Financial Market Weekly

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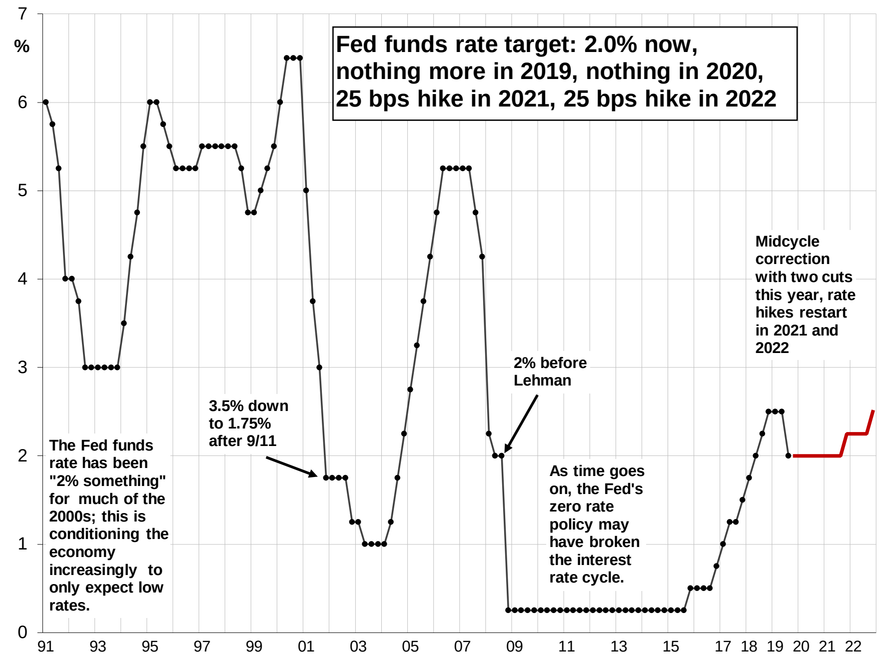
AFTER TWO RATE CUTS IN A ROW, PATH AHEAD IS LESS CERTAIN



The Fed took another 25 bps rate cut step at this week's meeting, but it looks like the uncertainty ahead for the economy is making them consider future policy moves on a meeting by meeting basis. After two in a row, there's no grand plan. No grand plan if the majority rules. They haven't changed rates in either direction at two consecutive meetings (eight each year) since the final cuts made during the last recession in 2008. Two meetings of Fed action in a row might signal some hurry-up urgency, even if Powell is still saying the moves are meant as just-in-case the house blows down insurance. He even said during the press conference Q&A that there is research suggesting it is better to be early than late when it comes to monetary stimulus: "it can be a mistake to try to hold onto your firepower until a downturn gains momentum… there's a fair amount of research that would show that that's the case." Quite the contrary, it is our real-time recollection that the early rate cuts in the last two recessions fell on deaf ears as the market was busy running for cover and couldn't care a fig if the Fed was cutting borrowing costs. They cut 325 bps from 5.25 to 2.0 percent before someone let Lehman go bankrupt. They cut 300 bps from 6.5 to 3.5 percent before 9/11. They got nothing for it.

> Donald J. Trump 9-18-19 2:25PM EDT
> @realDonaldTrump
> Jay Powell and the Federal Reserve Fail Again. No "guts," no sense, no vision! A terrible communicator!

The Fed's median forecast for the Fed funds rate doesn't fall below 2.0% ever in the years ahead. The forecast is still 2.0% in 2020, 2.25% in 2021 and 2.5% in the year 2022. Midcycle correction for interest rates just as the professor told us at the July 31 press conference. Two rate cuts to buy insurance against a downturn and then rate hikes after a pause in 2021 and 2022. Seven out of seventeen Fed officials see one more rate cut on the year to 1.75%, but that is not a majority. It is going to take a lot more trade uncertainty to get those no-votes for additional rate cuts off the sidelines before the Fed can play again. No more easing for now. The stock market seemed to take no more punch fairly well with the Dow industrials down 60 points at the 2 o'clock Fed announcement, falling as much as 211 points, before closing higher.

