RJO Previews and Perspectives for Wednesday, Sep 16

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Markets wait for any hints on when FOMC might start raising interest rates -- The markets will be closely watching the post-meeting FOMC statement and Fed Chair Powell's press conference after today's conclusion of the 2-day FOMC meeting for any hints about when the Fed might start raising interest rates.

The Fed currently wants to reassure the markets that there is no chance for a rate hike for at least two years. The last Fed-dot forecast, released in June, had a median prediction of unchanged interest rates through the end of the forecast period at the end of 2022, although there were two outlier FOMC members who did predict rate hikes in 2022.

Today's new Fed-dot forecast will contain predictions through the end of 2023, which means that there may be more FOMC members who are predicting some rate hikes by 2023.

The federal funds futures market is forecasting no rate hikes at least through July 2023. The longest-dated federal funds futures contract is the July 2023 contract. That July 2023 contract is currently trading at a yield of 0.00%, which is actually 9 bp below the current effective federal funds rate of 0.09%.

The Eurodollar futures market, which has contracts that trade out much farther than the federal funds futures market, is forecasting the first +25 bp rate hike by mid-2024 and an overall +100 bp rate hike by 2028. The expected funds rate hike of +100 bp by 2028 means that the funds rate would remain far below the funds rate target of 2.25%/2.50% that existed in early 2019 before the economy started fading later in 2019 and was then crushed by the pandemic in early 2020. That shows that the market currently expects the negative effects of the pandemic to linger and hurt the economy for at least the next decade.

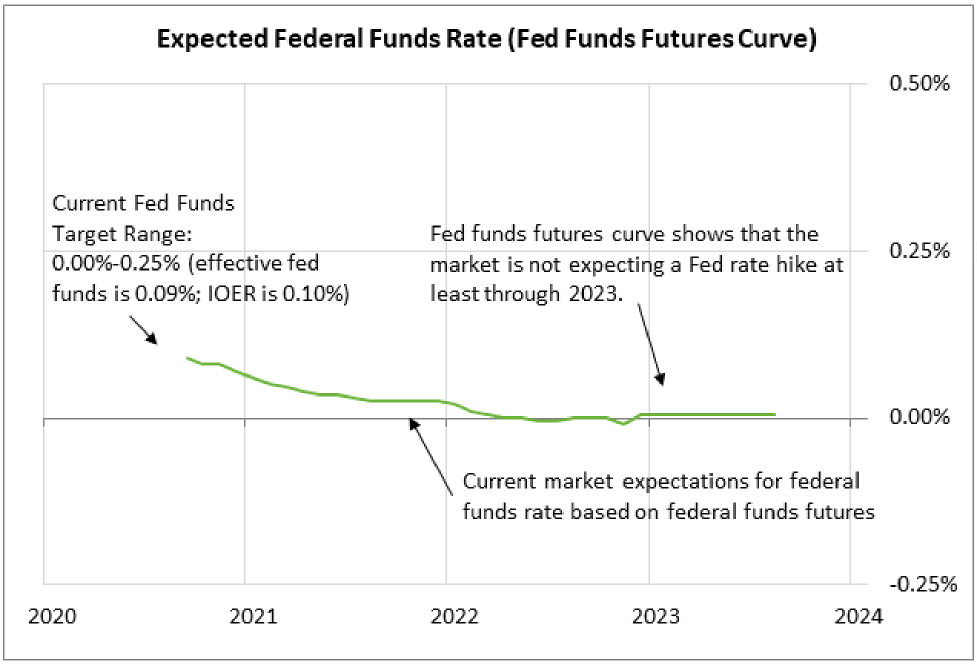
The Fed has so far been successful in convincing the markets that it will keep interest rates near zero for a long time into the future. The Fed bolstered market expectations for unchanged rates when Fed Chair Powell recently announced at the Jackson Hole virtual conference that the FOMC, as part of its long-term structural policy review, adopted an average inflation target.

