MORNING BRIEFING
September 26, 2023

Is Powell's Path Forward Widening Or Narrowing?

Check out the accompanying chart collection.

Executive Summary: The Fed has paused its rate hiking for now but not without warning that resumed tightening is possible. Either way, monetary policy will be kept restrictive for longer than investors previously expected, Fed Chair Powell has said. What does that scenario imply for the economic outlook? Peaks in the federal funds rate are coincident indicators of financial crises caused by restrictive policy, which often trigger credit crunches and recessions. That's the big risk of the Fed's higher-for-longer rate path. ... We don't expect that scenario—we're in the soft-landing camp—but were it to occur, the highly leveraged commercial real estate market might be the epicenter of the financial crisis.

YRI Weekly Webcast. This week, join Dr. Ed's live webcast with Q&A on Tuesday, September 26, at 11 a.m. EST. You will receive an email with the link one hour before showtime. Replays of the weekly webcasts are available *here*.

Credit I: Is Federal Funds Rate a Leading Indicator? Let's say that the Fed is done raising the federal funds rate (FFR) for now. So far, so good: There hasn't been a recession during this round of tightening. However, proponents of a hard-landing economic outlook observe that the FFR peaked before the last four recessions, implying that the peak might be a leading indicator of recession (*Fig. 1*).

It clearly was not a leading indicator of recessions during the 1970s and 1980s; it was a coincident indicator of the four recessions back then.

The soft-landers, including Debbie and me, observe that past peaks in the federal funds rate coincided with financial crises that were attributable to the tightening of monetary policy (*Fig. 2*). So the FFR actually was a coincident indicator of financial crises. The crises caused the Fed either to ease monetary policy or at least to pause its tightening until the financial crises morphed into widespread credit crunches that caused recessions.

This time so far, there has been a financial crisis that occurred in March, but the Fed contained it quickly. It didn't precipitate a credit crunch, so there hasn't been a recession.

Where are we now? The Fed has raised the FFR very aggressively, by 525bps, since

March 2022. There have been 13 FOMC meetings since then. The Fed paused its rate hiking only twice so far, and that was at last week's meeting and back in June (*Fig. 3*). Fed officials have said that there might be more rate hikes ahead if economic growth doesn't slow and if inflation doesn't continue to fall toward the Fed's 2.0% target.

Even if both conditions occur, Fed officials have indicated that they will be in no rush to lower interest rates. Indeed, at last week's FOMC meeting, the committee's median forecast for the FFR in 2024 was changed from four rate cuts to two of them, totaling 50bps rather than 100bps.

If the Fed is done raising the FFR but keeps it at the current level for a prolonged period through 2024, that still would be a restrictive stance for monetary policy. In our opinion, that would be preferable to more rate hikes, which would increase the chance of something breaking in the financial market.

During his *presser* last week, Powell was asked by one of the reporters: "Would you call the soft landing now a baseline expectation?" Powell responded saying: "No, no. I would not do that. … I've always thought that the soft landing was a plausible outcome, that there was a path, really, to a soft landing. … I've said that since we lifted off. It's also possible that the path is narrowed, and it's widened apparently. Ultimately, this may be decided by factors that are outside our control at the end of the day. But I do think it's possible."

So a soft landing isn't Powell's baseline scenario; but it is still possible, and the path to it might have widened. The reporter was right to ask whether a soft landing is the Fed's baseline since the FOMC's *Summary of Economic Projections* (SEP) released last week maps out a soft-landing scenario:

(1) The latest SEP shows headline PCED inflation continuing to moderate from 3.3% this year to 2.5% next year, 2.2% in 2025, and 2.0% in 2026. That's nearly identical to the path projected in June's SEP.

(2) The committee boosted this year's estimated real GDP growth rate from 1.0% to 2.1% and next year's from 1.1% to 1.5%. As a result, the trajectory of the unemployment rate was lowered to 3.8% this year from 4.1% and to 4.1% next year from 4.5%.