Fed Individual Forecasts					
Fed funds rate at year-end					Longer
Votes	2019 End	2020 End	2021 End	2022 End	run
1	1.625	1.625	1.625	1.625	2.000
2	1.625	1.625	1.625	1.875	2.250
3	1.625	1.625	1.625	1.875	2.375
4	1.625	1.625	1.625	1.875	2.500
5	1.625	1.625	1.875	2.125	2.500
6	1.625	1.625	1.875	2.125	2.500
7	1.625	1.625	1.875	2.125	2.500
8	1.875	1.625	2.125	2.125	2.500
9	1.875	1.875	2.125	2.375	2.500
10	1.875	1.875	2.125	2.375	2.500
11	1.875	2.125	2.125	2.375	2.500
12	1.875	2.125	2.375	2.375	2.750
13	2.125	2.125	2.375	2.375	2.750
14	2.125	2.125	2.375	2.625	2.750
15	2.125	2.125	2.375	2.625	3.000
16	2.125	2.125	2.375	2.875	3.250
17	2.125	2.375	2.625	2.875	
Median	1.875	1.875	2.125	2.375	2.500
Meeting	Sep 19	Sep 19	Sep 19	Sep 19	Sep 19

They should be done. The economic data have been superb and are showing no sign of a slowdown. Retail sales are strong, core consumer inflation is the highest since the recession, and industrial production has steadied and is climbing higher. The prospects for continued growth are strong.

So it looks like after cutting interest rates a second time this year, Fed officials are keeping their cards close to their vests for now and are not going out on a limb to guess whether or not a third insurance-type rate cut will be needed later this year to cushion the blow from a potential escalation in the trade war and the damage that uncertainty does to the economy by postponing business investment. Our best guess is that they are done for now because how much darn rate cut insurance does the economy need to guard against a downturn when the data show that growth isn't dying. Their own GDP forecasts look for 2.0% growth in 2020 same as they had forecast in June. Nothing has changed, the economy is steady as a rock and as long as that remains the case the odds of a third rate cut this year start to shrink dramatically. No trade war, no recession, no more rate cuts.

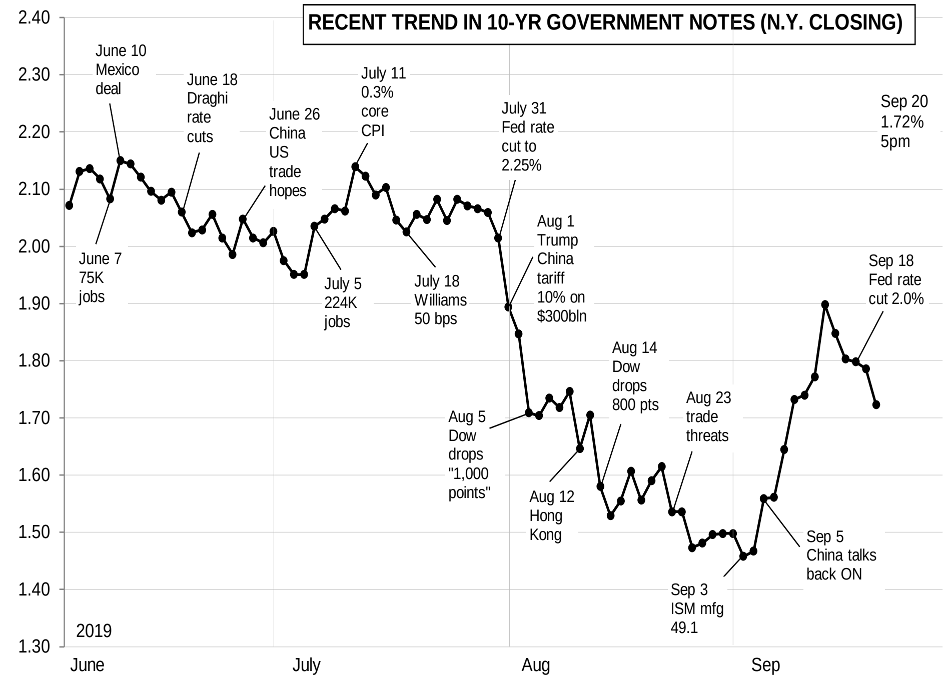
Powell: Read My Lips—No Negative Rates

So, negative interest rates is something that we looked at during the financial crisis and chose not to do. We chose to—after we got to the effective lower bound, we chose to do a lot of aggressive forward guidance and also large-scale asset purchases, and those were the two unconventional monetary policy tools that we used extensively. We feel that they worked fairly well. We did not use negative rates, and I think if we were to find ourselves at some future date again at the effective lower bound—again, not something we are expecting—then I think we would look at using large-scale asset purchases and forward guidance. I do not think we'd be looking at using negative rates. I just don't think those will be at the top of our list.

