ALPINEMACRO
A Unique Mind On The Markets

GLOBAL STRATEGY

September 23, 2024

A Preemptive Move

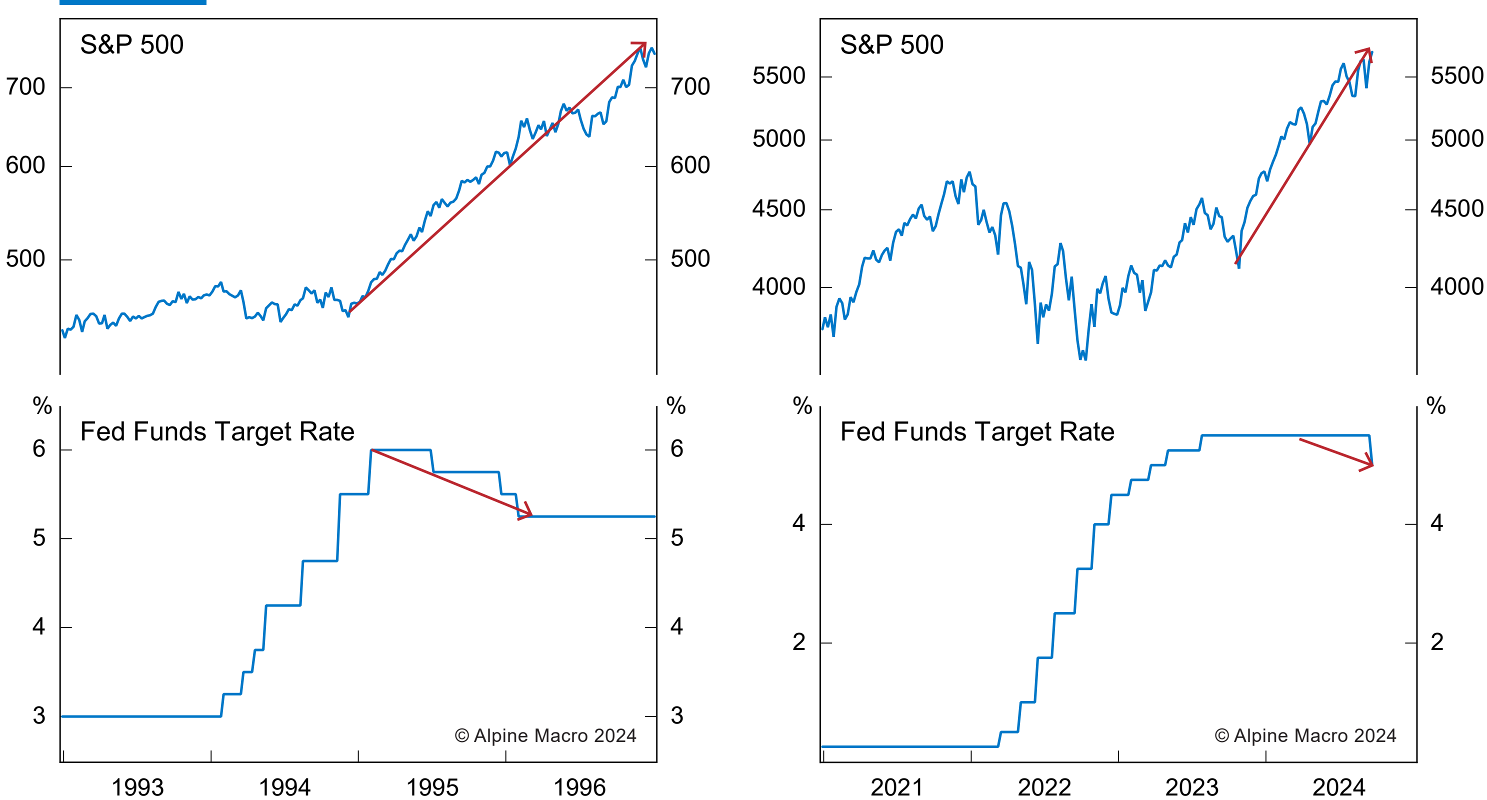
In This Report

Financial markets are still adjusting and digesting the Federal Reserve's 50 basis-point rate cut last Wednesday. Here is our take on this momentous move:

First, the 50 basis-point rate reduction is a necessary step to ringfence the economy against a possible downturn. The economy is doing fine, and the Fed could have moved slowly by chopping only 25 basis points. The jumbo rate cut suggests that the central bank is trying to be preemptive rather than passive in responding to signs of a cooling labor market.