(3) Last Thursday, we wrote: "It all adds up to a soft-landing scenario. Skeptics undoubtedly will claim that the Fed is always wrong, so a hard landing is an even more likely outcome. We are siding with the Fed. We think they've done a very good job so far. They've been

guiding the markets to expect higher-for-longer interest rates since last year. Now they are guiding markets to expect that the Fed will hold the federal funds rate for longer. That's a better way to keep monetary policy restrictive without raising the federal funds rate further (or much further). This approach reduces the chances of a financial crisis and credit crunch, in our opinion."

(4) Powell mentioned and was asked about "external factors" that might possibly determine whether the economy experiences a soft or hard landing. He responded to the question as follows: "So there is a long list, and you hit some of them. But, you know, it's the strike, it's government shutdown, resumption of student loan payments, higher long-term rates, oil price shock. You know, there are a lot of things that you can look at. And, you know, so what we try to do is assess all of them and handicap all of them. And ultimately, though, there's so much uncertainty around these things."

He concluded his answer by noting that the economy has "significant momentum ... but we do have this collection of risks."

Credit II: Cracks in Commercial Real Estate. Powell did not discuss the biggest risk of them all, namely that restrictive monetary policy could still trigger a financial crisis even if the Fed stops raising interest rates but maintains the FFR at the current level. It is widely recognized that there are long and variable lags between the tightening of monetary policy and its impact on the financial system and the economy.

Currently, our main concern is that the rolling recession is rolling into the commercial real estate (CRE) market, which tends to be highly leveraged. So CRE debt had been (during the S&L crisis of the late 1980s and early 1990s) and once again could be the epicenter of a financial crisis that could morph into a credit crunch and cause an economy-wide recession. Accordingly, Melissa and I are watching it closely. Consider the following:

(1) Most of the focus in the financial press has been on old office buildings in urban areas. They were hard hit by the pandemic when many workers worked from home. Many of those workers continued to work from home after the pandemic or went to their offices on a part-time basis, which reduced the amount of space that companies needed for their offices. Now many of those office buildings have lots of vacancies and face more as leases expire. Building owners must lower rents to keep or attract tenants. And now, many of the loans taken out to purchase the buildings will have to be refinanced at much higher interest rates. There are already delinquencies in the space and more to come.

(2) Of course, the issue of refinancing debt at much higher interest rates isn't a problem just for old office buildings but for all commercial real estate with debts that are coming due. That makes it a problem for their lenders. During the September 13 week, commercial banks held $2.9 trillion in CRE loans (*Fig. 4*). Large banks had $0.9 trillion, while small banks had $2.0 trillion. So the smaller banks are especially vulnerable to loan losses.

Commercial banks had $484 billion in construction and land development loans during the September 13 week. Large and small banks had $133 billion and $337 billion of them, respectively (*Fig. 5*).

CRE loans secured by nonfarm nonresidential properties totaled $1.8 trillion during the September 13 week. The large banks and small banks held $0.5 trillion and $1.2 trillion (*Fig. 6*).

(3) Also vulnerable to refinancing risk are CRE loans secured by multi-family residential properties. They totaled $580 billion during the September 13 week, with $232 billion at the large banks and $328 billion at the small ones (*Fig. 7*). We noticed that multi-family housing starts dropped 26.3% m/m during August (*Fig. 8*). Here is what happened regionally last month: Northeast (+4.9), Midwest (+3.9), South (-34.6), and West (-32.6) (*Fig. 9*).

August's weakness in multi-family starts might have been a fluke or it might be signaling that this CRE sector has overbuilt (especially down South and out West), as evidenced by rapidly declining rent inflation on new leases, while financing rates have soared (*Fig. 10*). In other words, the math may no longer work for the multi-family sector of the CRE market.

Credit III: Fed's Assessment of CRE Risk. The path to a soft landing has "widened apparently," according to Fed Chair Jerome Powell, as we noted above. We aren't quite so sure, which is why we raised our subjective odds of a hard landing from 15% to 25% in the September 18 issue of our *Morning Briefing*. In other words, we think the path may be narrowing. Our main concern is profligate fiscal policy. It is causing mounting federal deficits that could keep bond yields at levels that stress out many borrowers who must refinance their debts at much higher interest rates. This is certainly a problem in the CRE market.