To conclude, it looks like they are done with rate cuts this year, although they are probably just one trade tweet away from taking further action. The forecasts don't show rate cuts, but the decision is going to be made on a meeting by meeting basis. One rate cut to 1.75% is discounted by the end of this year: the October meeting discounts 14 bps, and by the December meeting a 26.5 bps rate cut is discounted by Fed funds futures. Realistically as long as the White House wants more rate cuts (to zero or negative) the market can't afford to turn its back on the possibility. Recession or not.

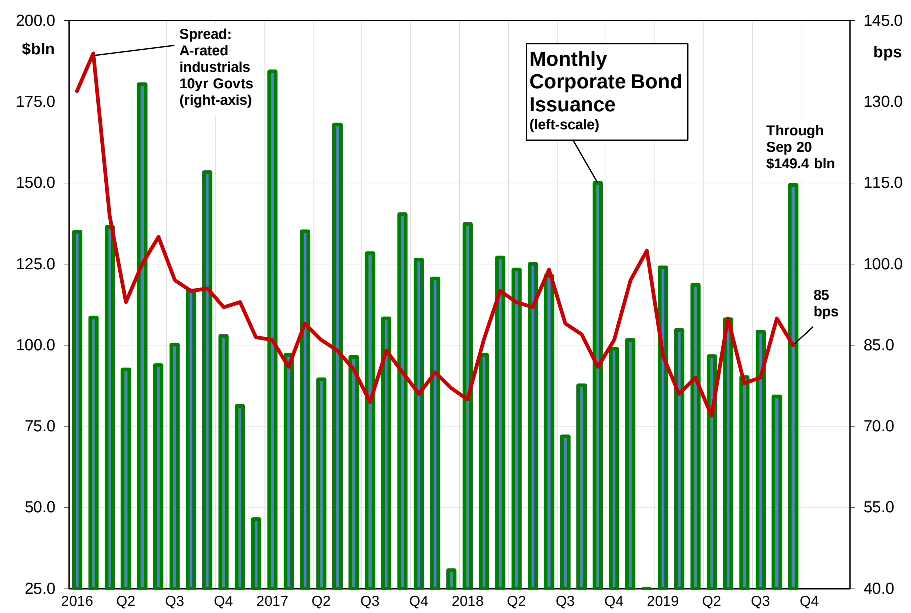
MARKETS OUTLOOK

	29-Mar 2019	28-Jun 2019	20-Sep 2019	Q4 2019	Q1 2020	Q2 2020	Q3 2020	Q4 2020	Q1 2021
30-Yr Treasury	2.81	2.53	2.16	2.20	2.25	2.30	2.40	2.50	2.70
10-Yr Note	2.41	2.01	1.72	1.75	1.80	1.90	2.10	2.20	2.40
5-Yr Note	2.23	1.77	1.60	1.55	1.65	1.75	1.85	2.05	2.25
2-Yr Note	2.26	1.76	1.69	1.60	1.60	1.70	1.80	2.00	2.20
3-month Libor	2.60	2.32	2.13	2.10	2.10	2.10	2.10	2.20	2.20
Fed Funds Rate	2.50	2.50	2.00	2.00	2.00	2.00	2.00	2.00	2.00
2s/10s spread	15	25	3	15	20	20	30	20	20



No reason to make major changes to the interest rate forecast after Wednesday's Fed meeting. We are keeping the slow upward drift in market yields, but are not forecasting any Fed rate hikes… not when we are a trade war tweet away from more Federal Reserve rate cuts. No recession, but plenty of uncertainty for policy makers. Even if the Fed were to cut rates a third time this year, just like the three insurance-style rate cuts done in the 1990s, the forecast of Treasury yields above is still likely to be realized as more than three rate cuts and anticipation of more Fed rate cuts are unlikely if there is no recession. There are 8 votes for a 1.75% Fed funds rate by 2020 out of 17 Fed officials.

