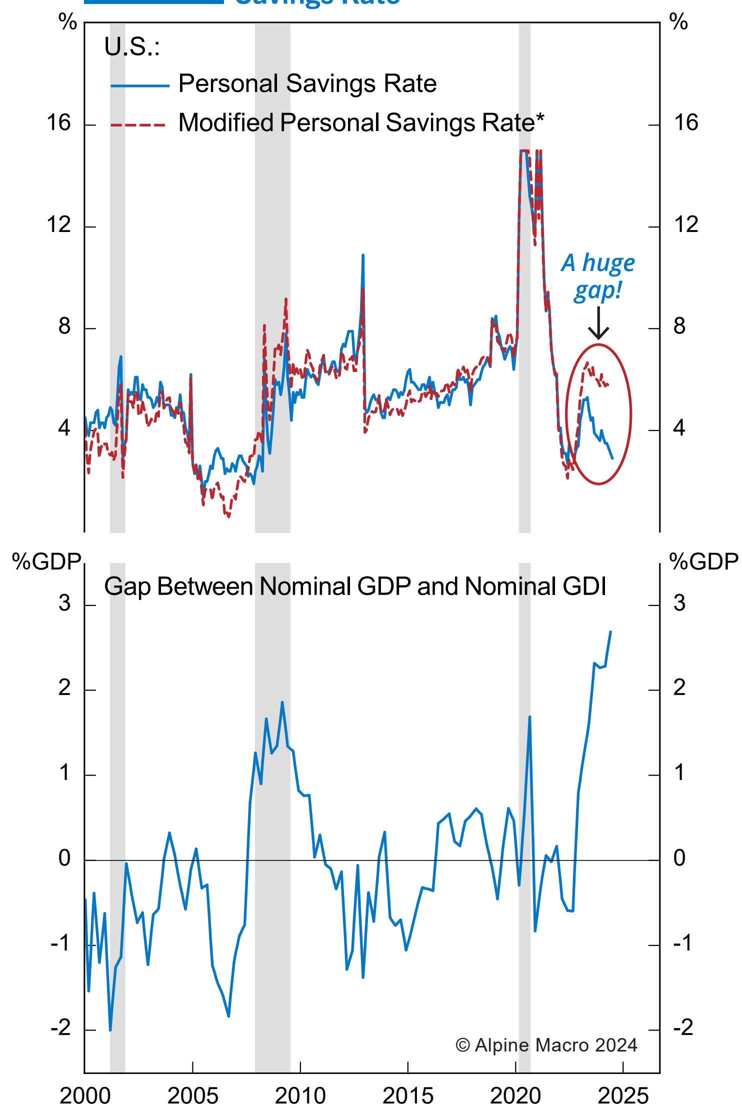
However, the Fed needs to front-load rate cuts as a precautionary measure against recession because falling inflation will tighten overall monetary conditions. That being said, it is questionable

Chart 7 How Tight Is Monetary Policy?



*Deflated by core PCE inflation
Note: Shading denotes U.S. recessions

Chart 8 Recalibration Of The Personal Savings Rate



*Calculated with disposable income scaled to nominal GDP
Note: Top panel series are truncated at 15; shading denotes U.S. recessions

whether the Fed needs to bring the policy rate all the way to 3% or even lower next year.

Second, the recent decline in the savings rate could turn out to be a statistical fluke. In recent quarters, GDP exceeds GDI by a huge, unexplained margin, but the savings rate is calculated by disposable income, which is backed out from GDI, subtracting private consumption, which comes from GDP.

This means either consumption is overestimated, or income is underreported. Either way, the savings rate should be much higher than the data shows. Our research team has recalibrated and reconciled the two series, and concluded that the savings rate is underreported by as much as 2.8 percentage points (Chart 8).

This is a very important point: it challenges the notion that a strong U.S. economy since 2023 has been mainly supported by a falling savings rate. Moreover, the point by recession proponents that the savings rate cannot fall any further and can only rise has also become very problematic.

