MORNING BRIEFING
January 10, 2023

Powell's Conundrum

Check out the accompanying chart collection.

Executive Summary: US bond markets haven't responded as expected to the Fed's warnings not to expect the federal funds rate to be lowered this year. Bond investors seem unfazed by this, which is fazing Fed Chair Jerome Powell. He's been fretting that easy financial conditions aren't what the Fed needs to see at this time of tightening by the Fed. It's all reminiscent of "Greenspan's conundrum" during the early 2000s. The bond market then too seemed unaffected by the Fed's tightening. This time, Fed officials have turned more hawkish because investors aren't listening to their warnings. Perhaps, Fed officials should listen to the bond market.

Weekly Webcast. If you missed Monday's live webcast, you can view a replay *here*.

Strategy: Don't Fight the Bond Market. Fed Chair Jerome Powell and his colleagues at the Fed are puzzled and concerned. They don't understand why the 10-year US Treasury bond yield has been falling since it peaked at 4.25% on October 24, 2022. It was down to 3.52% yesterday morning (*Fig. 1*). They are worried that the bond market isn't getting their message. They intend to raise the federal funds rate, which is currently 4.50%, to at least 5.25%. When they deem that it is at a level that is restrictive enough to bring down inflation, they'll keep it there until at least the end of the year. In other words, they will not be lowering the federal funds rate in 2023. Consider the following:

(1) *The December meeting and presser.* On January 4, the Fed released the *minutes* of the December 13–14 FOMC meeting. The committee raised the federal funds rate by 50bps following four straight 75bps increases. The committee also issued projections showing more federal funds rate hikes totaling 75bps this year. The minutes reinforced the FOMC's united resolve to bring inflation down. The minutes also reflected the committee's frustration with the bond market as well as the stock market and the trade-weighted dollar:

"Participants noted that, because monetary policy worked importantly through financial markets, an unwarranted easing in financial conditions, especially if driven by a misperception by the public of the Committee's reaction function, would complicate the Committee's effort to restore price stability."

During Powell's *press conference* following the December FOMC meeting, CNBC's Steve Liesman asked: "Since the November meeting, the 10-year has declined by 60 basis points, mortgage rates have come down, high-yield credit spreads have come in, the economy's accelerated, and the stock market's up 6%. Is this loosening of financial conditions a problem for the Fed in its effort, and its fight, against inflation? And, if so, do you need to do something about that? And how would you do something about that?"

The phrase "financial conditions" appeared 13 times in the transcript of the December 14 presser. The word "restrictive" appeared 15 times. For example, Powell responded as follows to Liesman:

"[I]t is important that overall financial conditions continue to reflect the policy restraint that we're putting in place to bring inflation down to 2%. We think that financial conditions have tightened significantly in the past year. But our policy actions work through financial conditions. And those, in turn, affect economic activity, the labor market, and inflation. So what we control is our policy moves in the communications that we make. Financial conditions both anticipate, and react to, our actions. I would add that our focus is not on short-term moves, but on persistent moves. And many, many things, of course, move financial conditions over time. I would say it's our judgment today that we're not at a sufficiently restrictive policy stance yet, which is why we say that we would expect that ongoing hikes would be appropriate."

(2) *Greenspan's conundrum.* We are getting a sense of Yogi Berra's "It's like déjà vu all over again." The federal funds rate was increased by 25bps to 1.25% at the June 29–30, 2004 meeting of the FOMC. That was followed by increases of 25 bps at every one of the next 16 meetings, putting the rate at 5.25% after the June 29, 2006 meeting. It remained at that level through August 2007 (*Fig. 2*). Then-Fed Chair Alan Greenspan explained that the "measured pace" of tightening was necessary to sustain the recovery and avert deflation.

In the bond market, the 10-year US Treasury bond yield fluctuated around 4.50% from 2001 to 2007. That was a big surprise given that short-term rates were almost certainly going to go up at every FOMC meeting, albeit at an incremental pace, once the Fed commenced its measured rate hikes. Mortgage rates, which tend to move with the 10-year US Treasury yield, also diverged from the steady upward march of the federal funds rate.