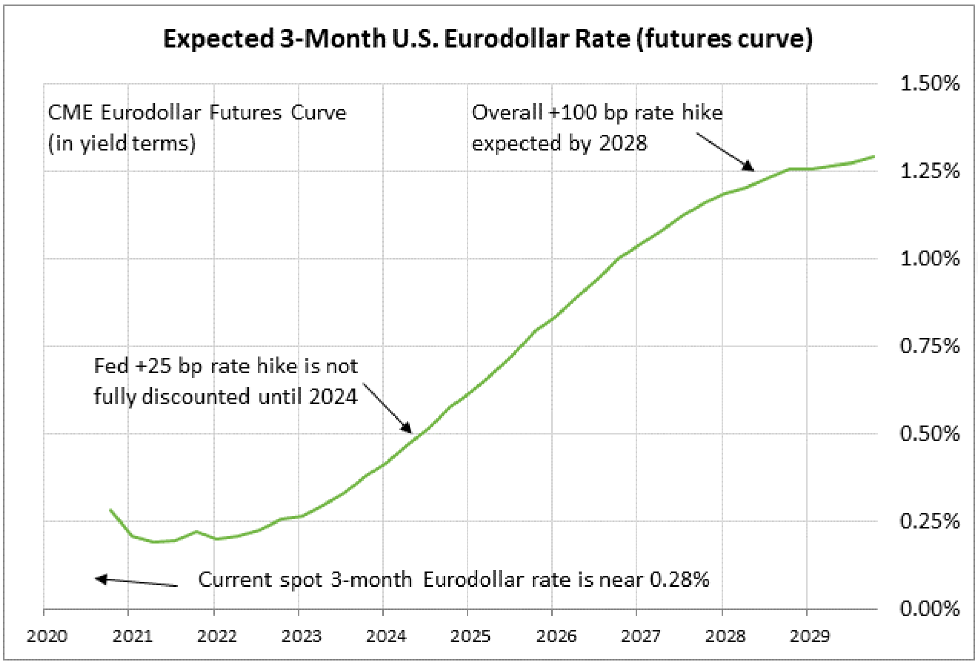
The new inflation targeting regime means that the FOMC will specifically encourage the inflation rate to move above 2% when inflation has been below the target for an extended period, thus producing a long-term average inflation rate that is closer to the 2% target. Inflation has persistently undershot the Fed's inflation target with the core PCE deflator averaging only +1.6% since the Fed set its +2% inflation target in 2012. The fact that the FOMC has adopted an average inflation target means that the FOMC has essentially pledged to keep rates extremely low until the inflation rate is well on its way above 2%, which could be a matter of years.

The markets today are waiting to hear from Fed Chair Powell about exactly how the Fed's new average inflation target will translate into near-term policy action. The markets are waiting for the Fed to provide more specific guidance on the parameters for when the Fed might start raising rates or curbing its QE program.

The markets are expecting the FOMC to eventually provide some quantitative guidance such as saying that rates will remain low until the unemployment rate falls below some threshold and inflation is on its way above the +2% target. The FOMC could provide that guidance as soon as today, but the consensus is that the FOMC will wait until later in the year or early next year when the Fed has a better idea of when the pandemic might end with an effective and widely-available vaccine, and when the economy might start to return to normal.

The FOMC today is not expected to announce any changes to its $120 billion per month QE program. The Fed has boosted its balance sheet by $2.85 trillion (+69%) to $7.01 trillion from the pre-pandemic level in February of $4.16 trillion. The Fed's balance sheet has ballooned to 32.5% of GDP from just 19.3% of GDP before the pandemic.