Third, R*, or the neutral rate of interest, could be higher for the economy. Chart 9A suggests that

Chart 9A Secular Swings In Labor Productivity

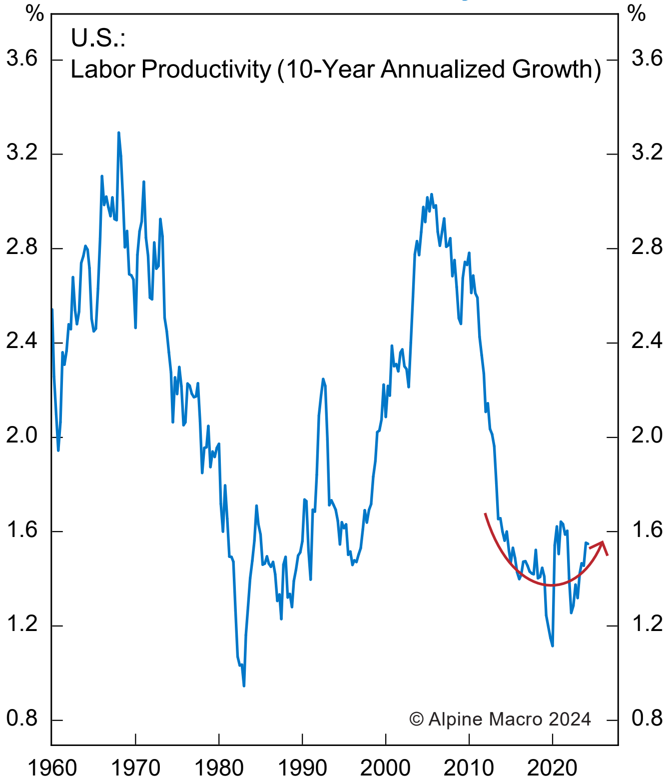
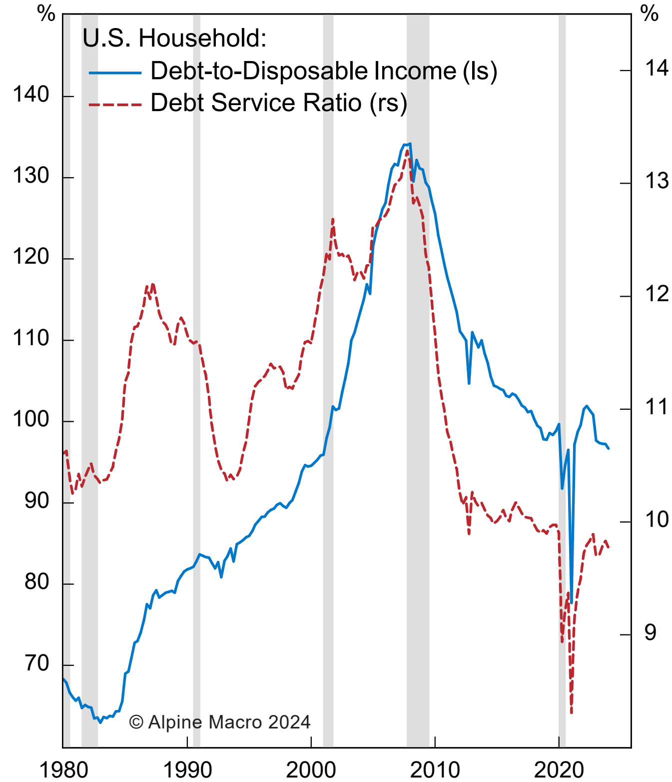


Chart 9B Households Are Under No Pressure



Note: Shading denotes U.S. recessions

the U.S. economy could be on the cusp of a major upswing in labor productivity growth, driven by wider application of AI. We are likely facing a similar situation as the 1990s when the internet revolution boosted labor productivity growth and triggered sustained strong economic growth.