Second, the U.S. equity market has embraced the rate cut with a strong rally, but bonds have softened with yields backing up. This could signal that the bond market has seen through the current rate cut by casting doubt on whether the U.S. economy needs 225-250 basis points in rate reductions by the end of 2025.

Chart 1 The 1990s Experience — Like Father, Like Son?



Third, industrial commodities and crude prices have all rebounded on the Fed's move last Wednesday, confirming that the rate cut is regarded as injecting a pro-growth stimulant by financial markets. Of course, a softening dollar may also have helped lift the commodity complex.

Finally, in recent decades, the starts of Fed easing cycles have often coincided with falling stock prices but a strengthening bond market. This is because the Fed almost always eases into recessions.

The only time when the Fed eased into an expanding economy was in the second half of the 1990s. During this period, stocks exploded upward (**Chart 1**). As we have often reminded our clients, the similarities between now and then are stunning, including:

- A strong U.S. economy but a weak rest of the world;
- a huge technology boom (internet then vs AI now);
- rising labor productivity growth;
- continued disinflation.

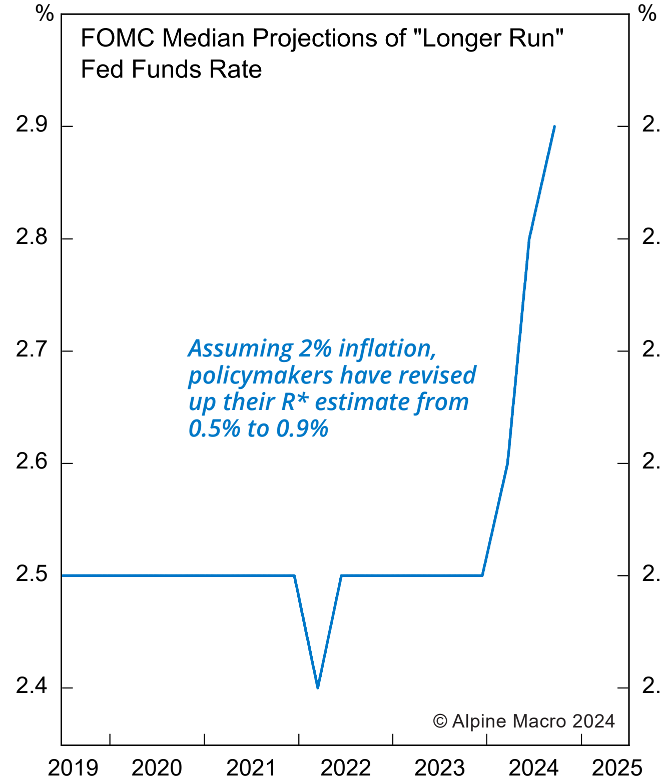
We envisage that the U.S. stock market will go through an experience similar to the second half of the 1990s.

Is The Fed Changing Its Mind On R*?

As discussed in last week's publication, *"Debating Federal Reserve Policy"*, I have long suspected that the U.S. economy may not need rate cuts as deep and aggressive as priced in by markets to secure continued expansion.

It seems that FOMC members are revising up their estimated R*. **Chart 2** is the FOMC members' median

