First Trust
Monday Morning OUTLOOK

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Still Overvalued

Prior to 2008, when the Federal Reserve ran a "scarce reserve" monetary policy, just about every bank in the US had a federal funds trading desk. These trading desks lent and borrowed federal funds (reserves) amongst each other.

In other words, there was an active marketplace that set the federal funds rate. Yes, the Fed could guide the overnight rate by adding or subtracting reserves. But this system meant there was a direct link between the money supply and interest rates.

Since the financial panic of 2008, and the introduction of Quantitative Easing, the Fed has flooded the system with reserves. Reserves are so abundant that banks no longer borrow or lend them. The Fed pays banks to hold them. As you can imagine, the Fed would like to pay almost nothing to banks, as it did for nine out of the last fifteen years. Under the new system there is no direct link between interest rates and the money supply.

Instead, the Fed just decides what rates should be. And this explains why market expectations about interest rates jump around with every piece of economic data. It's all about what the Fed "might" or "might not" do. Earlier this year, the market was pricing in multiple rate cuts in the second half of 2023.

But after last week's employment report, which showed continued solid job growth, the futures market finished the week with the odds of a July rate *hike* at almost 90%. We think the market is underestimating the odds that the Federal Reserve will raise short-term rates *again* this year, after July. Recent economic reports have been stronger than expected, and inflation remains stubbornly high around the world.

The Fed pays close attention to the labor market and average hourly earnings rose 0.4% in June and are up 4.4% from a year ago. We think the Fed needs to focus on actual inflation and the money supply, but its models tell Fed policymakers to focus on the labor market. Given a 2.0% inflation target and slow productivity growth, we think the Fed would like to see average hourly earnings grow at more like a 3% annual rate, not 4.4%.

Meanwhile, the unemployment rate is now 3.6% versus the 4.1% the Fed projected for the fourth quarter (back in June). Low unemployment is another reason the Fed is likely to be aggressive. Remember, back at the June meeting, two-thirds of Fed policymakers (twelve of eighteen) thought the Fed would raise rates at least two more times this year, so the flow of data on the economy and inflation would have to be generally weaker than expected to suggest only one rate hike is on the table for the remainder of 2023.

In turn, this bolsters the case that equities are overvalued. If the Fed ends up raising rates more than currently expected, long-term interest rates have some more risk to the upside in the months to come. Our Capitalized Profits model, which uses a measure of nationwide profits from the GDP report, discounted by the 10-year US Treasury yield, suggests that with the 10-year Treasury yield at 4.00%, the S&P 500 index is fairly valued at about 3,350. All else equal, a higher 10-year yield would drive this measure of fair value even lower.

We have been focused on the M2 measure of the money supply, which has dropped the most since the Great Depression. The US economy is still absorbing the massive money printing during COVID, but this is almost over. A decline in M2 should pull the economy into recession soon.

Apparently, investors aren't worried about that because they think the Fed will cut rates. And we would not be surprised if 2024 brought more aggressive rate cuts than the market is currently pricing in. However, our model says that if the 10-year yield fell to 3.00% but profits fell 15%, the S&P 500 would have a fair value of just 3,800.

In other words, the Goldilocks future, where the Fed manages everything perfectly, is likely too optimistic. Some stock valuations have become too high in our opinion. More defensive strategies are appropriate at this juncture.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
7-10 / 2:00 pm	Consumer Credit – May	$20.0 Bil	**$21.1 Bil**		$23.0 Bil
7-12 / 7:30 am	CPI – Jun	+0.3%	**+0.3%**		+0.1%
7:30 am	"Core" CPI – Jun	+0.3%	**+0.4%**		+0.4%
7-13 / 7:30 am	Initial Claims – Jul 8	250K	**248K**		248K
7:30 am	PPI – Jun	+0.2%	**+0.1%**		-0.3%
7:30 am	"Core" PPI – Jun	+0.2%	**+0.2%**		+0.2%
7-14 / 7:30 am	Import Prices – Jun	-0.1%	**-0.6%**		-0.6%
7:30 am	Export Prices – Jun	-0.2%	**-0.4%**		-1.9%
9:00 am	U. Mich Consumer Sentiment- Jul	65.5	**64.0**		64.4

Consensus forecasts come from Bloomberg. This report was prepared by First Trust Advisors L. P., and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.