Another key factor bolstering R* is that the U.S. household sector is done with deleveraging, which plagued the U.S. economy for more than a decade after the 2008 Global Financial Crisis. Last decade, policymakers had to throw the proverbial kitchen sink to stop the deleveraging process, which resulted in a sustained rise in the savings rate. This was the key reason why aggressive QE was needed, and real rates had to stay vastly negative to clear the savings market.

Today, with debt levels down and net worth way up, consumers are no longer under pressure to save more to pay down their debt. Even with the Fed having jacked up rates aggressively since 2021, household debt service costs remain very muted (**Chart 9B**). This implies that the economy does not need extraordinary measures like QE and/or very negative rates to prop up spending growth, implying a higher R*, or the neutral rate of interest, than before.

Fourth, we all know that monetary policy works "with long and variable lags" of 12-18 months, and a major concern in the marketplace is that the lagging impact of tight money will continue to work through the economy, dragging down economic activity and pushing the economy into a recession — even if the Fed begins to cut rates now.

Chart 10 Fed Policy: "Long And Variable Lags"

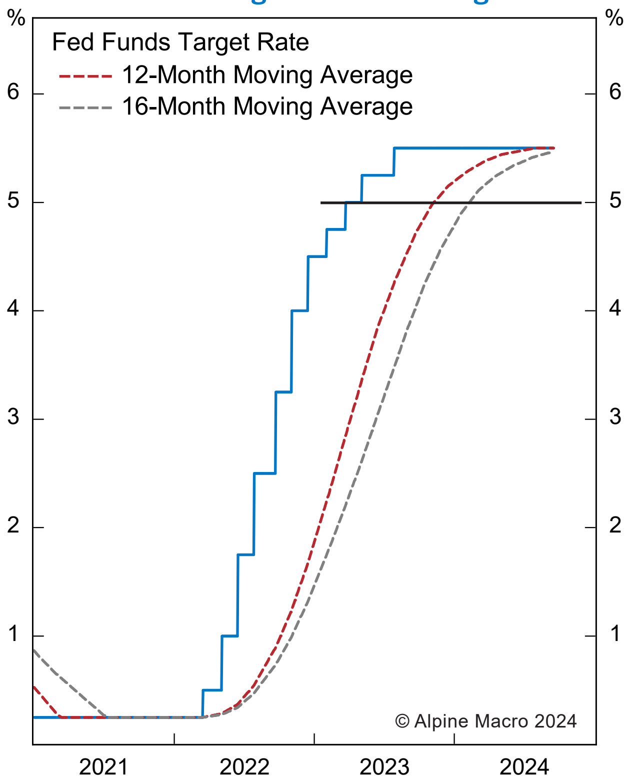
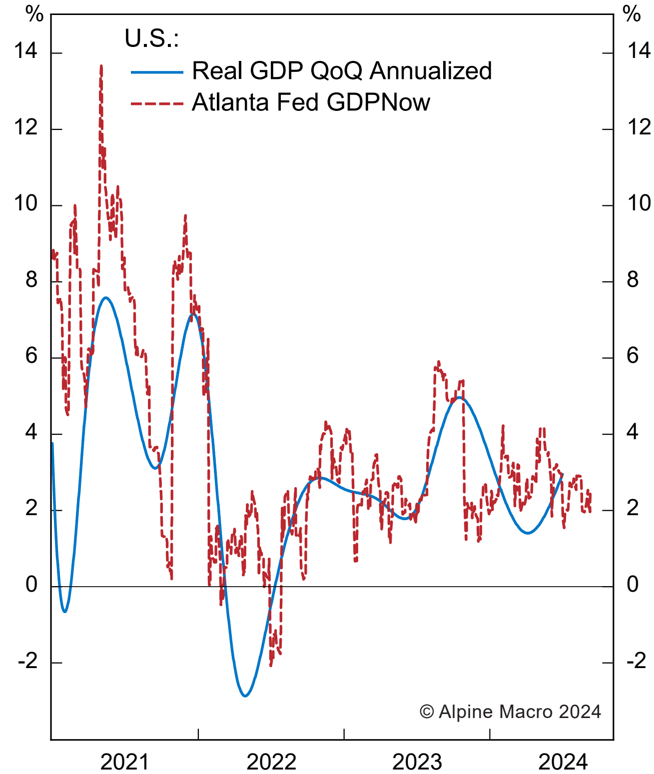


