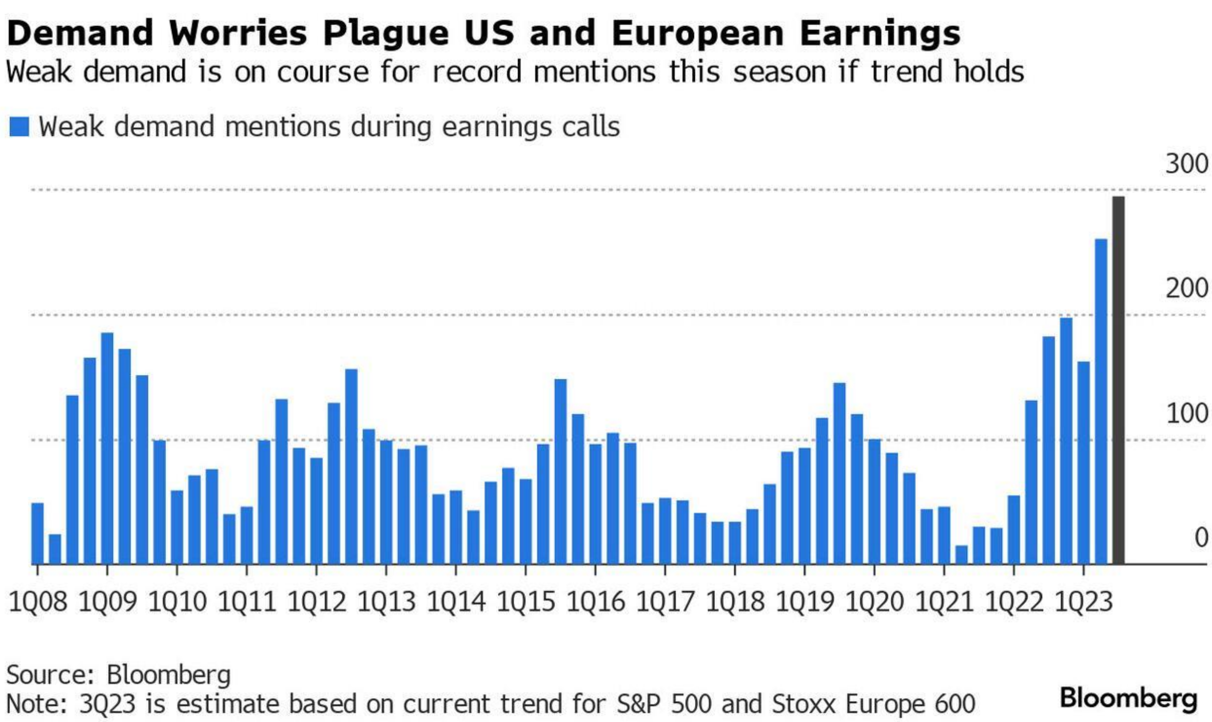
THE FED & THE MARKETS, ARE THEY ON THE SAME PAGE?

The FOMC minutes issued by the FED last week noted the economy was strong. Recent corporate earnings reports covering Q3 and their outlook, proposed otherwise. Both cannot be right.

This is what the FED FOMC had to say about the economy. "*Recent indicators suggest that economic activity has been expanding at a **solid pace**.*" And "*The U.S. banking system is sound and resilient*." Given this positive outlook it was to be expected that the FED would not reduce its interest rate.

On the other hand *Bloomberg* this week announced that with 80% of S&P 500 corporations having reported, over half of these corporations missed their revenue expectations, the most since 2019, a year when the economy teetered on the brink of recession. In terms of the outlook for the 4th quarter and beyond, more companies reported a weak outlook than at any time since 2000, even worse than at the dawn of the financial crash in 2008. This weak outlook has been confirmed by Costco's sales report for October which came in at 1.1%, compared to an annual average of 3.3% and most interestingly, far below the growth in international sales. In addition employment in retail fell sharply. "*Amid the early holiday shopping season, retailers have cut 72,182 jobs through October, a 258% increase from the 20,191 jobs eliminated in 2022, according to a new report from Challenger, Gray & Christmas. This marks the most significant number of job cuts since retailers cut 179,520 jobs in October 2020.*"

Graph 1.