Chart 2 The Fed Has Changed Its Mind On R*



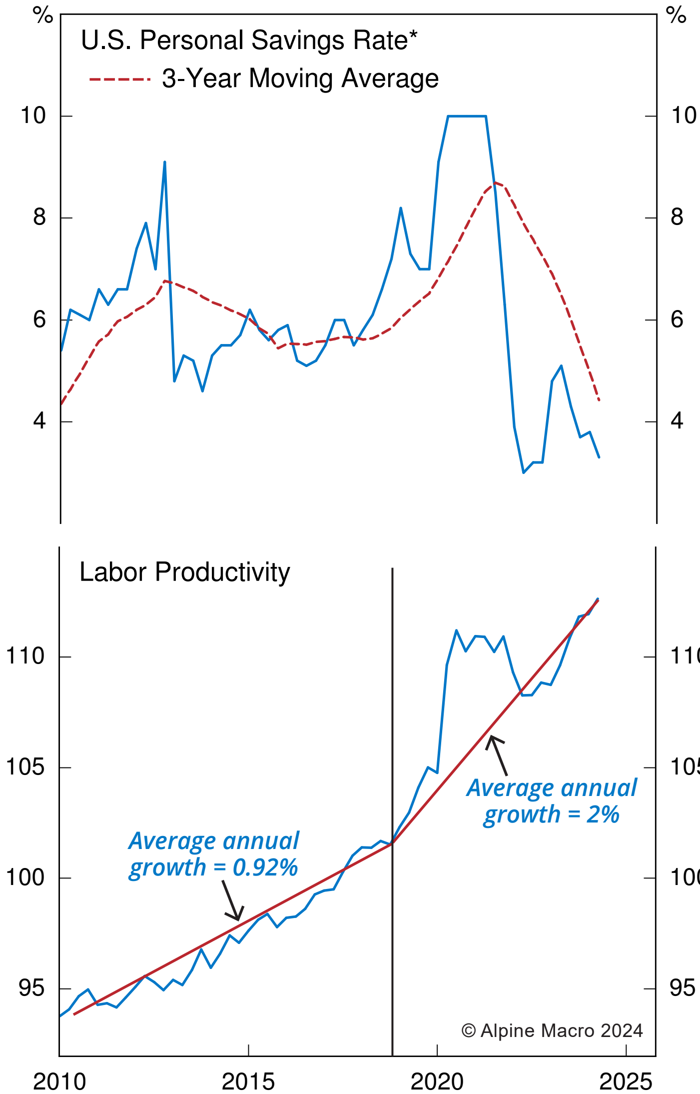
projections of the "longer run" fed funds rate, as laid out in quarterly projections in September. The Fed has raised its estimate of the neutral rate from 0.5% last December to about 1% today.

We suspect this number will get revised up further as time passes.

First, the U.S. household sector is done with the so-called "deleveraging process", which plagued the U.S. economy for the entire 2010s. With household debt levels having been cut sharply, U.S. consumers are no longer under pressure to save more and spend less (**Chart 3**, top panel).

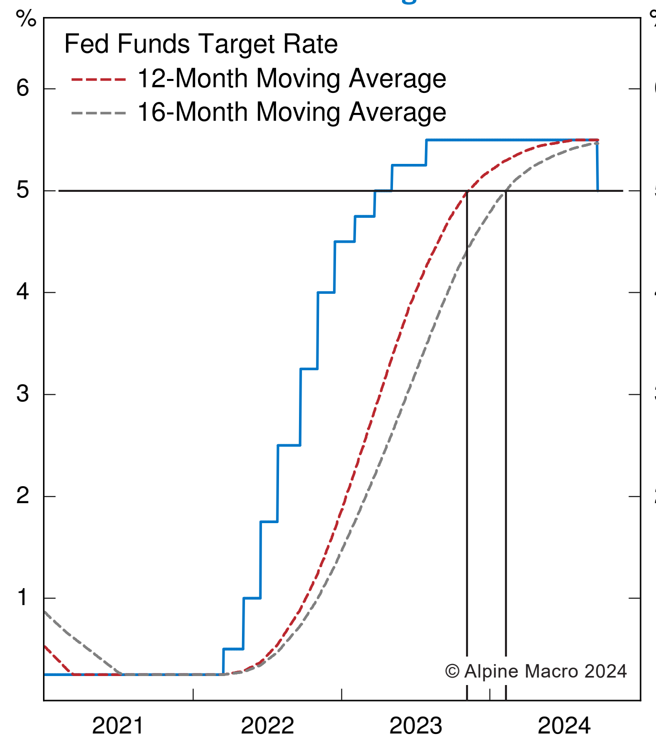
Second, there is clear evidence of accelerating labor productivity. Output per hour grew at 0.9% annually between 2010 and 2019. Since then, the

Chart 3 Forces That Increase R*



*Truncated at 10

Chart 4 Approximating Long And Variable Lags



trend growth has more than doubled, now at a 2% annual rate (**Chart 3**, bottom panel). Higher productivity growth means higher steady-state growth for the economy and, hence, higher R*.

Third, the large number of undocumented workers have boosted the true size of U.S. labor force growth. This, plus more than 2 million new entrants into the labor market per quarter, is helping overcome the impact of an aging population on GDP growth.