Chart 11 Atlanta Fed GDPNow



This is a legitimate argument and indeed represents a key risk to the "soft landing" scenario. Nevertheless, we should also take note that the 12-month moving average of the fed funds rate surpassed 5% a year ago, and its 16-month moving average did the same thing early this year (**Chart 10**).

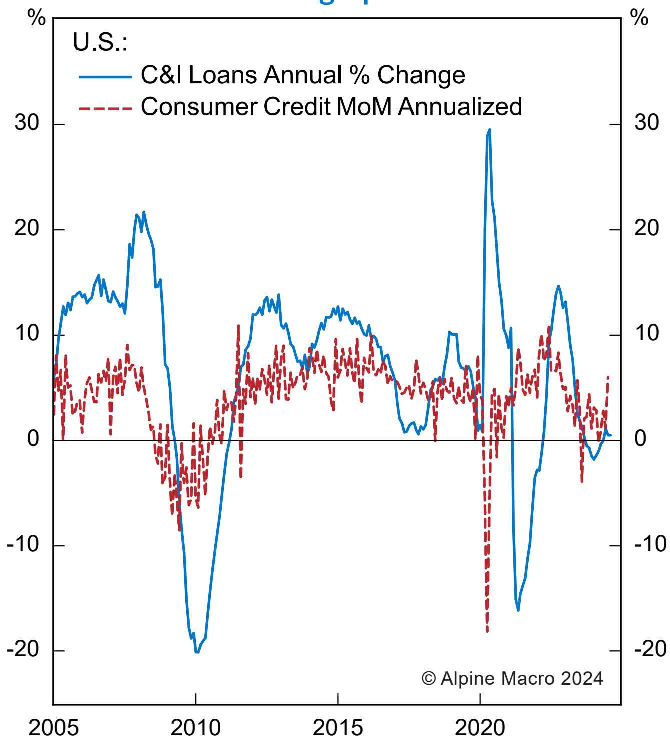
These moving averages are the best proxy for the lagging impact of rising rates. The point is that if monetary policy works with 12- or 16-month lags, the U.S. economy should have already felt the pinch a long while ago. This is the point where the U.S. economy would have already been tipped into a recession.

Of course, a recession may still happen as the impact of higher rates continues to work through the system, but most recession indicators do not point to elevated risks. The Atlanta Fed GDPNow cast is projecting 2.5% annualized GDP growth for Q3 (**Chart 11**) in spite of bad ISM numbers, a rising unemployment rate, and softening wage growth.

Finally, credit seems to be expanding again, as is bank loan growth (**Chart 12**). It is important to note that a credit crunch already seems to have occurred in 2023 and the consumer credit impulse is turning better. This is probably reflective of financial markets' anticipatory nature.

With bond yields having peaked out and fallen, overall bank loan production is beginning to pick up. It is rare to see a recession hit the economy at a time when credit creation is speeding up, though admittedly, bank credit is not a leading indicator.

