JAVLIN Invest

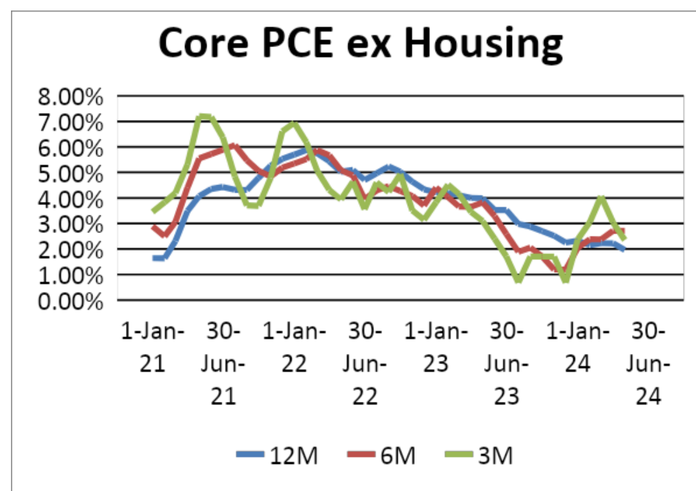
June 2024 Q2 Macroeconomic Perspective

Original Sin – Why the Fed is Dovish but Can't Show it

The Fed was right. At least that's what they think.

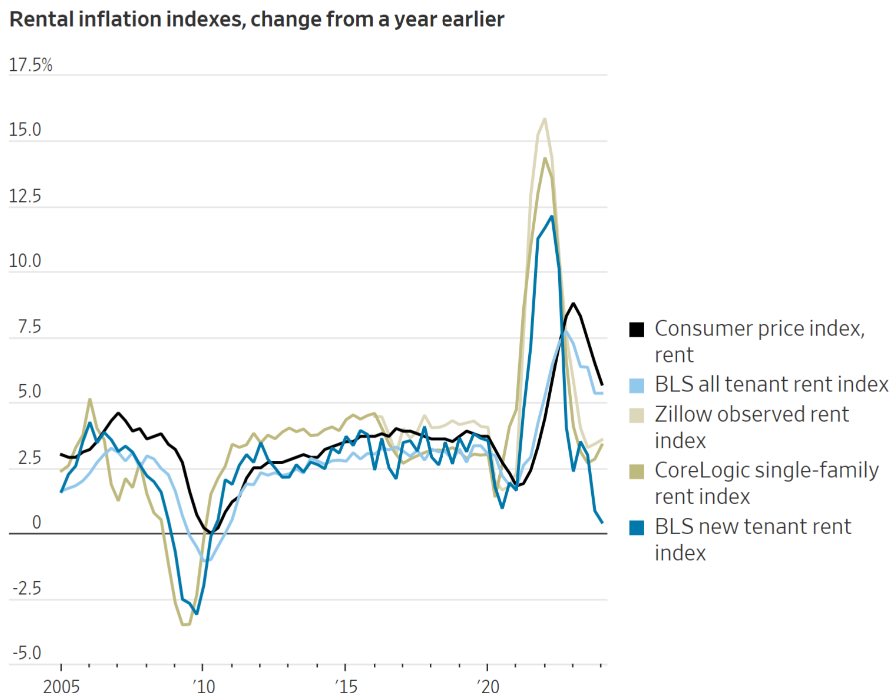
In 2021, the Fed was slow to raise rates because they believed it was transitory, due to supply chain disruptions coupled with a surge in demand from the global economy recovering from COVID. In their minds, they were largely correct – as supply chains have healed, the cost of goods have actually seen deflation since the end of 2023.

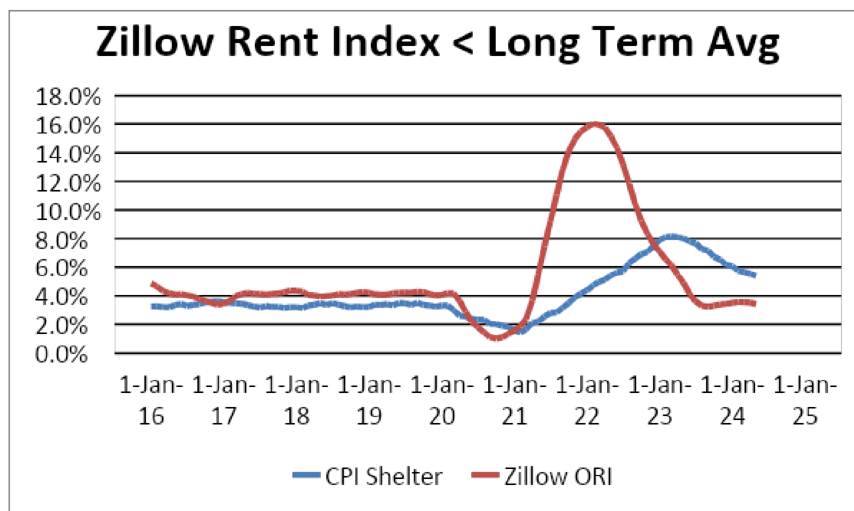
The Fed's preferred inflation measure, Core PCE, has continued its descent with the latest print at 2.6%. Moreover, the Fed is likely looking at Core PCE minus Housing/Rental costs as further vindication as it clocked in at less than 1.96% in May:



***Source**: St. Louis Fed (FRED)*

It's an open secret amongst Economists that due to the way housing inflation is measured; there is a lag between real time indicators and housing CPI. In short, they are expecting inflation to come down further.