And this is not only true for Europe and the USA, but for the world economy as well. This what the Econoday weekly report summary released on the 3rd November had to say: "*The Relative Performance Index for the global economy broke sharply lower in the week, pulled down by weak GDP reports from the eurozone and lower-than-expected growth in US employment.*" This followed the S&P Global report for

October covering manufacturing: "*Global manufacturing remained in the doldrums in October, according to the latest JPMorgan Global Manufacturing Purchasing Managers' Index™ (PMI®) compiled by S&P Global. The headline PMI registered 48.8, down from 49.2 in September to indicate a deterioration in business conditions for a fourteenth successive month.*" "*Production continued to edge lower, led by a further deterioration in order books. A lack of demand from customers pushed businesses into gloomier moods, in turn causing firms to cut back further on their purchasing of materials and on their payroll counts. The latter fell globally at the steepest rate since 2009 barring only the initial pandemic lockdown months.*" "*Global output was 1.0% below that of a year ago in August (the latest month for which official data are available for the major economies) based on our calculations. That's the steepest rate of decline for three years.*"

The FED has pledged to keep its eye on economic developments in its recent FOMC meeting which includes international developments. "*The Committee would be prepared to adjust the stance of monetary policy as appropriate if risks emerge that could impede the attainment of the Committee's goals. The Committee's assessments will take into account a wide range of information, including readings on labor market conditions, inflation pressures and inflation expectations, and financial and* ***international developments****.*" Well it was clear by the time of the FED meeting, that the economic weather internationally was deteriorating in part due to high US interest rates having a knock-on effect throughout the world economy.

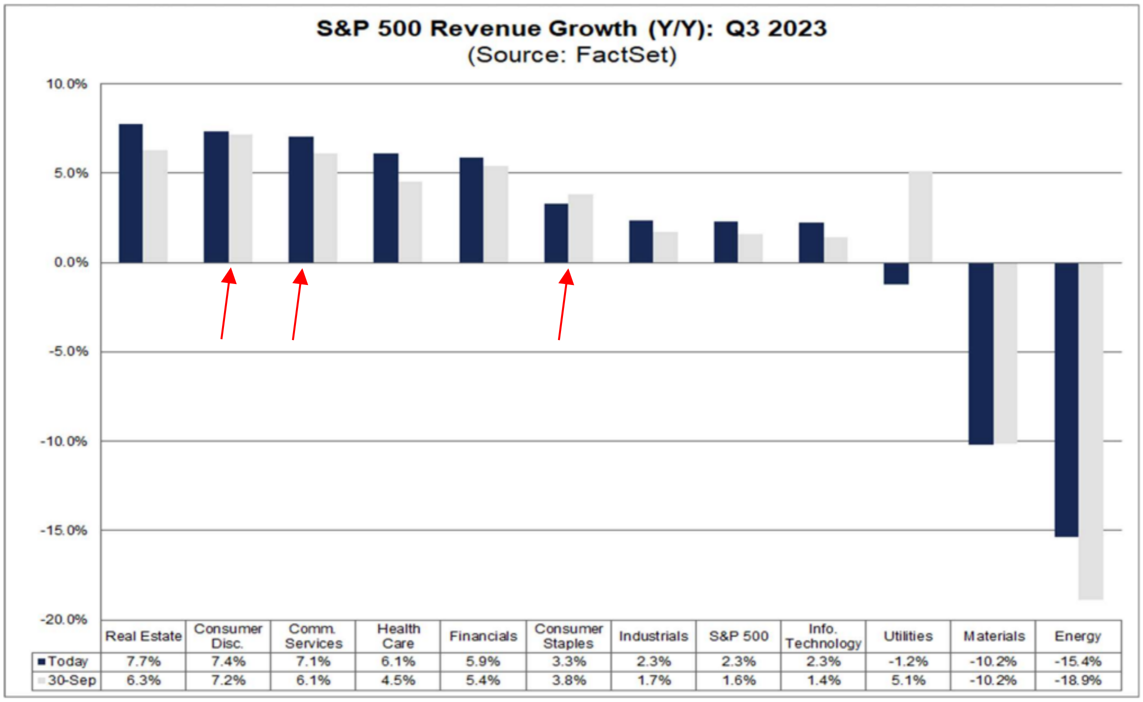
Or perhaps the FED is more concerned with justifying high interest rates so as to support the dollar which is vulnerable due to the large trade deficit and federal budget deficit. The recent fall in interest rates has weakened the dollar.

Graph 2.

Its all in the deflator.

