SMBC

SMBC Group

US Macroeconomics

June 22, 2023

Joseph Lavorgna, Chief US Economist | 212.893.1528 | joseph.lavorgna@smbcnikko-si.com

Markets Are Believing Fed But Ignoring Leading Indicators

The Fed has been successful in altering market expectations of future policy actions. No longer are the futures markets fully discounting interest rate cuts this year. And yearend 2024 fed funds expectations have been lifted over the last month from 2.75% to 3.75%. **There is a lot less easing priced into the forwards than what had previously been the case**. Meanwhile, the FOMC central tendencies show only 100 basis points (bps) in rate cuts next year.

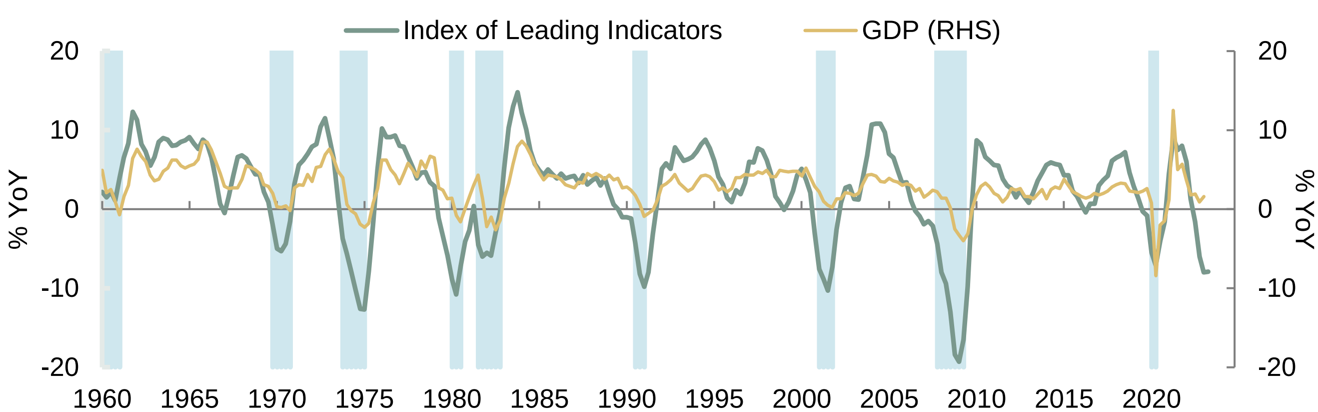
Interestingly, this adjustment has occurred against the backdrop of continued deterioration in GDP growth prospects. **The Index of Leading Economic Indicators fell 0.7% in May, its 14th consecutive decline**. This is the longest span of declines since the 24 months from April 2007 to March 2009. Over the last year, the Index of Leading Indicators is down -7.9%, the lowest reading since September 2009 (-9.8%). Is the Fed making a significant policy mistake?

As illustrated in the chart below, the growth rates in Leading Indicators and real GDP are highly correlated. Seldom does either series move in the opposite direction on the other for any length of time. Both series are trending downward, with Leading Indicators down more substantially than real GDP, which is often the case.

While the depth of the decline in Leading Indicators does not necessarily tell us how big of a drop we will see in real GDP — witness its big decline in 2001 and what turned out to be a mild recession. Despite this, the Index of Leading Indicators has nevertheless been a good predictor of economic inflection points. The series is telling us that we could nearing one now.

Whenever the next downturn begins, its depth in part is going to be determined by how aggressively the Fed responds. Right now, the probability of a policy pivot is low. Chair Powell has repeatedly stated that it is the FOMC's intention to lift rates another 50 bps from already restrictive levels. If so, this would be happening against the backdrop of a worsening in Leading Indicators.

The upshot is that while the timing of recession may have been pushed out, its depth could be much deeper because of Fed hawkishness. If this is the case, then ultimately the Fed will cut rates much more than it anticipates. Consequently, earlier futures market expectations may be proven right.



Source: Conference Board, Haver, SMBC Nikko

Disclaimers

This document is provided by SMBC Nikko Securities America, Inc. (“SMBC Nikko”), the US-registered broker-dealer affiliate of Sumitomo Mitsui Banking Corporation, for informational purposes only. This document was prepared by SMBC Nikko’s economist(s). The views statements, assumptions and forecasts expressed herein are those of the author(s) and do not reflect the judgment of any other person or of SMBC Nikko, it does not constitute an offer, or solicitation of the sale or purchase, of securities or other investments. The information contained herein is obtained or derived from sources believed to be reliable, but SMBC Nikko and the author(s) make no representations as to its accuracy or completeness. In some cases, such information may be incomplete or summarized. This document has been prepared based on assumptions and parameters determined by the economist(s) in good faith. The assumptions and parameters used are not the only ones that could have been selected, and therefore no guarantee is given as to the accuracy, completeness, or reasonableness of any such quotations, disclosures, or analyses. Past performance is not a reliable indicator of any future results.

This document has been prepared for and is directed at institutional investors and other market professionals and is not intended for use by retail customers. It does not take into account any specific investment objective, financial situation, or particular need of any recipient. The information contained herein should, for whatever purpose, be used solely at the discretion and responsibility of the recipient. SMBC Nikko and its affiliates do not accept any liability or responsibility for any results in connection with the use of such information. Recipients are responsible for making final investment decisions and should do so at their own discretion after conducting a careful examination of all documentation delivered prior to execution, explanatory documents pertaining to listed securities, prospectuses, and other relevant documents, and their own independent analysis and assessment of the merits of any transaction. The financial instruments discussed may be speculative and may involve risks to principal and interest.

Sources: BLS, Haver Analytics, SMBC Nikko

Conflicts of Interest Disclosures

The views statements, assumptions and forecasts expressed herein may differ from those expressed in globally branded research produced by SMBC Nikko or its affiliates. The trading desks of SMBC Nikko and its affiliates trade or may trade as principal in the financial instruments that are the subject of this material, and the author(s) of this document may have consulted with the trading desks while preparing this document. The proprietary interests of SMBC Nikko and its affiliates may conflict with those of the recipient. SMBC Nikko and its affiliates may seek to do business with the companies mentioned in this material and the trading desks may have accumulated, be in the process of accumulating, or accumulate long or short positions in the financial instruments mentioned and may have acquired them at prices no longer available. The trading desks may also have or take positions inconsistent with the views expressed in this document or may have already traded on those views.

This material is not a research report, and neither this material nor its author(s) is subject to SMBC Nikko policies and procedures that apply to the globally branded research reports and research analysts of SMBC Nikko and its affiliates or to legal requirements designed to promote the independence of investment research. It is not subject to any prohibition on dealing ahead of the dissemination of investment research. This means that on the date of this document, SMBC Nikko, its affiliates, and their respective directors, representatives, or employees, may have a long or short position in any of the instruments mentioned in this document and may make a market or trade in instruments economically related to the securities, derivatives or other underlying assets mentioned herein, in each case either as principal or as agent.

No part of the author(s) compensation was, is, or will be, directly or indirectly related to the specific recommendations or views expressed herein. The personal views of authors may differ from one another.

Distribution, possession or delivery of this document in, to or from certain jurisdictions may be restricted or prohibited by law. Recipients of this document are required to inform themselves of and comply with all such restrictions or prohibitions.