Chart 12 U.S.: Credit Creation Is Picking Up



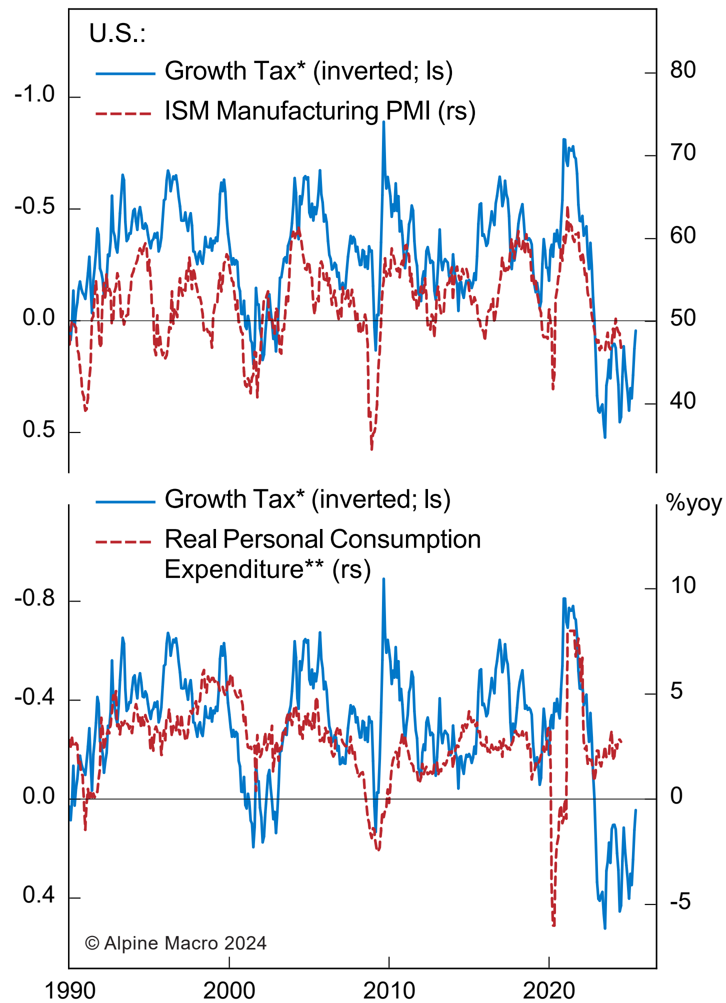
A Few Thoughts

In the end, all of us at Alpine Macro agree that the Fed not only needs to ease monetary policy but also front-load rate cuts, although we have different opinions on how much and how fast the Fed needs to move. As far as markets are concerned, a few points are worth noting:

First, markets are self-regulating. The recent sharp drop in crude prices and bond yields will act like tax cuts and boost growth. **Chart 13** shows that although ISM manufacturing PMI looks bad, cheaper oil and lower borrowing costs will likely contain the weakness in both private consumption and overall manufacturing.

Second, for bonds, we are currently at benchmark duration, but with a bullish bias for the remainder of the year. If the Fed indeed slashes rates to 3%, the long end of the curve should settle at 3.5%, even though it can undershoot this level in the short term. With the 10-year Treasurys trading at 3.7%, there is still some room for bond yields to fall.

Chart 13 Falling Oil Prices And Bond Yields Will Help Stabilize The Economy



*Combination of the dollar, brent oil price and interest rates; standardized and advanced by 9 months
**Truncated at -6 and 8

Early next year, we will evaluate the initial impact of rate cuts on the economy and reassess the Fed's policy outlook and our bond view. It is not impossible that we shorten duration and bet against continued, aggressive rate cuts in 2025.

Third, as for the stock market, investors should separate technical vulnerability from recession risks. The parabolic gains made by the Mag 7 since a year ago have set the stage for a major shakeout or correction. With the Mag 7 taking up so much weight in the S&P 500 index, the latter has been held hostage by the idiosyncratic shocks of the former.