***Source**: WSJ (top) | **Source**: St. Louis Fed (FRED) (bottom)*

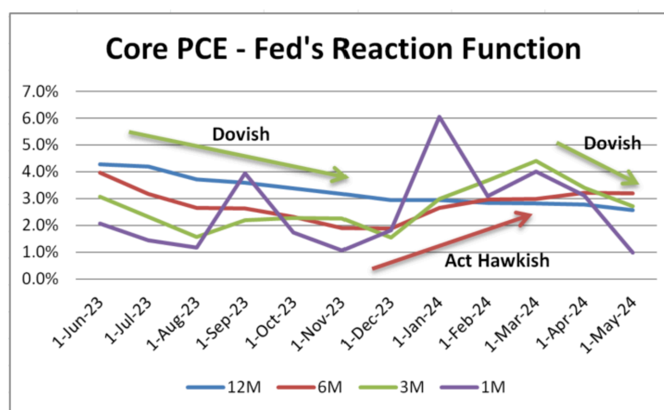
In the June quarterly Dot Plots, the Fed estimated the long run “neutral rate” as 2.8% which implies that the current Fed Funds rate of 5.33% is significantly restrictive. While employment data has held up quite well, it is also well accepted that this is a lagging indicator and with monetary policy having “long and variable lags” is it any wonder that the Fed is keen to ease?

I think I’m not alone when I say that every time I hear Powell speak, I hear a guy who’s desperately trying not to blurt out his true desire: to cut. But Powell knows he is constrained by their error in 2021 where they confidently held off from raising rates and saw it blow up in their faces. While they expect the lag effect on housing to play out, they are not certain it will.

You see, what Powell, and the Fed, rightly understands is that their greatest tool is not setting interest rates – it is influencing expectations and behavior. When the economy dips into recession, a cut in interest rate only helps borrowers. Far more powerful are the signals of near limitless support that the Fed sends to the economy as that lifts everyone. Enterprising businesses see opportunity; contrarian investors buy the dip; and markets start recovering, which instills confidence amongst the populace. For all of this to work, the Fed's credibility is paramount. Another big mess up is something the Fed can't afford. What do inflation, fear, confidence and Covid all share in common? They are contagious.

The Fed Put is Back

The Fed believes the right tail risk of high inflation is gone and hence the "Fed put" is back... sort of… the Fed has your back, but they will have to act tough when the slope of the short term averages of PCE are positive.



***Source**: St. Louis Fed (FRED)*

Cyclical vs Structural Investing

How could the S&P 500 rally 17% ytd with high interest rates and moderately slowing growth? All while markets price in less Fed cuts now than at the start of the year? When we dig into the details things aren't completely bonkers.

As has been much reported, most of the gains in the S&P500 can be attributed to 7 stocks, all of which have an AI flavor, none more so than the leader NVIDIA. If we look at the S&P 500 equal weight index which represents the average performance of companies, we are only up 3.5% for the year. The Russell 2000 index which represents smaller companies and better reflects the US economy is slightly down for the year. The market is largely cautious in pricing the broader market.

The driver of performance has been certain investors who believe that AI is a structural growth story and are taking a long horizon approach. Most professional equity investors and analysts don't care much about economic cycles. They believe macro is impossible to forecast and therefore concentrate on doing a deep dive analysis on the micro. Let's not debate if this is right

or wrong – it just is how most (not all) equity analysts think. With this framework it is understandable why AI stocks have done so well, specifically NVIDIA and semiconductor stocks which are selling the picks and shovels of this modern day Gold Rush.

If we zoom way, way out, is there a world where NVIDIA can surpass 3 trillion dollars in market cap? There are roughly 167 million working adults in the US with an average salary of $63k, representing roughly 10.5 trillion dollars of annual income. Outsourcing and automation in the US manufacturing sector saw a decrease in jobs just shy of 50%. If AI only replaces 10% of the current US workforce you have a 1 trillion dollar Total Addressable Market (TAM) and that's only in the US!

I'm not arguing that this will happen and whether NVIDIA can maintain their juicy 75% gross margins but nothing drives a bull case like momentum! Time will tell if these investors are correct and while I don't have a strong opinion on how AI stocks will do in the near/medium term, I don't think they are trading tulips.

Not an AI Analyst

At the start of the year I predicted bond yields to rise which would then be a headwind for equities. I was right on the former and dead wrong on the latter, mainly because I was not on top of the AI story. Diversification and staying invested remain undefeated.

Lastly, I have updated probabilities for my scenarios of a soft landing, shallow recession or hard landing. As the Fed's calculations are now asymmetrically dovish the hard landing scenario is quite unlikely. Data still hints at late cycle dynamics and the price of the Fed's original sin keep a shallow recession a reasonable likelihood. The big picture though is that if a recession happens, it probably won't be too bad for risk assets as a shallow recession (the bear case) usually sees a selloff of 15-25% (link: June 2023 Macro Perspective). AI stocks will be the main question as companies tend to cut capex during recessions but the extent of overinvestment is arguable as supply remains a bottleneck. Non-AI stock valuation and performance are reasonable. Pair these together and I feel that even if we see a recession the selloff will be on the shallow side (10-20%).

Scenario 1 Year Ahead	Jul-24	Jan-24	Sep-23
No Recession	50%	40%	10%
Shallow Recession	45%	45%	55%
Hard Landing	5%	15%	35%

Christopher Chou CFA
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Bio

Christopher T Chou has 15 years of experience in the investment industry. He began his career at RiskMetrics Group (now part of MSCI) advising banks, hedge funds, pension funds and other asset managers in risk management. He transitioned to the sell side trading credit and interest rate bonds for Mitsubishi UFJ Trust International and spent 10 years at Macquarie Bank under a macro focused proprietary trading desk where, most recently, he was head of North Asia trading. Christopher graduated from Princeton University with a Bachelor's degree in Electrical Engineering and a certificate in Computer Science. He approaches the market with a macro-oriented, fundamental driven bias while embracing quantitative and behavioral methods.

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