That phenomenon in the bond market became known as "Greenspan's conundrum." In his February 16, 2005 semiannual testimony to Congress on monetary policy, the Fed chair said globalization might be expanding productive capacity around the world and moderating

inflation. It might also be increasing the size of the global savings pool. He concluded:

"But none of this is new and hence it is difficult to attribute the long-term interest rate declines of the last nine months to glacially increasing globalization. For the moment, the broadly unanticipated behavior of world bond markets remains a conundrum. Bond price movements may be a short-term aberration, but it will be some time before we are able to better judge the forces underlying recent experience."

Following the Great Financial Crisis, in his 2010 *testimony* before the Financial Crisis Inquiry Commission, Greenspan blamed the calamity on a global savings glut, which also explained his conundrum. The crisis wasn't the Fed's fault since the Fed had been raising the federal funds rate before the crisis. He blamed foreign investors for piling into the US bond market, especially mortgage-backed securities, which provided the credit that fueled the housing bubble notwithstanding the Fed's efforts to tighten monetary policy.

(3) *Powell's conundrum.* Powell seems to be facing a very similar conundrum. Foreign investors have been piling into the US bond markets. US Treasury data show that US private net capital inflows totaled a record $1.7 trillion over the 12 months through October 2022 (*Fig. 3*). Private net foreign purchases of US Treasury, agency, and corporate bonds soared to a record $1.2 trillion over this period, led by $1.0 trillion in purchases of US Treasury notes and bonds (*Fig. 4* and *Fig. 5*).

The only problem with this narrative is that bond yields soared even as foreigners snapped up US bonds at a record pace over the 12 months through October. This confirms our view that the balance of supply and demand matters less in determining bond yields than do expectations for Fed policy and how it is likely to impact the economy and inflation.

(4) *They just won't listen.* Fed officials are frustrated because the bond market isn't listening to them. Perhaps they should be listening to the bond market? The adage "Don't Fight the Fed!" certainly was sensible last year. Perhaps this is the year we also should be listening to the bond market.

The 2-year Treasury note yield is a very good leading indicator of the federal funds rate (*Fig. 6*). The former tends to lead the latter by a few weeks on the way up and on the way down. The yield tends to peak at about the same time as the federal funds rate.

This time, the Fed seems to be committed to raising the federal funds rate by at least another 75bps to 5.25% during the first half of the year. Yet the 2-year yield peaked at

4.72% last November 7 and was down to 4.20% yesterday (*Fig. 7*). That's despite the barrage of warnings from Fed officials that they will continue to hike the federal funds rate and keep it in restrictive territory at least through the end of this year.

Bond investors also haven't responded as expected to the Fed's recent warnings. The 10-year Treasury bond yield peaked at 4.25% on October 24, 2022 and was down to 3.52% yesterday.

(5) *Listen to the yield curve.* The yield-curve spread between the 10-year and 2-year Treasuries inverted during the July 8 week last year (*Fig. 8*). It was -68bps yesterday. In the past, the yield curve inverted at the tail end of monetary tightening cycles, signaling that fixed-income investors believed that any further tightening would trigger a financial crisis that would turn into an economy-wide credit crunch and a recession, which would bring inflation down (*Fig. 9* and *Fig. 10*).

This time might be different. The chain of events might not lead to a financial crisis, in turn leading to a credit crunch, a recession, and lower inflation. Instead, the 2-year and 10-year yields and their yield spread may be signaling that inflation peaked last summer and will continue to moderate this year. If inflation does moderate relatively quickly, the terminal federal funds rate may not be any higher than 5.25%. In this scenario, the credit system and the economy should remain surprisingly resilient despite the Fed's tightening, in our opinion.