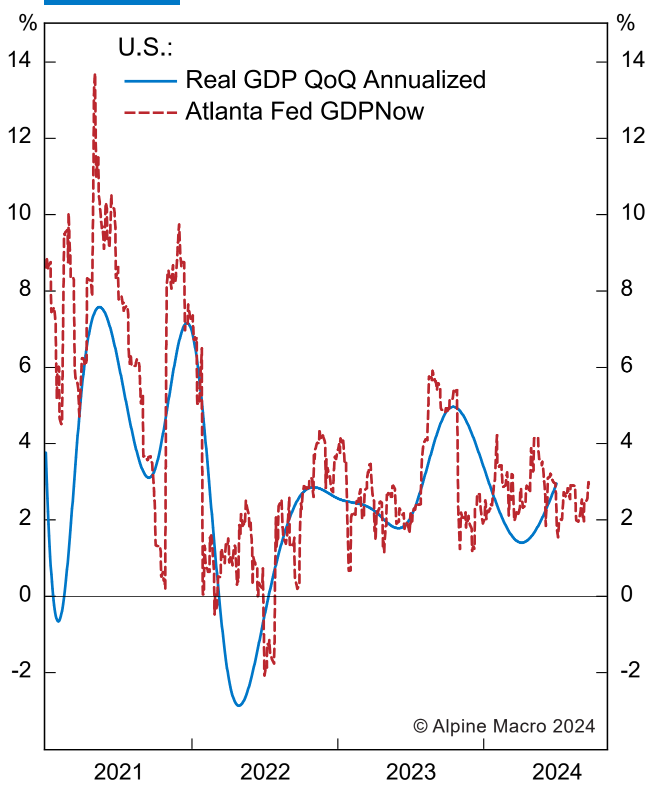
What About Long And Variable Lags?

Some may say that monetary policy works with long and variable lags, so even if the Fed cuts rates today, the impact will not be felt for a year or more. This is why some are saying that it is too late for the Fed to pull the economy away from a recession.

The problem with this argument is that the U.S. economy has already been dealing with very high rates of interest for some time. **Chart 4** shows the 12-month moving average of the fed fund rate, which is a proxy for the lagging impact of the policy rate, crossed the 5% threshold last November, and the 16-month moving average has done the same thing since this past February.

Yet, there are few signs that the U.S. economy is buckling. Retail sales growth has been strengthening,

Chart 5 Atlanta Fed GDPNow

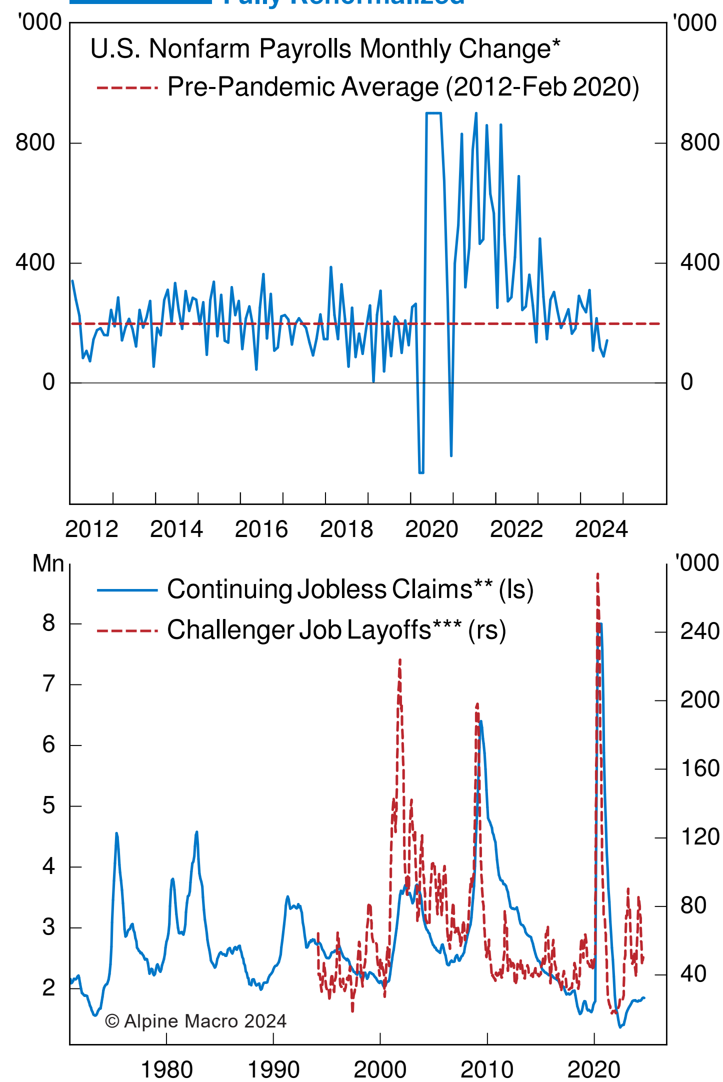


while the Atlanta Fed GDPNow is projecting nearly 3% growth for Q3 (**Chart 5**). Job creation was soft last month, but it is still within the range of average monthly private payroll increases in pre-pandemic times (**Chart 6**, top panel). It seems the labor market has already "landed" from the extraordinary post-pandemic boom. Needless to say, any additional weakening is not desirable, but both job losses and corporate layoffs are still very low (**Chart 6**, bottom panel).