In a previous article I reported that I had analysed over 20 consumer facing corporations who had announced price rises of 6% to compensate for stagnant or falling volumes. With the exception of Starbucks this trend has been repeated and confirmed by analysists interviewed on Bloomberg TV who admit to stagnant if not falling volumes. These inflated prices are also confirmed by [FactSet's most recent report](). Although overall revenue rises are much lower than 6% this is primarily due to the fall in pump prices. "*The blended (year-over-year) revenue growth rate for Q3 2023 is 2.3%,* but excluding the fall in pump prices the average would be higher. *The Consumer Discretionary sector is reporting the second-highest (year-over-year) revenue growth rate of all eleven sectors at 7.4%. The Communication Services sector is reporting the third-highest (year-over-year) revenue growth rate of all eleven sectors at 7.1%."* When we add in consumer staples to the other two sectors it averages out at 6%.

Graph 3.



Admittedly this refers to the larger corporations with more established pricing power. Nevertheless as these corporations account for around 70% of the revenue in their sector it is unlikely that the current Consumer Price Index figures are real. The overall figure was just 3.7% or 2.8% excluding owner occupier rents and 3.1% when excluding both owner occupier rents as well as energy costs, which fell. Taking the 2.8% CPI figure we can compare this to the 2.5% nominal annual increase in retail sales for Q3 implying a small fall in volumes of 0.3%. (The CPI is of course inflated by higher service sector prices.)

Both my calculations and that of the BEA estimating retail prices only yields a deflator of 0.4%. This 0.4% can be interpreted as the Retail Price Index. (Obviously the data does coincide as we are both using the same statistics.) This would yield a rise in volumes of 2.1% consistent with the GDP data for a rise in volumes of 2.6%. However, this is definitely not in line with the reports from the Corporations themselves which on balance report marginally falling volumes as well as price rises well above 0.4%. Given that the inflated figures for the sale of goods adds nearly a quarter to the overall increase in GDP, this difference is disturbing, while indicating a much weaker economy dependent on personal consumption.

And the future outlook for goods inflation has deteriorated. A report from the European Central Bank on reshoring published in the *Financial Times* warns that reshoring, as I predicted, is coming with a hefty price tag. 60 percent of companies polled said that over the last five years reshoring had pushed up the price of inputs and nearly half of the companies polled said it would continue to push up prices in the future. The IMF has weighed into this debate saying that all this reshoring will lead to a fall of 2% in global output.

The Stock Market.

In the three months to October, US stock exchanges handed back most of their gains this year. However since then, November's trading has been on a temporary winning streak. This relief rally is propelled by the view that the FED is done raising interest rates despite saying the economy is strong, which it is not. In addition the Treasury forecast for future borrowing surprised on the low side. The reason for this was mainly deferred tax payments being restored. Despite falling by $76 billion below estimates, the figure of $776 billion needing to be raised, is still a record for the fourth quarter of any year.

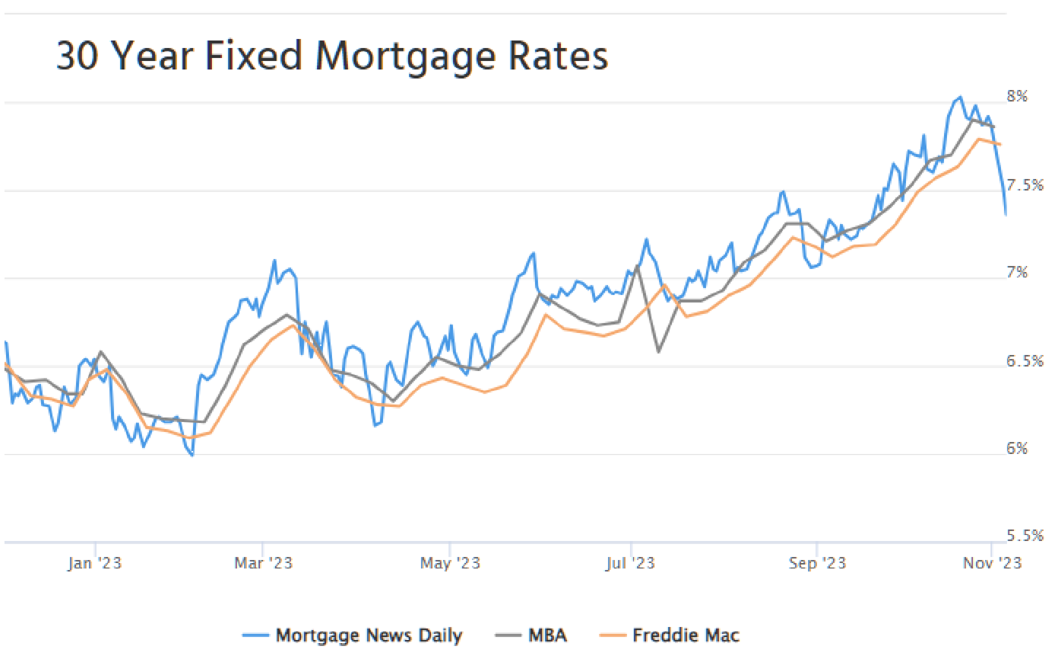
As a result of all this 'good' news the crucial 10-year yield, which briefly poked its head above the 5% parapet, has fallen back to 4.5% removing fears that the FED had lost control of monetary policy due to a panic in the bond market. It appears the 5% level was breached because of Hedge Funds heavily shorting the bonds, then having to reverse their bets, taking large losses in the process.