Powell's conundrum can be resolved by following the lead of the yield curve. In our 2019 study *The Yield Curve: What Is It Really Predicting?*, Melissa Tagg and I concluded that inverted yield curves predict that additional monetary policy tightening would cause a financial crisis leading to a credit crunch and a recession. We are now updating our conclusion to include the possibility that the current inverted yield curve might simply be anticipating lower inflation, which would cause the Fed to stop raising interest rates sooner rather than later.

In our study, we suggested that the Fed should tighten monetary policy when the yield curve is widening. It should pause tightening when the yield curve flattens, and easing might be in order when the yield curve inverts.

Calendars

US: Tues: NFIB Small Business Optimism Index; Wholesale Inventories; API Weekly Crude

Oil Inventories; Powell. **Wed:** MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production. (Bloomberg estimates)

Global: Tues: France Industrial Production; China New Loans; China M2; Buch; Macklem; Kuroda; Schnabel. **Wed:** Spain Industrial Production; Italy Retail Sales; Japan Leading & Coincident Indicators; China CPI -0.1%m/m/1.8%y/y; China PPI -0.1%; Australia Trade Balance $10.8b. (Bloomberg estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose simultaneously w/w for all three of these indexes for the first time since mid-June, but that's typical of the winter holiday when revision activity is very light. Forward earnings remains on a modest downtrend for these three indexes compared to their deep declines during the Great Virus Crisis and the Great Financial Crisis. LargeCap's edged up w/w from a 44-week low and is down in nine of the past 14 weeks. MidCap's rose from a 42-week low and has dropped in 14 of the past 16 weeks. SmallCap's was up for a second week from a 57-week low after dropping for 12 straight weeks. For a 28th straight week, none of these three indexes had forward earnings at a record high. LargeCap's is 4.3% below its record high at the end of June; MidCap's is 6.5% below its record high in early June; and SmallCap's is 9.0% below its mid-June record. Forward earnings momentum remains near two-year lows. The yearly rate of change in LargeCap's forward earnings was down to a 21-month low of 2.6% y/y; that compares to a record-high 42.2% at the end of July 2021 and is up from -19.3% in May 2020, which was the lowest since October 2009. MidCap's rate of 4.9% y/y is near a 22-month low, down from a record high of 78.8% in May 2021, and compares to a record low of -32.7% in May 2020. SmallCap's rate of -0.1% y/y remains near a 24-month low, down from a record high of 124.2% in June 2021. It had been at a record low of -41.5% in June 2020. Analysts' consensus earnings forecasts for 2023 have been heading lower since June. Here are the latest consensus earnings growth rates for 2022 and 2023: LargeCap (5.6%, 4.3%), MidCap (15.5, -4.2), and SmallCap (5.3, 3.8).

S&P 500/400/600 Valuation (*link*): Valuations moved higher w/w for these three indexes. LargeCap's forward P/E rose 0.3pt to a four-week high of 17.0 but remains 0.7pt below its four-month high of 17.7 in early December. It's up 2.9pts from its 30-month low of 15.1 at the end of September, which compares to a four-month high of 18.1 in early August and an 11-year low of 11.1 during March 2020. MidCap's forward P/E rose 0.3pt to a five-week high of 13.3 to 0.4pt below its eight-month high of 13.7 in early December. That's up 2.2pts from

a 30-month low of 11.1 at the end of September and compares to a record high of 22.9 in June 2020 and an 11-year low of 10.7 in March 2020. SmallCap's forward P/E rose 0.2pt w/w to a five-week high of 12.7 to 2.1pts above its 14-year low of 10.6 at the end of September and compares to a record low of 10.2 in November 2009 during the Great Financial Crisis. That also compares to its record high of 26.7 in early June 2020 when forward earnings was depressed. The forward P/Es for the SMidCaps have been mostly below LargeCap's since August 2018. MidCap's current 21% discount to LargeCap is near its biggest since September 2000. SmallCap's current 25% reading is near its biggest discount since February 2001. SmallCap's P/E had been mostly above LargeCap's since 2003. Looking at SmallCap's P/E relative to MidCap's, it was at a discount for an 82nd straight week; the current 5% discount is an improvement from its 9% discount in December 2021 but remains near its lows during 2000-01.