CORPORATES: VOLKSWAGEN, ALCON, CATERPILLAR, PAYPAL, FMC CORP

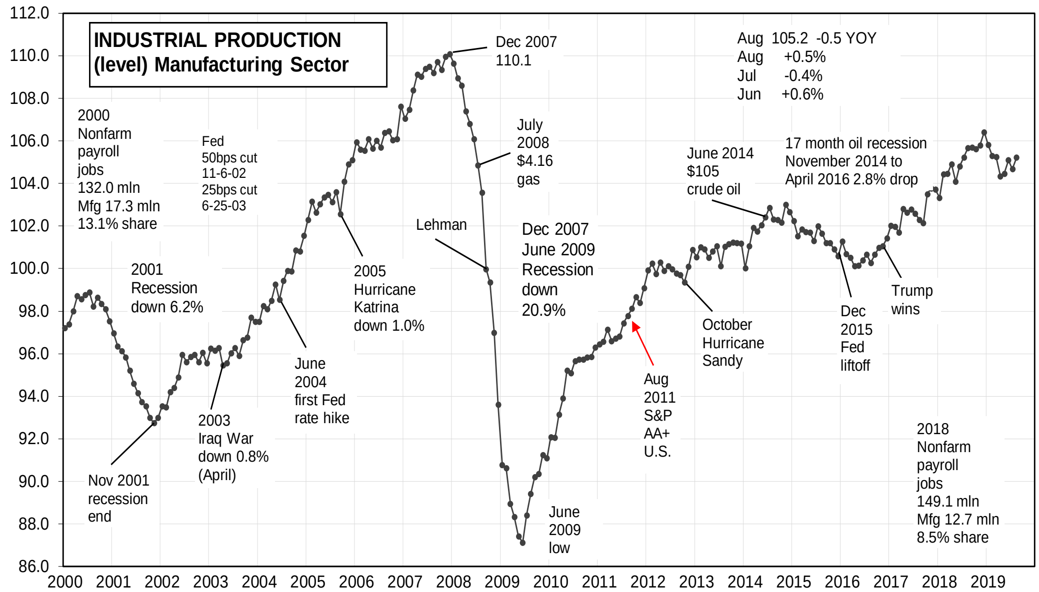


Corporate offerings were $29.0 billion in the September 20 week versus $46.1 billion in the September 13 week. On Thursday, Walmart Inc. sold $1.5 billion 10s/30s. It priced a $500 million 2.375% 10-yr (m-w +10bp) at 60 bps (Aa2/AA). The world's largest retailer will use the proceeds for general corporate purposes, including the repayment, refinancing or replacement of maturing debt. Corporate bond yields (10-yr Industrials rated A2) were 85 bps above 10-yr Treasuries Friday versus 86 bps last Friday.

OTHER ECONOMIC NEWS THIS WEEK

Wow. Complete turnaround in manufacturing as night turns into day (Tuesday)

Breaking economy news. Why again is the Federal Reserve going to cut interest rates tomorrow afternoon? It is going to help the beleaguered export-driven manufacturing sector that has been hit with trade tariff headwinds. Back in 2014 after the oil price crash late in the year, manufacturing hit an air pocket and dropped nearly 5%. The Fed may have paused its rate hikes after just lifting off in December 2015 and didn't raise rates a second time until a year later in December 2016. Now the Federal Reserve has already cut rates once and probably twice tomorrow, and yet industrial production, wait for it, has fallen just 0.6% from the peak last December through August this year.



Industrial production in August jumped 0.6% in August rebounding sharply from a 0.1% decline in July. Manufacturing production more than reversed July's 0.4% drop by increasing 0.5% in August. The manufacturing sector suddenly looks much steadier than Fed officials had been thinking leaving the ball in their court tomorrow on whether the economy needs another rate cut especially with the truce for now in the trade war escalation.

Purchasing managers say the manufacturing sector is in recession, but the contraction in factory production actually looks much more modest. Production is off the highs last December, but the trend is looking more like a modest midcycle correction which begs the issue of whether the Fed's midcycle correction in interest rates is drawing to a close.