Market Implications

- We have been bullish on stocks and remain so. However, we are less bullish on bonds, having moved our recommended duration from "overweight" to benchmark since early August.[1] Our bond model suggests that the fair value for 10-year

Chart 6 The Labor Market Has Fully Renormalized



*Truncated at -300 and 900
**Truncated at 8; shown as 3-month moving average
***Shown as 3-month moving average; source: Challenger, Gray & Christmas, Inc.

Treasury yields is 3.7%. Should recession fears return and drive yields far below those levels, we will short duration.

- Our recommended equity/bond split has been 60-40. With bond yields already at their fair value, it is logical to allocate more to stocks and less

1 Alpine Macro *Global Strategy Special Report* "Why Are We Still Bullish?" (August 5, 2024).

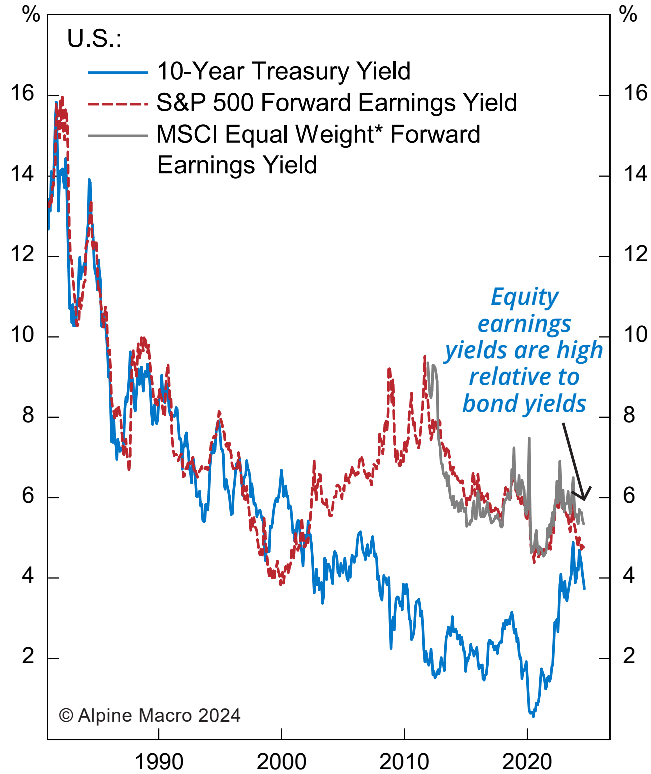
to bonds. We are changing our recommended allocation to 70% in stocks and 30% in bonds.

- The S&P 500 Equal Weight Index is trading at 19 times forward P/E. This means that the vast number of stocks in the equity market are undervalued. Historically, bond yields and equity earnings yields were identical most of the time throughout the 1970s and 1990s (**Chart 7**). Based on this yardstick, the equal-weighted index could be undervalued by as much as 25%. Even the cap-weighted index is still undervalued.

- In the next 6-12 months, "broadening out" could continue to characterize the bull market, which means small caps, financials, and REITs could outperform the benchmark. Tech could continue to do well in a falling rate environment.

Chen Zhao
Chief Global Strategist

Chart 7 Are Equities Too Expensive?



*Mid & Large Cap

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	-	-	22.9%
Long Russell 2000 (ETF: IWM)	08/19/2024	215.20	-	-	-	3.0%
Long Gold (ETF: GLD)[1]	04/01/2024	207.82	Rolling -5%	-	-	16.5%
Long Nikkei 225 Unhedged	08/19/2024	37,389	-	-	-	2.5%
Long Long-Dated Treasury Bonds (ETF: TLT)	06/10/2024	90.89	95	-	-	9.9%
Long U.S. Financials (ETF: IYF)	08/19/2024	101.30	-	-	-	2.9%
Short Brent Oil	08/26/2024	80.00	79	-	-	6.1%

Note: P&L is calculated using daily closing prices.
[1] We are adding a rolling -5% stop point on our Long Gold (ETF: GLD) trade.

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