The Fed's May 2023 *Financial Stability Report* included a review of the CRE credit market. After we read it, we concluded that troubles in that market shouldn't cause an economy-wide credit crunch and a recession. We still think so, but we are on alert. The report observed:

“The shift toward telework in many industries has dramatically reduced demand for office space, which could lead to a correction in the values of office buildings and downtown retail properties that largely depend on office workers. Moreover, the rise in interest rates over the past year increases the risk that CRE mortgage borrowers will not be able to refinance their loans when the loans reach the end of their term. With CRE valuations remaining elevated (see Section 1, Asset Valuations), the magnitude of a correction in property values could be sizable and therefore could lead to credit losses by holders of CRE debt.”

For more of our analysis of the Fed’s report, see the July 24 issue of our *Morning Briefing* titled “Rolling Recession Rolling Over Commercial Real Estate.”

Calendars

US: Tues: Consumer Confidence 105.9; New Home Sales 700k; Richmond Fed Manufacturing; API Weekly Crude Oil Inventories; Bowman. **Wed:** Durable Goods Orders -04%; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production. (FXStreet estimates)

Global: Tues: BoJ Monetary Policy Meeting Minutes; Lane; Wuermeling. **Wed:** Eurozone Private Sector Loans 1.2%; Germany Gfk Consumer Climate -25.5; France Consumer Confidence 84; European Central Bank Non-Monetary Policy Meeting; Japan Leading & Coincident Indicators -1.2%/-1.1%. (FXStreet estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Forward earnings surged last week for SmallCap, but dropped for LargeCap and MidCap as S&P/Dow Jones Indices performed their quarterly rebalance and many index changes. There were two changes to the S&P 500 constituents, 11 for MidCap, and 17 for SmallCap. Forward earnings falls when higher P/E companies replace lower P/E companies in the index, and vice-versa. A week earlier, forward earnings had risen for all three indexes for a fourth straight week, matching the longest streak since April 2022, and LargeCap’s forward earnings was at a record high for the first time in 63 weeks, dating back to the June 24 week of 2022. Now, LargeCap’s 0.1% is below its record high; MidCap’s remains 4.9% below its record high in early June 2022; and SmallCap’s has improved to 8.7% below its mid-June 2022 record. Through the week ending September 22, LargeCap's forward earnings has risen 6.3% from its 54-week low during the week of February 10; MidCap's is 3.5% above its 55-week low during the week of March 10; and SmallCap's is 5.7% above its 72-week low during the March 17 week. These three indexes' forward earnings downtrend since mid-2022 has been relatively modest compared to their deep double-digit percentage declines during the Great Virus Crisis and the Great Financial Crisis. Forward earnings momentum remains near two-year lows but is no longer worsening. The yearly rate of change in LargeCap's forward earnings has improved to 1.2% y/y from a 29-month low of -3.2% y/y during the June 23 week. Those levels compare to a record-high 42.2% at the end of July 2021 and, on the downside, to -19.3% in May 2020, which was the lowest since October 2009. MidCap's rate of -4.4% y/y is up from a 31-month low of -5.9% in early June, which compares to a record high of 78.8% in May 2021 and a record low of -32.7% in May 2020. SmallCap's -6.8% y/y rate is up from a 32-month low of -12.9% in mid-June and down from a record high of 124.2% in June 2021; it compares to a record low of -41.5% in June 2020. Analysts' consensus earnings forecasts for 2023 and 2024 had been heading steadily lower since June of last year, but the 2023 estimate for the S&P 500 ticked higher during the Q1 and Q2 reporting seasons as analysts incorporated the strong earnings beats into their forecasts. Here are the latest consensus earnings growth rates for 2023 and 2024: LargeCap (1.2% and 12.1%), MidCap (-12.6, 13.6), and SmallCap (-8.0, 12.2).