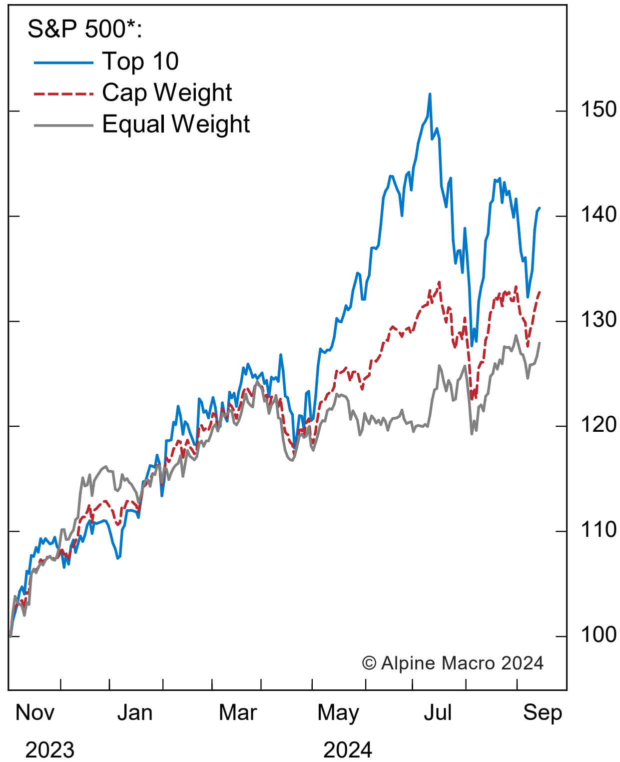
Chart 14 highlights this phenomenon. While the rise and fall of the S&P 500 index is largely dictated by the dramatic swings of a few mega-cap stocks, the equal-weighted index has barely corrected. We believe that the bull market will continue to broaden out, but the cap-weighted index will continue to gyrate for the remainder of the year until the overbought excesses in the mega-cap stocks are wrung out.

All of this means that investors need to be very careful how they interpret the recent market moves. It is very premature to extrapolate the recent weakness in the cap-weighted index into a recession. The broad-based, equal-weighted index is only down by 1%, which is hardly qualified as a correction.

Fourth, we need to keep in mind that the U.S. is a "consuming economy", while Eurasia is largely a "producing economy". The world has been in a manufacturing recession, and the "producing economy", led by China, is in trouble. Nevertheless, suppliers' troubles usually benefit consumers because the former need to cut prices and liquidate.

From a macro perspective, this implies that goods prices will likely keep deflating, while the dollar will unlikely fall much despite the Fed cutting rates. Commodity prices will also take a hit, while EM may continue to underperform.

Chart 14 U.S. Equities In A Proper Perspective



*Rebased to Nov 2023=100

Bottom line: We continue to look for a sharp runup in stock prices in 2025 on lower rates, steady growth and strengthening productivity growth. Keep in mind that the macro setup today is almost identical to that of the second half of the 1990s when the internet boom ultimately evolved into a massive equity bubble.

Chen Zhao
Chief Global Strategist

Investment Recommendations						
Tactical Investment Positions (3 - 6 months)						
Recommendations	**Open Date**	**Open Levels**	**Stop**	**Closing Date**	**Closing Levels**	**P&L Since Inception**
Long U.S. Regional Banks (ETF: KRE)	12/04/2023	48.12	53	-	-	18.9%
Long Russell 2000 (ETF: IWM)	08/19/2024	215.20	-	-	-	0.8%
Long Gold (ETF: GLD)	04/01/2024	207.82	-	-	-	14.8%
Long Nikkei 225 Unhedged	08/19/2024	37,389	-	-	-	1.5%
Long Long-Dated Treasury Bonds (ETF: TLT)	06/10/2024	90.89	95	-	-	11.5%
Long U.S. Financials (ETF: IYF)	08/19/2024	101.30	-	-	-	0.1%
Short Brent Oil[1]	08/26/2024	80.00	79	-	-	9.7%

Note: P&L is calculated using daily closing prices.
[1] We are adding a stop to our Short Brent Oil trade at $79.

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