Expected Federal Funds Rate (Fed Funds Futures Curve)
Current Fed Funds Target Range: 0.00%-0.25% (effective fed funds is 0.09%; IOER is 0.10%)
Fed funds futures curve shows that the market is not expecting a Fed rate hike at least through 2023.
Current market expectations for federal funds rate based on federal funds futures
0.50%
0.25%
0.00%
-0.25%
2020
2021
2022
2023
2024


Expected 3-Month U.S. Eurodollar Rate (futures curve)
CME Eurodollar Futures Curve (in yield terms)
Overall +100 bp rate hike expected by 2028
Fed +25 bp rate hike is not fully discounted until 2024
Current spot 3-month Eurodollar rate is near 0.28%
1.50%
1.25%
1.00%
0.75%
0.50%
0.25%
0.00%
2020
2021
2022
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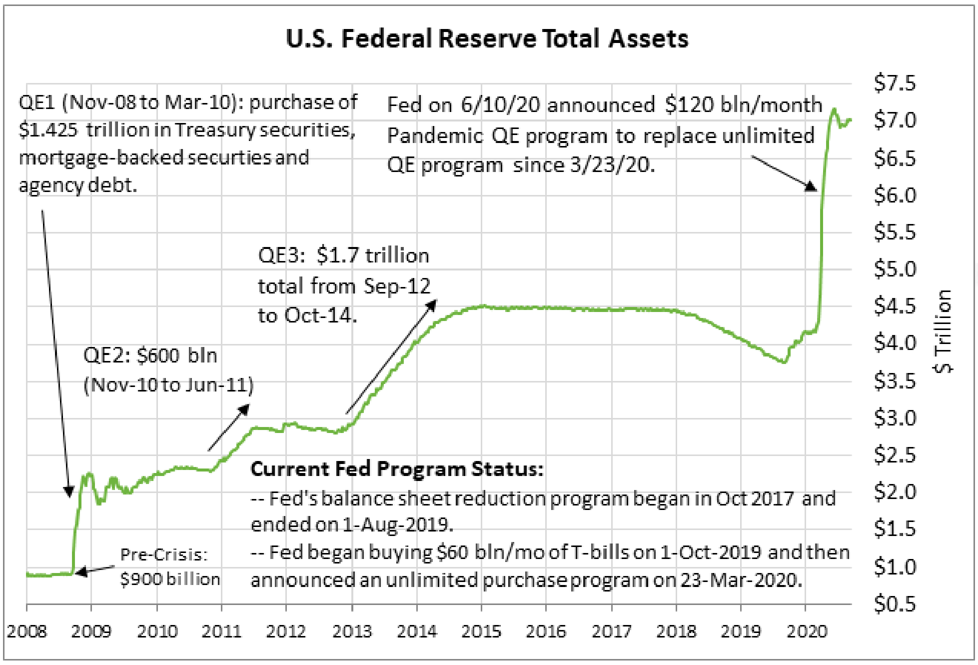
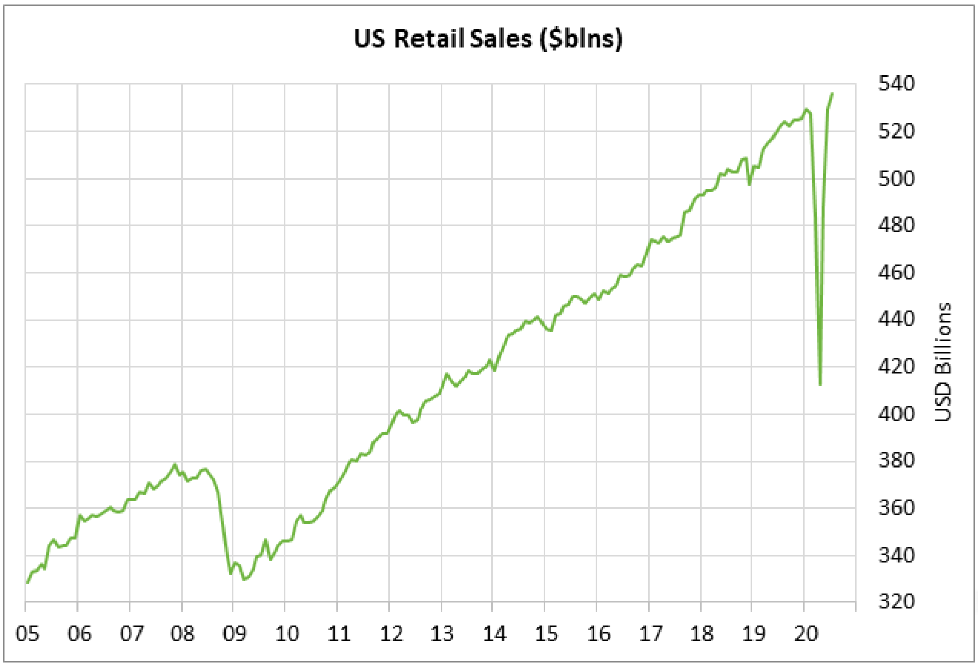

