July FOMC meeting preview

Economy & Policy
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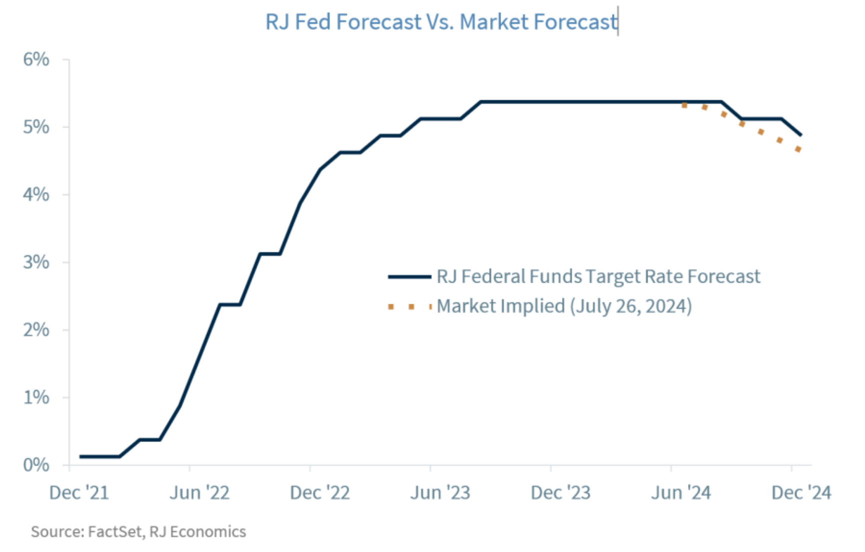
Chief Economist Eugenio J. Alemán discusses current economic conditions.

The Federal Reserve (Fed) doesn't like to spook markets, that is the reason why it has crafted its communication on monetary policy to give indications way in advance and nothing has been pointing to a change of heart that could lead to a surprise move next week. It is true that 'Fedspeak' has become a bit less hawkish after several weak monthly inflation readings during the second quarter of the year compared to the severe hawkishness expressed after the higher-than-expected inflation readings during the first quarter of the year.

Furthermore, external voices have been making appearances on several news media outlets indicating the need to start moving sooner rather than later. The latest one was William Dudley who was the president of the New York Federal Reserve until 2018. He seems to have changed his tune and his view and now seems to believe that the Fed should go ahead and lower interest rates at the conclusion of the July meeting of the Federal Open Market Committee (FOMC) next week.

Others have started to argue that because of the impending slowdown in economic activity during the second half of the year (see our *Weekly Economic* commentary on July 19, 2024) the Fed is going to have to reduce interest rates by 50 basis points rather than 25 basis points in September. Furthermore, markets are currently pricing in three 25-basis points cuts for the federal funds rate between today and the end of the year starting in September.

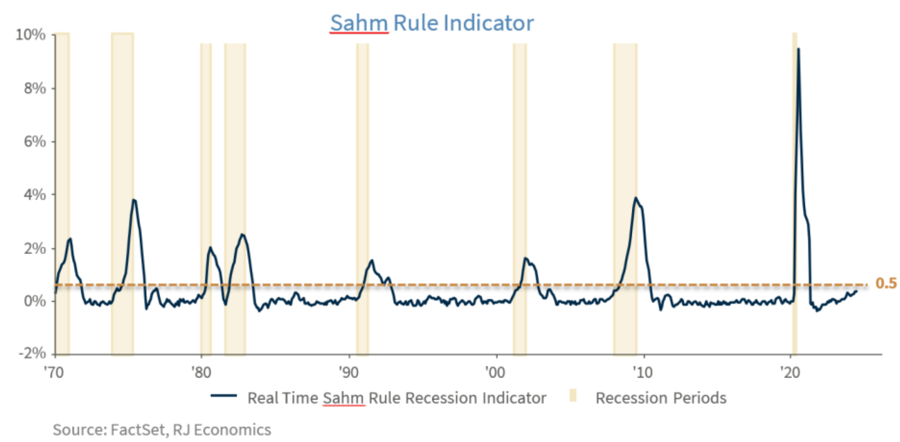


We believe that it is highly unlikely that the Fed would act on Dudley's comments. Furthermore, if you have followed our view, we mentioned several times before that we disagreed with the hawkish pivot Fed members made after higher-than-expected inflation readings during the first quarter of the year. However, the threshold for surprising the market next week is very high and would probably require Fed officials to have concrete information that the economy is on the precipice of a recession. And if that occurred it will really spook markets.

Is the Sahm Rule signaling trouble? What about LEI, ISM Manufacturing, and ISM Services?

A recession indicator based on the increase in the unemployment rate is starting to flash a warning sign. The indicator is called the Sahm Rule, which is calculated as the three-month average rate of change in the rate of unemployment. If this rule increases by 0.5 percentage points compared to the low of the previous 12 months, this may be an indication that the economy may be in a recession. The Sahm Rule increased to 0.43 in June of this year (see graph below). If the rate of unemployment for July, which is expected to be released next week stays at 4.1%, then the Sahm Rule will increase to 0.466. However, if the rate of unemployment increases to 4.2% or higher, then the Sahm Rule will be triggered.