However, the forward projections for borrowing going into 2024 are less comforting. Goldman Sachs projects net notional issuance at $2.4 trillion and gross issuance, the more important one which feeds the auctions of bonds, at $4.2 trillion equal to $1 trillion a quarter. This equates to an 8% budget deficit not far removed from the deficits during the pandemic when government support compensated for the loss in the production of revenue due to lockdowns. The Goldman outlook was confirmed by Deutsche Bank. Clearly this is unsustainable even if the markets have not yet twigged.

And of course Congress has not yet agreed additional funds for the government despite the deadline being a week away. Though once again a stopgap fix will be agreed this is no way to fund such a major economy.

The fall in the 10-year yield which sets mortgage rates through the medium of SWAPS has fallen from the critical 8% level in October to 7.5% currently. They are likely to fall further to below 7% making owning a home slightly more affordable. In October the unaffordability index was at a record high.

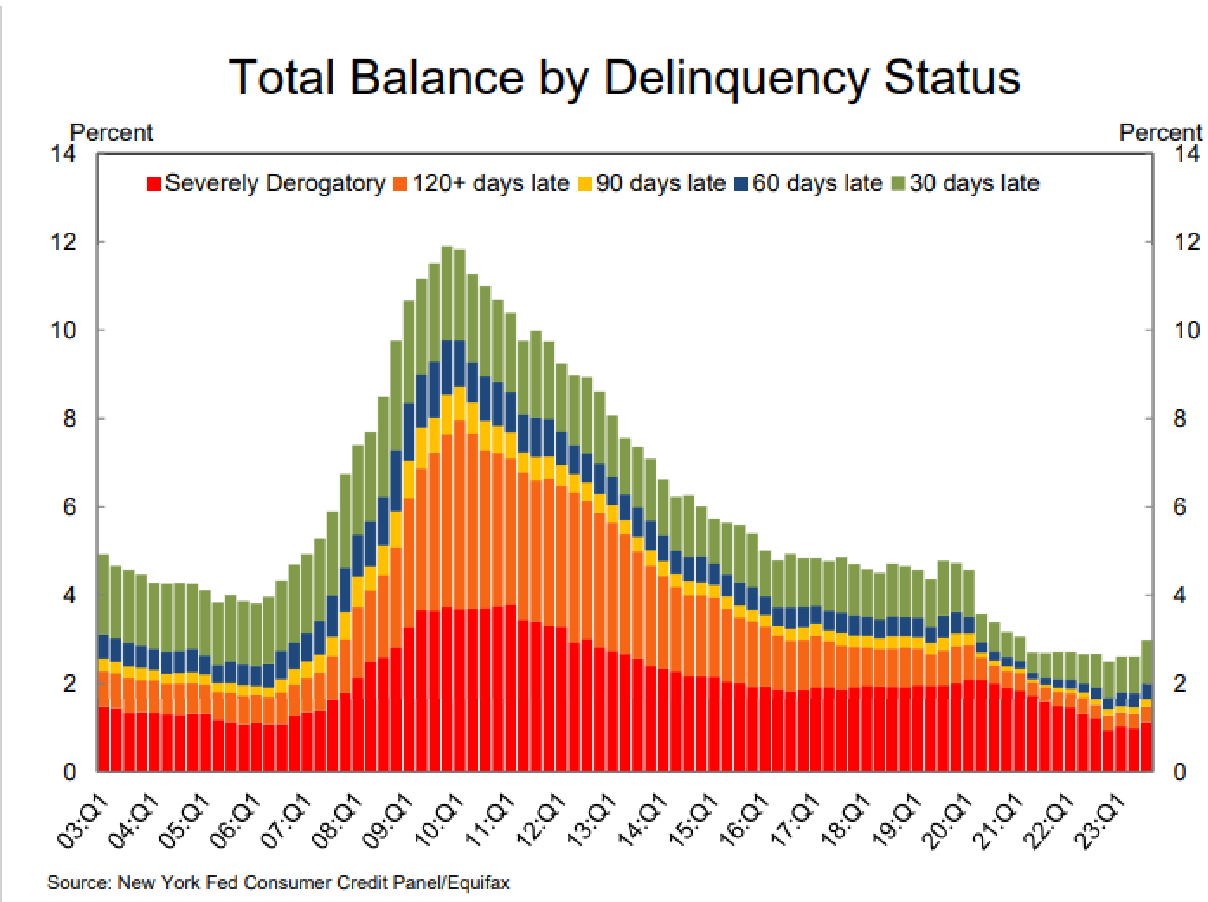
Graph 4.