U.S. Federal Reserve Total Assets
QE1 (Nov-08 to Mar-10): purchase of $1.425 trillion in Treasury securities, mortgage-backed securties and agency debt.
Fed on 6/10/20 announced $120 bln/month Pandemic QE program to replace unlimited QE program since 3/23/20.
QE3: $1.7 trillion total from Sep-12 to Oct-14.
QE2: $600 bln (Nov-10 to Jun-11)
Pre-Crisis: $900 billion
Current Fed Program Status:
-- Fed's balance sheet reduction program began in Oct 2017 and ended on 1-Aug-2019.
-- Fed began buying $60 bln/mo of T-bills on 1-Oct-2019 and then announced an unlimited purchase program on 23-Mar-2020.
$7.5
$7.0
$6.5
$6.0
$5.5
$5.0
$4.5
$4.0
$3.5
$3.0
$2.5
$2.0
$1.5
$1.0
$0.5
$ Trillion
2008
2009
2010
2011
2012
2013
2014
2015
2016
2017
2018
2019
2020

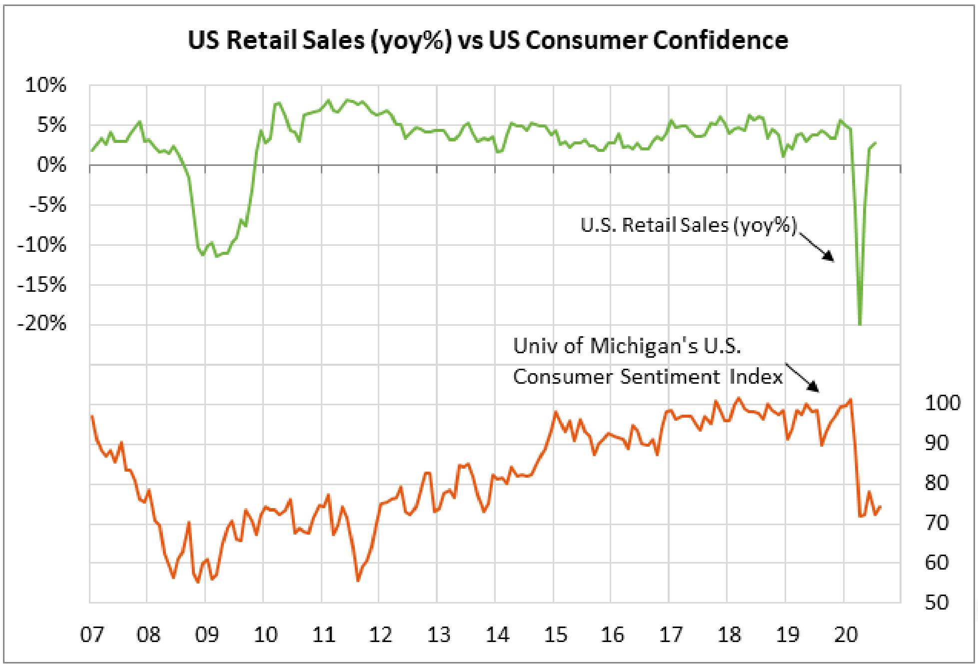
U.S. retail sales recovery is expected to slow -- The consensus is for today's Aug retail sales report to show an increase of +1.0% and +1.0% ex-autos, adding to July's increase of +1.2% and +1.9% ex-autos.