Would this mean that the U.S. economy has entered a recession? Nobody knows. So many tested and, in the past, trustworthy economic indicators have been so wrong since the end of the pandemic recession that we would not put our trust in only one indicator. Furthermore, since other indicators of economic activity have become unreliable after the pandemic recession there is a chance that the Sahm Rule has also been affected and can no longer be trusted.



Furthermore, we don't estimate economic growth by just watching only one indicator and we are still not predicting a recession this year, just a slowdown in economic activity. However, the Fed has to realize that there are several warning signs pointing to slower economic growth, and it should go ahead sooner rather than later with several rate cuts to accommodate this lower economic growth scenario before other sectors of economic activity start to falter under the pressure of high interest rates.

Consumer Price Index is a measure of inflation compiled by the US Bureau of Labor Statistics. Currencies investing is generally considered speculative because of the significant potential for investment loss. Their markets are likely to be volatile and there may be sharp price fluctuations even during periods when prices overall are rising.

Consumer Sentiment is a consumer confidence index published monthly by the University of Michigan. The index is normalized to have a value of 100 in the first quarter of 1966. Each month at least 500 telephone interviews are conducted of a contiguous United States sample.

Personal Consumption Expenditures Price Index (PCE): The PCE is a measure of the prices that people living in the United States, or those buying on their behalf, pay for goods and services. The change in the PCE price index is known for capturing inflation (or deflation) across a wide range of consumer expenses and reflecting changes in consumer behavior.

The Consumer Confidence Index (CCI) is a survey, administered by The Conference Board, that measures how optimistic or pessimistic consumers are regarding their expected financial situation. A value above 100 signals a boost in the consumers' confidence towards the future economic situation, as a consequence of which they are less prone to save, and more inclined to consume. The opposite applies to values under 100.

GDP Price Index: A measure of inflation in the prices of goods and services produced in the United States. The gross domestic product price index includes the prices of U.S. goods and services exported to other countries. The prices that Americans pay for imports aren't part of this index.

The Conference Board Leading Economic Index: Intended to forecast future economic activity, it is calculated from the values of ten key variables.

The Conference Board Coincident Economic Index: An index published by the Conference Board that provides a broad-based measurement of current economic conditions.

The Conference Board lagging Economic Index: an index published monthly by the Conference Board, used to confirm and assess the direction of the economy's movements over recent months.

The U.S. Dollar Index is an index of the value of the United States dollar relative to a basket of foreign currencies, often referred to as a basket of U.S. trade partners' currencies. The Index goes up when the U.S. dollar gains "strength" when compared to other currencies.

The FHFA House Price Index (FHFA HPI®) is a comprehensive collection of public, freely available house price indexes that measure changes in single-family home values based on data from all 50 states and over 400 American cities that extend back to the mid-1970s.

Import Price Index: The import price index measure price changes in goods or services purchased from abroad by U.S. residents (imports) and sold to foreign buyers (exports). The indexes are updated once a month by the Bureau of Labor Statistics (BLS) International Price Program (IPP).

ISM New Orders Index: ISM New Order Index shows the number of new orders from customers of manufacturing firms reported by survey respondents compared to the previous month. ISM Employment Index: The ISM Manufacturing Employment Index is a component of the Manufacturing Purchasing Managers Index and reflects employment changes from industrial companies.

ISM Inventories Index: The ISM manufacturing index is a composite index that gives equal weighting to new orders, production, employment, supplier deliveries, and inventories.

ISM Production Index: The ISM manufacturing index or PMI measures the change in production levels across the U.S. economy from month to month.

ISM Services PMI Index: The Institute of Supply Management (ISM) Non-Manufacturing Purchasing Managers' Index (PMI) (also known as the ISM Services PMI) report on Business, a composite index is calculated as an indicator of the overall economic condition for the non-manufacturing sector.

Consumer Price Index (CPI) A consumer price index is a price index, the price of a weighted average market basket of consumer goods and services purchased by households. Changes in measured CPI track changes in prices over time.

Producer Price Index: A producer price index (PPI) is a price index that measures the average changes in prices received by domestic producers for their output.

Industrial production: Industrial production is a measure of output of the industrial sector of the economy. The industrial sector includes manufacturing, mining, and utilities. Although these sectors contribute only a small portion of gross domestic product, they are highly sensitive to interest rates and consumer demand.

The NAHB/Wells Fargo Housing Opportunity Index (HOI) for a given area is defined as the share of homes sold in that area that would have been affordable to a family earning the local median income, based on standard mortgage underwriting criteria.

The S&P CoreLogic Case-Shiller U.S. National Home Price NSA Index measures the change in the value of the U.S. residential housing market by tracking the purchase prices of single-family homes.

The S&P CoreLogic Case-Shiller 20-City Composite Home Price NSA Index seeks to measures the value of residential real estate in 20 major U.S. metropolitan.

Source: FactSet, data as of 7/7/2023