S&P 500/400/600 Valuation (*link*): Valuations were mostly steady for these three indexes during the September 15 week. LargeCap's forward P/E dropped 0.5pt w/w to an 18-week low of 18.0, and remains below its 18-month high of 19.6 during the July 28 week. It's up 2.9pts from its 30-month low of 15.1 at the end of September 2022, which compares to an 11-year low of 11.1 during March 2020. MidCap's forward P/E was down 0.4pt to an 18-week low of 13.1, and is down from its 21-week high of 14.4 during the July 28 week. It's now 0.8pt below its recent 10-month high of 14.7 in early February and up 2.0pts from its 30-month low of 11.1 at the end of September 2022, which 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 tumbled 0.8pt to a 46-week low of 12.3, which compares to a 21-week high of 14.1 during the July 28 week and is now 1.2pt below its recent 12-month high of 14.3 in early February. It's up 1.7pts from its 14-year low of 10.6 in September 2022 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 27% discount to LargeCap's P/E remains near its 24-year-low 30% discount during the June 23 week. It had been at a 21% discount during the March 17 week, which was near its best reading since November 2021. SmallCap's fell to a 23-year low discount of 29%, which compares to a 22% discount during the March 10 week, which was near its lowest discount since August 2021. 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 119th straight week; the current 7% discount is an improvement from its 20-year-low 9% discount in December 2021.

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 estimate declines accelerated considerably for the three quarters through Q1-2023 before easing for Q2-2023. Looking at Q3-2023, the revisions pendulum has turned neutral as analysts' forecasts are unchanged since the beginning of the quarter 13 weeks ago. They're now forecasting that the S&P 500's earnings will drop 0.2% y/y in Q3-2023. That's up from a 5.4% decline in Q2-2023, which likely marked the cyclical bottom for earnings growth. On a pro forma basis, they expect a y/y earnings gain of 1.5% in Q3, up from a 2.8% decline in Q2-2023. S&P 500 ex-Energy earnings are forecasted to be up 6.7% y/y in Q3-2023, an improvement from the 3.6% gain in Q2-2023, the 1.6% decline in Q1-2023, and the 7.4% drop in Q4-2022. Seven sectors are expected to record positive y/y percentage earnings growth in Q3-2023, unchanged from Q2-2023's count. However, that's up from five sectors that did so in Q1-2023 and up from only two in Q4-2022. Here are the S&P 500 sectors' expected earnings growth rates for Q3-2023 versus their nearly final earnings growth rates for Q2-2023: Communication Services (34.2% in Q3-2023 versus 15.7% in Q2-2023), Consumer Discretionary (22.5, 57.0), Utilities (12.4, 0.6), Financials (12.0, 9.3), Industrials (9.1, 15.7), S&P 500 ex-Energy (6.7, 3.6), Information Technology (5.7, 5.0), S&P 500 (1.5, -2.8), Consumer Staples (1.3, 8.5), Real Estate (-6.8, -2.1), Health Care (-9.7, -26.7), Materials (-20.2, -26.4), and Energy (-36.5, -47.7).

US Economic Indicators

Regional M-PMIs (***link***): Three Fed districts have reported on manufacturing activity for September—New York, Philadelphia, and Dallas—and were a mixed bag. *Manufacturing* activity (to -9.9 from -8.1) contracted at a slightly faster rate this month, though was consistent with readings since June. The New York (to 1.9 from -19.0) region's measure swung from contraction to expansion, while Philadelphia's (-13.5 from 12.0) swung from expansion to contraction. Meanwhile, the Dallas (-18.1 from -17.2) region contracted at a steady pace. The *new orders* (-3.4 from –6.6) gauge is moving closer to the breakeven point of zero, up from its recent low of -24.1 in March. The Philadelphia (-10.2 from 16.0) area experienced a wide 26.2-point swing back into contractionary territory, while New York's (5.1 from -19.9) recorded a positive 25.0-point swing back into expansionary territory. Meanwhile, the Dallas (-5.2 from -15.8) measure is moving nearer to expansionary territory. *Employment* (1.7 from -1.0) has been bouncing around the breakeven point of zero for several months, with both the New York (-2.7 from -1.4) and Philadelphia (-5.7 from -6.0) regions showing slight contractions this month, while Dallas (13.6 from 4.3) manufacturers hired at a faster pace. Looking at the prices-paid indexes, the Philadelphia (25.7 from 20.8) measure showed an acceleration from April's 8.2 reading—which was its lowest since mid-2020—while the Dallas (25.0 from 17.4) gauge also continued to accelerate from its 38-month low of 1.4 in June. New York's (25.8 from 25.2) measure held steady. *Prices-received* indexes were mixed: New York's (19.6 from 12.8) measure picked up a bit from July's three-year low, while Philadelphia's (14.8 from 14.1) barely budged in September, though did ease from May's 23.0. The Dallas measure was unchanged at 1.8.

