



Cut to the Chase

The S&P 500 closed at an all-time new high this week, hitting 3,386 (on Wednesday), providing investors with almost a 5% total return YTD. For the bulls, the continued melt-up in the popular large-cap index is warranted. Investors have recently enjoyed mostly positive economic reports and data. Over the last week, [retail sales](#) proved resilient, [consumer sentiment](#) improved, [building permits](#) surprised to the upside, [initial unemployment](#) claims remained low, the [Philadelphia Fed Index](#) showed increased activity, and [Index of Leading Economic Indicators](#) hooked up. So is the market signaling an all-clear, despite trading at 19.0x next year's earnings? We reminded our readers last week that at 19.0x, the S&P is not only sitting at the highest valuation level dating back to 2001 but is close to a 2-standard deviation mark (95% out of whack), and well above the long-term average of roughly 15x. While the economic backdrop in the U.S. seems solid to many investors, we feel the rate of change of several economic data series is beginning or has already begun, to inflect. So where is the disconnect?

In our opinion, much of the recent market moves are driven by either: 1) that the Federal Reserve dare not act during a Presidential election year, and/or 2) expectations of further Fed easing to offset any potential near-term economic disruption caused by weakening economic trends or spillover from the Coronavirus. This

was the topic of a recent [CNBC interview](#) with the Federal Reserves, Fed Vice Chairman Richard Clarida, and subsequent [Bloomberg article](#). While the Vice-Chair played down the notion of another Fed cut in the offing, when we revert to our Fed Fund Probability analysis with data provided by the [CME Group](#), **we find that the market is indeed pricing one, if not two additional 25 basis point cuts by year-end.** Based on the table above, we calculate that by July 2020 FOMC meeting, there stands almost a 65% chance that the Fed cuts policy rates (Fed Funds) by 0.25% to 1.50%. And there stands a 54% chance that another cut will take place by the December 2020 meeting. We determine these estimates by taking the cumulative probability below a target rate. This is not as complicated as it sounds. So at the July 29, 2020, meeting we ascribe a 64.6% chance that the prevailing Fed Funds rate will be 1.5% or lower (hence a 25bps cut from the current 1.75% level) by simply adding up the corresponding market-implied probability (yellow shaded area) for each Fed Funds level below 1.75%.

Probability Below 1.75% @ 7/29/2020 : (0.0% + 0.1% 2.9% + 18.3% + 43.3%) = 64.9%

For the December 16, 2020 meeting, we apply the same math, only add the probabilities associated with a Fed-Funds level of 1.25% or lower (pink shaded area). As we suggested in last week's note entitled, "[A Jolt To Complacency](#)" we continue to believe investors remain numbed to recent economic or geopolitical headwinds, believing that any uncertainty or risk will be assuaged by additional central bank intervention (aka [helicopter drop](#)). Hence investors continue to chase market returns in hopes additional rate cuts. **We'd love to hear your thoughts.**

Fed Fund Rate Probabilities

| Meeting Date | Expected Fed Fund Rate Levels @ Meeting Date | | | | | |
|--------------|----------------------------------------------|-------|-------|-------|-------|-------|
| | 0.50% | 0.75% | 1.00% | 1.25% | 1.50% | 1.75% |
| 3/18/20 | | | | 0.0% | 5.5% | 94.5% |
| 4/29/20 | | 0.0% | 0.0% | 1.3% | 26.5% | 72.2% |
| 6/10/20 | 0.0% | 0.0% | 0.4% | 9.2% | 40.9% | 49.5% |
| 7/29/20 | 0.0% | 0.1% | 2.9% | 18.3% | 43.3% | 35.3% |
| 9/16/20 | 0.0% | 1.0% | 7.6% | 25.8% | 40.9% | 24.7% |
| 11/5/20 | 0.2% | 1.8% | 9.9% | 27.8% | 38.9% | 21.5% |
| 12/16/20 | 0.8% | 4.8% | 16.5% | 31.9% | 32.4% | 13.5% |

(a) Weighted Rate (Wgt. Rate) equals the probability weight rate at the time of the meeting.

Source: [CME](#) Group and NEPCG



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