US Macroeconomics

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Making Sense of the Latest Price Action

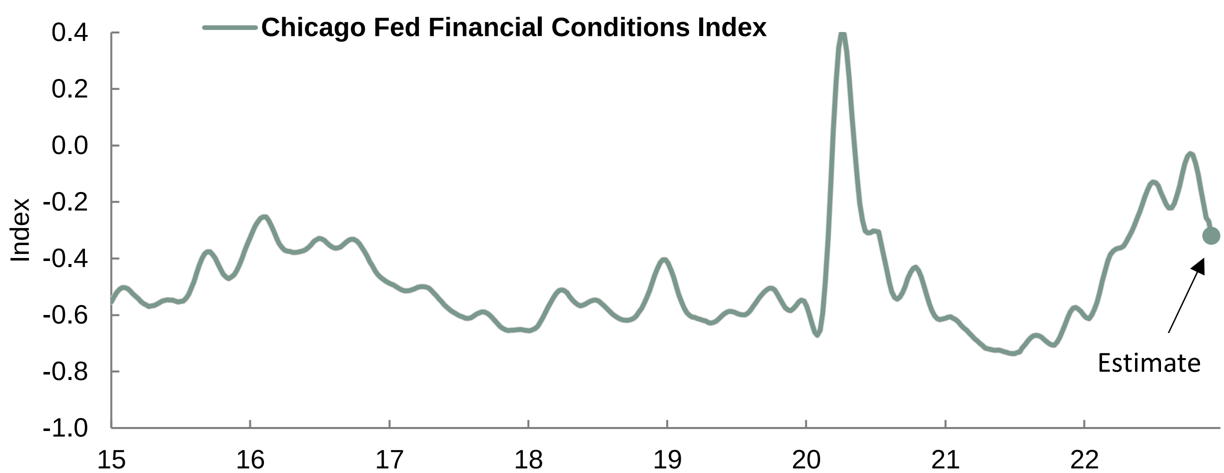
The bond market has rallied substantially over the past month but the fall in yields has been dramatic over the past several days. The same has been true for the stock market as well. The conditions that have caused bonds and stocks to rally have weighed on the dollar, which has fallen at a near record pace. The yield on 10-year treasury notes is down to 3.60% from a cyclical peak of 4.25% six weeks ago. But in the last several days, yields are down a sharp 15 basis points (bps). At the same time, stock prices are up 14% from their cycle low. In the last day, the S&P 500 surged 3%. Meanwhile, the trade-weighted dollar is down a massive 8% since last quarter's cyclical peak.

Powell stuck to his hawkish November 2 post-FOMC script but with two caveats. One, he explained in detail why he believes inflation will come down by late next year, even the sticky portion (core prices ex housing services). Two, and maybe more importantly, **Powell did not push back against the recent easing in financial conditions**. Consequently, the rally in bonds and stocks alongside the decline in the dollar accelerated yesterday and has continued into today.

As we highlighted earlier this week, **the Chicago Fed financial conditions index has eased further**. The series as of November 25 is down to -0.27, the lowest level since May 2022. And back then, the fed funds rate was only 1% or 300 bps lower than now. In some sense, **it is as if monetary policy never really tightened**. Moreover, based on what happened in the last day, it looks like financial conditions will finish this week even lower! Can this persist?

The rally in bonds (and sell-off in the dollar) is consistent with our view that both real GDP growth and inflation will come down substantially over the next year, thereby allowing the Fed to adopt a more accommodative stance. This is consistent with history. In fact, **our work has demonstrated that a pivot from hiking to easing is relatively quick**, with the time from the last hike to the first ease generally within six months and sometimes shorter. The fact the bond market was discounting an easing of policy before Powell spoke was consistent with history. Then when he did not push back against the latest trends, they accelerated in scope.

The rally in bonds is likely to be more durable and persistent than the rally in stocks because the former will rise in price whether the economy enters a recession or not. Since our view is that the probabilities favor a 2023 downturn, we are more circumspect on a sustained rally in equities. Of course, this can change if inflation falls more than we expect, or the Fed pivot is more aggressive than we assume. Stay tuned.



Source: Haver, Chicago FRB, SMBC

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