S&P 500 Sectors Quarterly Earnings Outlook (*link*): Following the Q3-2020 earnings season when the US economy emerged from the Covid shutdown, analysts began raising their consensus forecasts for future quarters instead of lowering them as is the historical norm. That six-quarter streak of positive revisions throughout the quarter ended during Q1-2022, and the declines began to accelerate considerably beginning with Q3-2022. The S&P 500's earnings growth rate weakened q/q in Q3 to 4.0% y/y from 9.9% in Q2 on a frozen actual basis, and to 4.4% from 8.4% on a pro forma basis. Just four sectors recorded double- and triple-digit percentage growth in Q3-2022, two have a single-digit gain, and five have y/y declines. Looking ahead to Q4, analysts expect further deterioration; a 2.2% y/y decline is expected for the S&P 500, with just four sectors expected to record positive y/y earnings growth and seven expected to decline. Here are the S&P 500 sectors' latest expected earnings growth rates for Q4-2022 versus their Q3-2022 growth rates: Energy (64.7% in Q4-2022 versus 140.9% in Q3-2022), Industrials (42.7, 19.6), Real Estate (6.9, 14.8), Utilities (3.4, -7.1), S&P 500 (-2.2, 4.4), Consumer Staples (-2.7, 1.3), Health Care (-6.4, 1.5), Financials (-8.7, -16.4), Information Technology (-8.7, -0.2), Consumer Discretionary (-15.1, 13.3), Communication Services (-21.4, -26.1), and Materials (-22.4, -7.8).

Global Economic Indicators

Germany Factory Orders (*link*): Orders in November fell for the third time in four months, sinking 5.3% m/m (largest monthly decline since October 2021) and 9.4% over the period to its lowest level since July 2020. *Foreign orders* plummeted 8.1% and 12.5% over the comparable periods, while *domestic orders* fell for the fourth time in five months, by a total

of 8.3%. *Foreign orders from within the Eurozone* tanked 10.3% in November and 16.9% over the four months through November, while *orders from outside the Eurozone* contracted 6.8% and 9.6% over the same time periods. Total orders fell eight of the 11 months through November, by 13.1%. Here's a look at the ytd movements in domestic orders, along with the breakdown from both inside and outside the Eurozone for the main industry groupings, respectively: consumer nondurable goods (-4.6%, -10.2%, +8.9%), intermediate goods (-10.6, -15.2, -12.6), consumer durable goods (-11.4, -16.6, -19.5), and capital goods (-21.2, -14.3, -8.1).

Germany Industrial Production (*link*): Output increased at a faster-than-expected rate in November despite a sharp 2.2% drop in construction output, which followed a two-month gain of 3.4%. Germany's *headline production, which includes construction*, recovered 0.2% after a 0.4% decline (first reported down 0.1%) and a 1.1% gain during October and September, respectively. Meanwhile, *production* *excluding construction* (which the overall Eurozone uses) rebounded 0.6% after a 1.0% loss and a 1.3% gain the prior two months. Industrial production including construction fell 1.1% ytd, while the measure excluding construction dropped 1.4%. Looking at the main industrial groupings, *capital goods output* climbed in November for the seventh time in eight months, by 0.7% m/m and 14.0% over the period, more than recovering from the 9.5% slump during the two months through March—with output at its highest level since November 2020. *Output of intermediate goods* jumped 1.1% in November after sinking in October to its lowest level since September 2020. Meanwhile, *consumer durable goods production* plunged for the third successive month, by 1.7% m/m and 6.1% over the period, after climbing to its highest level since March 2019 in August. *Consumer nondurable goods production* sank 4.9% during the two months through November, reversing the 4.8% gain the prior two months; it's down 7.6% from its recent peak during February.

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