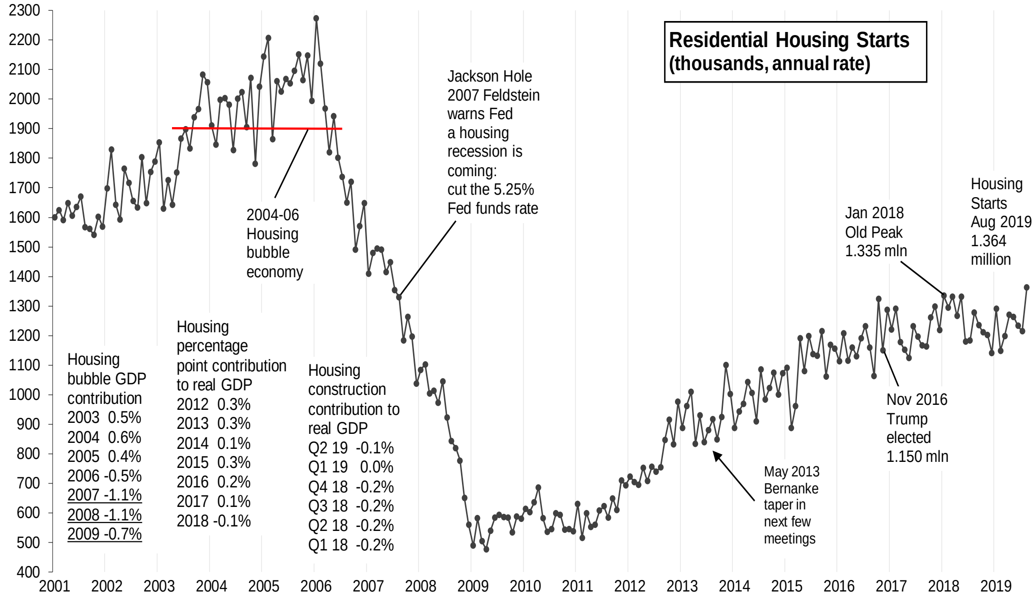
Net, net, there has been a complete turnaround in the export-driven manufacturing sector that has been trounced by the trade war this year. The damage is less than we thought and factory activity appears to be stabilizing. Production is down less than 1% from record highs last year and this correction looks more like a speed bump than anything more damaging for the broader economy.

Manufacturing certainly isn't the canary in the coal mines warning recession is just around the corner. The economy is stronger than you think. Bet on it. There has been a complete turnaround in the fortunes of manufacturers with a rebound that turns the night into day for the economic outlook this year.

Housing construction reaches a new high for the recovery (Wednesday)

Breaking economy news. Another day another bit of economic data showing the Fed doesn't need to put another log on the economic fire to boost growth. Housing starts jumped 12.3% in August to 1.364 million at an annual rate which is a new record for this long road to recovery from the housing bubble crash over a decade ago.

Housing starts are up 149 thousand from 1.215 million in July to 1.364 million in August. Multifamily construction with 5 or more units were up 100 thousand but single family homes improved as well and will help to alleviate that housing shortage in many areas of the country. Single family homes rose 4.4% or 39 thousand to 919 thousand in August from July. Single family home starts were up everywhere except for a slight decline in the Northeast.