Global Economic Indicators

Eurozone PMI Flash Estimates (*link*): Flash estimates for September show the Eurozone private sector continued to contract as Q3 ended. The manufacturing sector once again led the decline, though the service sector saw a decrease in activity for the second straight month. The Eurozone's *C-PMI* edged up to 47.1 in September, after a four-month decline of 7.4 points, from 54.1 in April to 46.7 in August. The *M-PMI* deteriorated for the seventh time in eight months, by 5.4 points, from 48.8 in January to 43.4 in September, and has been below the breakeven point of 50.0 for 15 straight months. The *NM-PMI* edged up to 48.4 after sliding the prior four months by 8.3 points, from 56.2 in April to 47.9 in November. Looking at the two largest Eurozone economies, *Germany's C-PMI* remains in contractionary territory, though ticked up to 46.2 this month, after falling from 54.2 in April to 44.6 by August. *Germany's NM-PMI* climbed to 49.8 in September after falling from 56.0 in April to 47.3 by November. Meanwhile, *Germany's M-PMI* posted back-to-back gains, after falling for six straight months. It climbed to 39.8 in September, still a very weak reading, after falling from 47.3 at the start of the year to 38.8 by July. Meanwhile, *activity in France* declined at its fastest pace since November 2020, with its *C-PMI* slowing for the sixth straight month to 43.5 this month, after advancing the prior four months from 48.7 in November to a 10-month high of 52.7 in March. *France's NM-PMI* slipped for a fifth month in September, from 54.6 in April to a 34-month low of 43.9. *France's M-PMI* was in contractionary territory for the 12th time in 13 months, sinking to 43.6 this month—the lowest since May 2020. The *rest of the region* saw business activity broadly stable this month. Manufacturing output fell for the sixth consecutive month, though at a slower pace, while service activity increased at a slightly faster pace. Looking at pricing, there were differing trends in terms of *inflation*: A shaper rise in input costs contrasted with a softer pace of output price inflation, according to the report.

Germany Ifo Business Climate Index (*link*): "The German economy is treading water," warns Clemens Fuest, Ifo president. German business confidence dropped for the fifth straight month in September, sinking 7.8 points over the period to 85.7, after climbing the prior six months from 85.3 last October to 93.5 this April—which was the highest since February 2022. *Current conditions* fell for the sixth straight month, down 6.8 points to 88.7 this month, to its lowest level since August 2020. Meanwhile, the *expectations* component ticked up 0.2 points this month to 82.9, after falling the prior four months by 9.1 points. Before the recent weakness, the expectations' measure experienced a 15.2-point upswing from 76.6 last September to 91.8 this April. Looking at the different sectors, *manufacturing* (-16.4 from -16.6) saw a slight uptick, though remained deep in contractionary territory. Companies were a bit more satisfied with their current conditions (-1.8 from -2.3), while their expectations (-29.9 from -29.8) remained very pessimistic. The *service sector* saw its business climate index (to -5.0 from 8.6 in March) drop 13.6 points over the past six months, with the current situation component sinking 15.5 points the past four months, to 9.2, its lowest since April 2021. The expectations component ticked up a point to -18.2 this month, remaining mired in negative territory. Sentiment in the *trade sector* (-25.0 from -25.6) edged slightly higher, due to a less pessimistic expectations (-36.3 from -39.4) component, which still remained dismal. Meanwhile, current conditions fell for the sixth straight month by 21.1 points (to -13.1 from 8.0). The *construction* sector saw its business climate index fall to -31.3—the lowest value since January 2009. Companies assessed their current situation (to 9.2 from 12.2) as worse, while expectations (-44.5 from -43.8) remained grim.

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