In the meantime the crisis in Commercial Real Estate deepened. This week *WeWork* one of the biggest landlords and bellwether for the temporary office space sector finally filed for Chapter 11 Bankruptcy. However, in the Senior Loan Officer Survey there was no sense of urgency. While it admitted that bank standards on balance tightened and the demand for short term commercial loans weakened, there was no sense of crisis in the banking system as conditions had generally improved since Q2. To put this in figures, the demand for Commercial & Industrial Loans which are short term cash flow loans, are down 5% so far this year in real terms. Additionally the Survey reports that spreads on these loans increased as the premium paid by riskier borrowers increased.

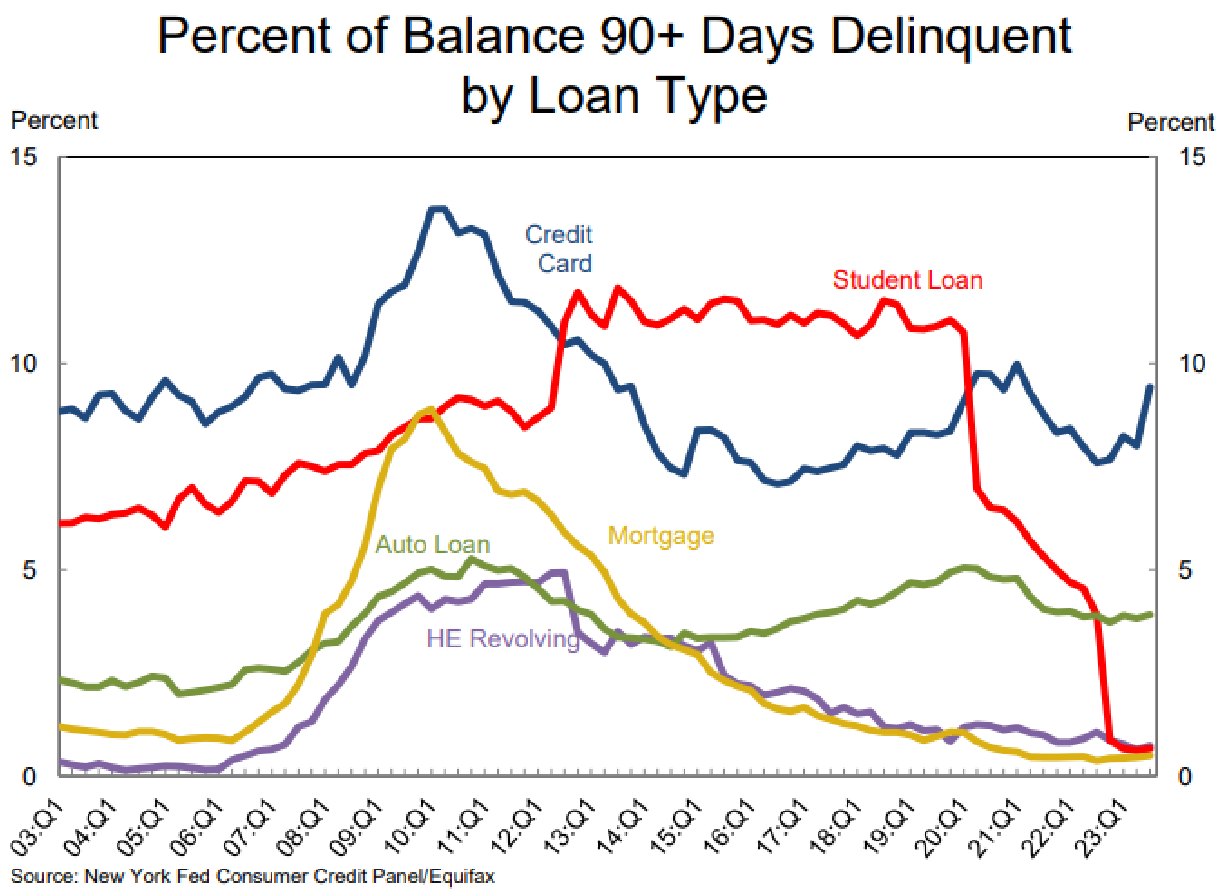
However in terms of delinquencies, i.e. late payments, the picture was not as benign, due to third quarter delinquencies rising significantly as can be seen in the graph below taken from the *HOUSEHOLD DEBT AND CREDIT REPORT* issued by the New York FED.