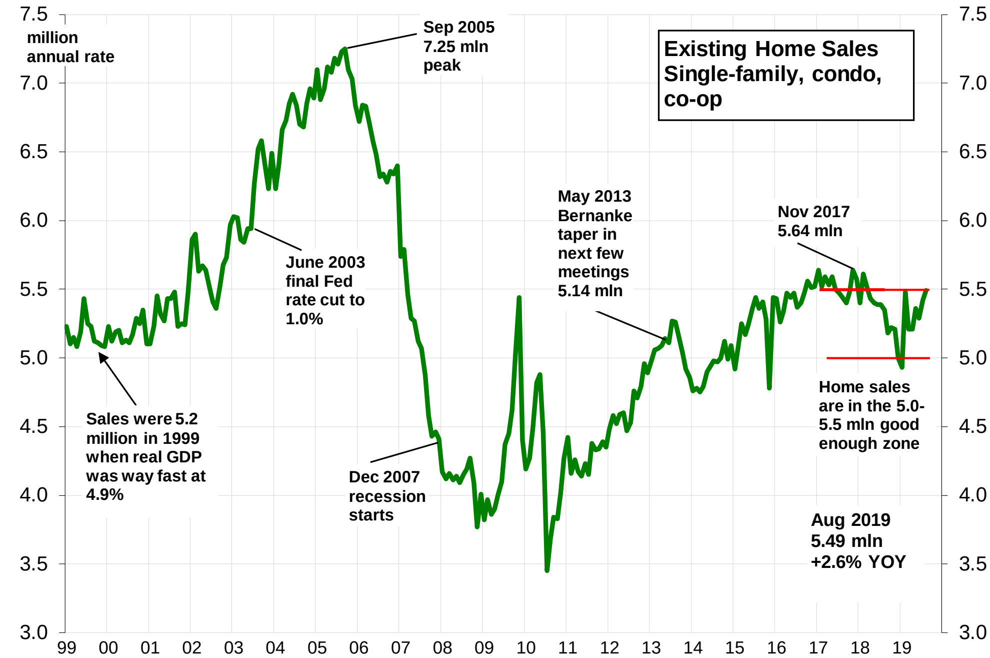


Net, net, if the Federal Reserve is thinking of taking out insurance with more rate cuts this year, the economy plainly doesn't require it because the weakest link in the economy just rebounded sharply and isn't in as bad shape as we thought. And why not? Mortgage rates peaked long ago when the crazy, loco Fed was pushing rates up to 2.5% last year with 30-year mortgage yields just missing 5%. Mortgage rates were 4.94% in the November 15, 2018 week and are 3.56% today which makes it a lot cheaper to finance the purchase of a new home. It looks like the sharp drop in mortgage rates has finally ignited the housing market's recovery. And there's more good news to come. Housing permits are even higher at 1.419 million in August meaning more new housing starts are on the way. If this housing trend continues, the Fed won't be needing to cut interest rates much further. They have only cut just 25 bps as this is written just hours away from the September Fed meeting decision, but mortgage rates that stimulate investment have fallen 138 bps. You do the math. The Fed has done all they need to do for now. Bet on it. This economy is better than you think.

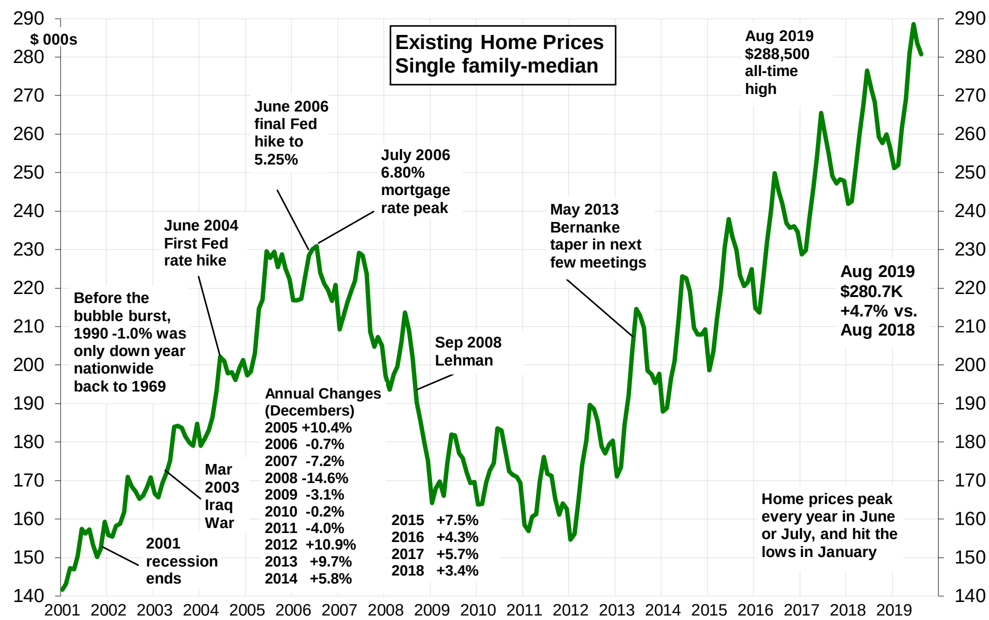
Home sales rebound completely from weakness as mortgage rates plummet (Thursday)

Breaking economy news. Existing home sales continue climbing after the sharp drop in purchases at the turn of the year when home buyers were scared out of the market by a stock market crash, a Federal government shutdown, a trade war with China, everything but the kitchen sink was thrown their way. That was yesterday.

Existing home sales moved up 1.3% in August to 5.49 million at an annual rate versus the 4.93 million low recorded in January during the panic. Mortgage rates were close to 5% in November last year helping to spark a consumer retreat from the home resales market, but now homes are more affordable with mortgage yields down at roughly 3.7% this week. Single family home sales are up everywhere except out in the West where sales fell to 1.01 million from 1.04 million in July. From July to August, sales in the Northeast moved from 0.57 to 0.60 million, in the Midwest they went up from 1.2 to 1.24 million, and in the South sales moved from 2.03 to 2.05 million.



Net, net, the consumer is back and buying the biggest big-ticket item that they can make so you know that home buyer confidence must be pretty high and that their jobs and incomes are secure. Fed officials are done cutting interest rates for the rest of this year and one of the reasons for this is that the economic data continue to surprise us on the upside. The Fed cuts rates twice by 50 basis points in total, but mortgage rates have plummeted over 100 bps; monetary stimulus is sure getting its money worth when it comes to producing better home sales.



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Better buy them when you can is the mantra of home buyers because home prices just won't stop climbing. The median price of single-family homes and condos is up 4.7% the last year to $278,200 in August and is unlikely to stop climbing as the Fed is pouring more fuel on the fire to keep the economy humming. Stay tuned. Story developing.

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