U.S. retail sales have already recovered from the pandemic-induced plunge. Retail sales in August rose by +1.0% to a new record high of $535.982 billion, which was +1.2% above Jan's pre-pandemic record of $529.616 billion.

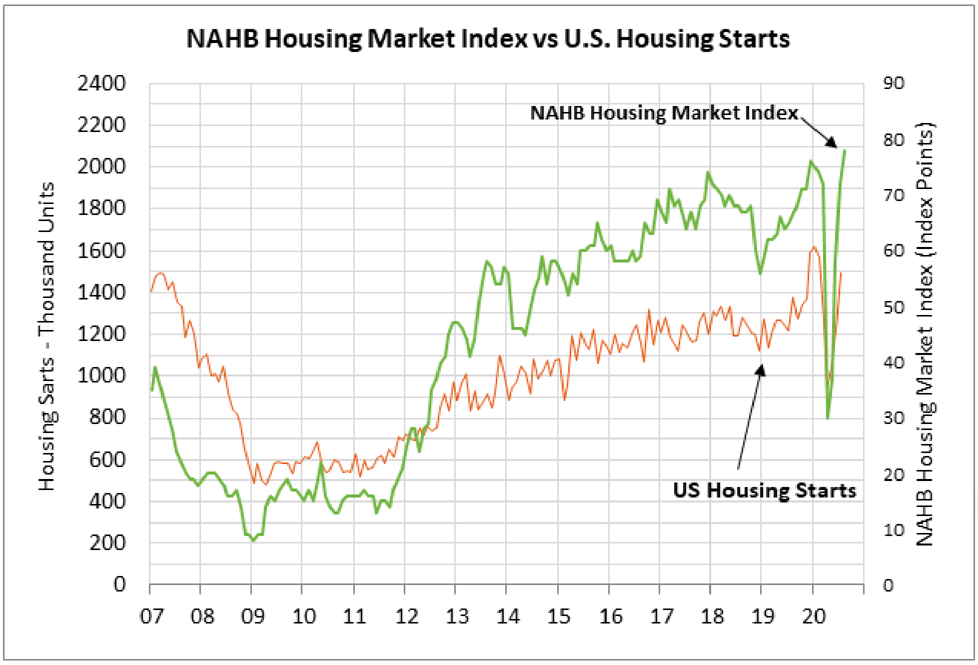
However, the question is whether the surge in retail sales will continue now that the pent-up demand from the pandemic shutdowns has been satisfied. Most of the pandemic stimulus money has now run out and the economy is now operating with high levels of unemployment and reduced consumer income.

Also, consumer confidence is faltering with Washington deadlocked on a new stimulus bill and with the upcoming Nov 3 election, which could be chaotic. Indeed, the Conference Board's U.S. consumer confidence index in August fell to a new 6-year low of 84.8, and the Aug University of Michigan's U.S. consumer sentiment index of 74.1 was just mildly above April's 8-3/4 year low of 71.8.





U.S. homebuilder confidence expected to remain very strong -- Today's Sep NAHB housing market index is expected to be unchanged from Aug's 21-year high of 78. Home builders are very confident due to low mortgage rates and strong demand for new homes.


NAHB Housing Market Index vs U.S. Housing Starts
NAHB Housing Market Index
US Housing Starts
Housing Sarts - Thousand Units
NAHB Housing Market Index (Index Points)
2400
2200
2000
1800
1600
1400
1200
1000
800
600
400
200
0
90
80
70
60
50
40
30
20
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0
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