Graph 5.



This rise in delinquencies was mainly driven by late payments on credit card balances. Again this is ominous for the retail industry particularly in the context of the resumption in student loan repayments. Notably delinquencies on mortgage repayments remained low.

Graph 6.



The US foreign policy is not in disarray.

The genocide in Gaza caused by the dropping of the equivalent in fire power of [2 nuclear bombs] has deservedly aroused global condemnation. It has led to the diplomatic isolation of Israel and the USA. Even if Israel crushes Hamas it will have lost the economic war. The silent but extensive economic damage being done within Israel goes unreported. The required government support, likely to be funded by the USA, needs to equal that given out during the Pandemic. But what will not be funded and cannot be funded, is the loss of regional markets, future boycotts of Israeli goods even if not organised, and the mass flight of those who can, notably STEM graduates, from Israel itself. Already, before the war, [twenty eight percent] of the Israeli population stated they would like to emigrate if they could. No doubt that figure is much higher today. The economic damage done by the loss of these brains and skills cannot be calculated especially when it will tip the balance further in the direction of the religious right whose only skill and exercise is to drag their finger along the lines of the Talmud.

What a pair Israel and the USA make. The former irrational and the latter stumbling. The USA too is paying a high price for its unconditional support for Israel. Here the test is for an immediate ceasefire which the US steadfastly vetoes instead calling for pauses whatever those are. This has caused Blinken to be verbally abused by Arab leaders, it has led to ructions within the US State Department itself, bled electoral support for Biden, divided the Democratic Party, led to mass protests, and disfigured the so called 'rules based' system championed by the USA. (More like a 'fools based' approach swallowed by dummies.)

The question is posed, given this political fall-out why is the US continuing to pursue this single-minded assault on the Palestinian people? Answer China. The military objective dominates political considerations, even if the results end up damaging Israel itself. The USA would not hesitate to sacrifice Israel in pursuit of this goal. The goal is to crush not only Hamas but Hezbollah and Iran as well. Only that way can the USA secure the Middle East, ensuring there is not a second front in the war with China which ends up blocking this strategic gateway linking three continents.

In this context the brutality of the Israelis becomes explicable. When they cruelly bombed the ambulance convoy heading for the Rafah this was not a careless act but a calculated act. They wanted the revulsion to fan out and draw in Hezbollah. They seek to create such unbearable carnage that the rank and file in Hezbollah will revolt and attack Israel, and when that happens, it will be difficult for Iran to stand aside.

And this second front imperative has become all the more important because the first front in Ukraine is collapsing. There is now visible and undeniable proof that the Ukrainian military leadership and the Ukrainian government are at each others' throats due to all the military setbacks. Military men and women tend to be more realistic than politicians especially those hiding in bunkers. General Valery Zaluzhny, the commander in chief, has admitted in the western press that Ukraine has lost the war. This led to fierce denunciations by Zelensky who was in turn described as increasingly deluded in a recent interview in *Time Magazine*. It seems Zelensky's behaviour is preparing the script for a future remake of the film *The Bunker*; 78 years after the first one in Berlin. And to make matters worse, the Ukrainian style of eliminating differences has once again resulted in the fragging of one of Zaluzhny's closest aides, a Major Hennady Chastyakov, who received a birthday gift to die for. The circumstances seem to mirror the explosion which caused the death of Wagner's leader.

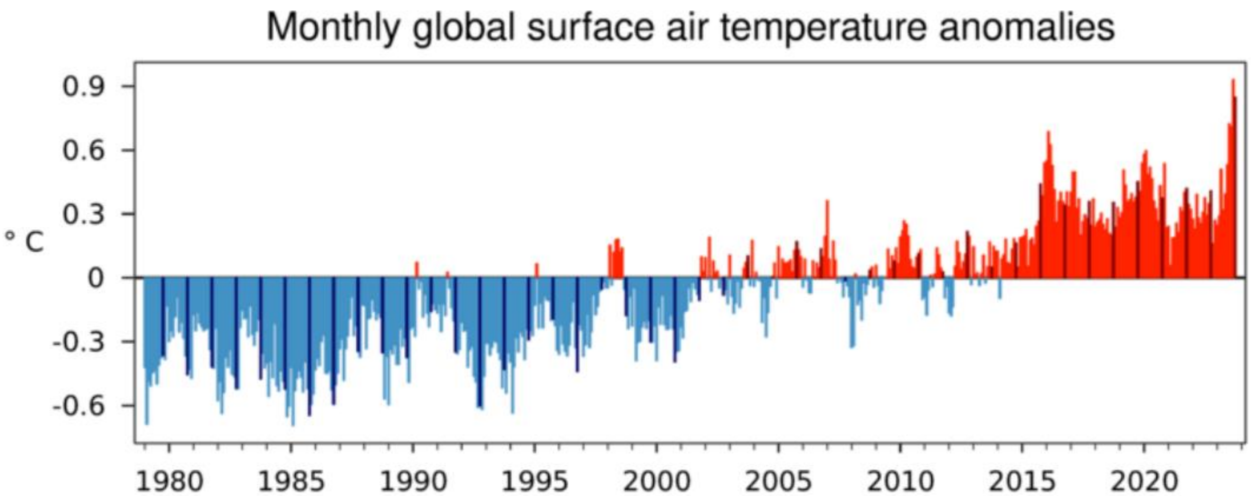
Conclusion.

Following the astounding rebound in the GDP during the 3rd quarter which hit an annualised growth rate of 4.9%, all talk of a recession, never mind a soft landing, was put on the back burner. This has now changed. The recent sharp slowdown in the economy has caught analysts off guard. One of the more alert analysts, Peter Tchir, interviewed on Bloomberg TV was of the opinion that a hard landing would be back on the agenda as soon as the 10-year yield moved towards 4%. Presently the markets are basking in the sun of stalling rates. But as rates fall the shadows will re-appear and begin to gain definition forcing investors to ask the obvious question: what is causing rates to weaken? In particular if government bond yields fall while the yield on junk bonds rise, which is not happening yet, that question becomes even more urgent. Clearly such an event describes a subsiding economy despite the huge federal deficit fuelling demand, and in the end it is earnings in the real economy which drives the markets.

My own opinion is that October has been a second inflection point where the flat to rising economy gave way to a falling economy. "*We're hearing from all the public carriers and the private ones that there's been a significant deterioration in October* (in trucking)." This time there will not be a reversal in the downward trend, there will be no future updraft supporting the increasingly overstretched and vulnerable stock market. Perhaps today's OPENAI crash amongst others, is a portend of what is to come.

And of course the weather just keeps getting hotter as the October release by the Copernicus Climate Change Service shows.

Graph 7.



Is it not interesting how the Biden administration is able to find money to damage the world through military assistance to the Ukraine and Israel but cannot find the money do undo the damage caused by climate change? "*The last round of talks to set out how to get the so-called loss and damage fund up and run-ning before COP28 later this month ended in acri-mony late on Saturday night in Abu Dhabi, with the US absenting itself at a critical juncture*." In fact the US walked out before the vote and only returned after the vote insisting that financial support had to be voluntary. Biden may claim to have green fingers but in reality all he has are bloody hands.

The sun may be setting on the U.S. Empire, but if we are not careful, it will set on this planet as well. The Zionists have never shown the Palestinians any mercy, in turn we should show no mercy towards the capitalist system which threatens us all. Gaza is not an aberration but a demonstration of the lengths a dying empire and its minions will go to, to preserve their domination.

Brian Green, 8th November 2023.