June 30, 2022

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MARKET UPDATE

The hits keep coming.

No easy answers for the Fed.

Equities continue to get hammered (7% down this month!), the Fed hiked rates 75bps (the single largest rate hike in over 25 years!), and headline inflation came in at 8.6% (highest in 40+ years!).

Inflation is being driven by a myriad of factors: COVID policies, monetary policy error, changes in demographics, geopolitical events, etc. The Fed's primary tool to combat inflation, raising interest rates, helps dampen demand as goods bought on credit become more expensive. But that too has undesirable consequences. Lower demand means less revenue for companies to pay their employees, leading to job cuts. At the same time, those companies are seeing their input prices increase, compressing margins and further exasperating the spiral.

We continue to believe there is little chance the Fed can thread the needle and achieve a soft landing.

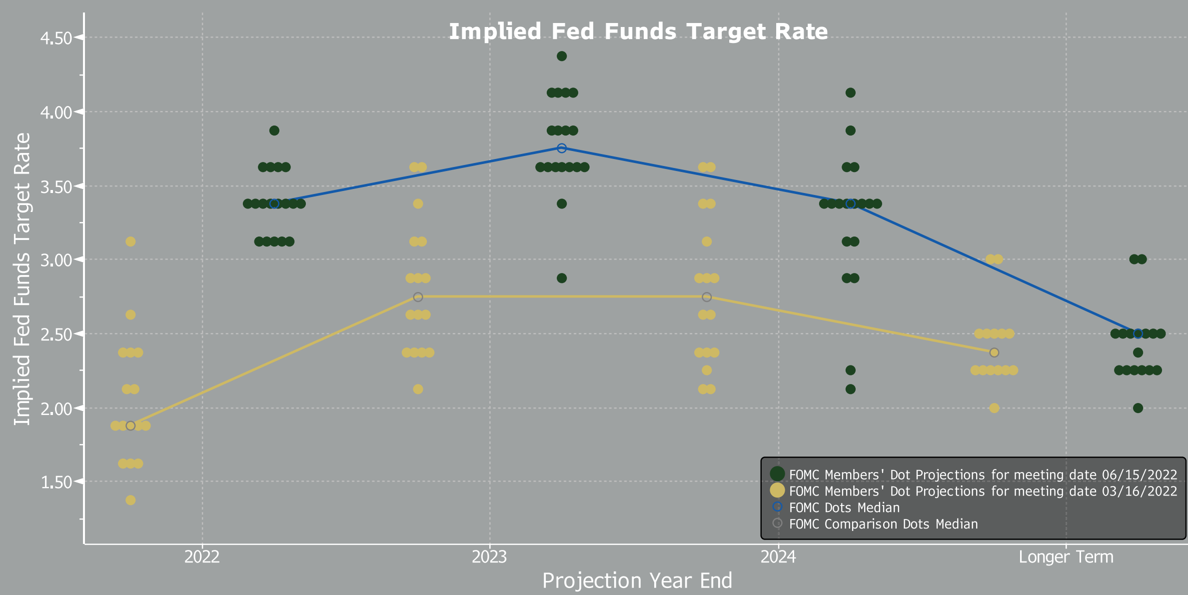
FOMC meeting.

The Fed decided to increase rates 75bps this month, the largest single move since 1994. This was after essentially taking a 75bp hike off the table earlier this month. The surprising 8.6% CPI print and an all-time low University of Michigan Sentiment reading the Friday before the meeting caused them to reconsider. But they were in the self-imposed blackout period (no public communication the week ahead of a Fed meeting) and they prefer to telegraph rate hikes as to not surprise the market. So they turned to the Fed insider at the Wall Street Journal, Nick Timiraos, to 'leak' the message to the market two days before the rate hike announcement. Almost instantly, traders priced in a 75bp increase and cleared the way for the Fed to do what they wanted.

A few highlights from the meeting and Chairman Powell's press conference:

• The Fed is determined to bring inflation down to the 2.0% range, as a stable job market depends on price stability. The FOMC statement included a new sentence that said the Federal Reserve is "strongly committed to returning inflation to its 2% objective;" while simultaneously removing the prior language about expecting "inflation to return to its 2% objective and the labor market to remain strong."

• Based on the updated Summary of Economic Projections, Fed members' median forecast for fed funds is 3.4% for EOY 2022 and 3.75% for EOY 2023. Compared to the committee's March forecast, these estimates are up 1.5% and 1.0%, respectively.



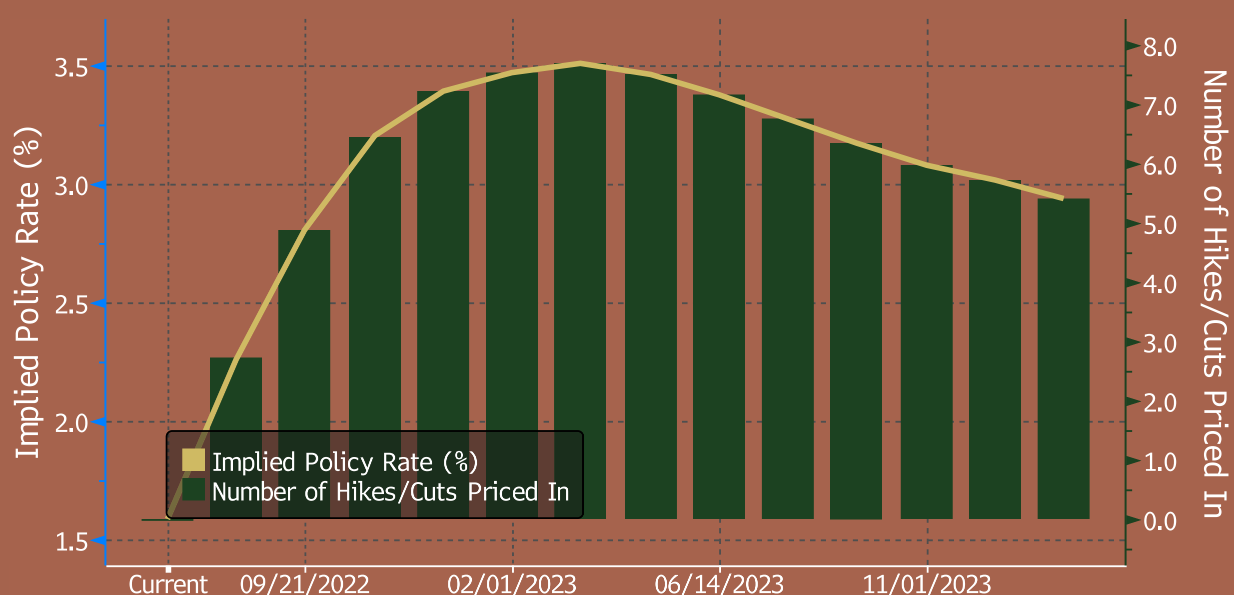
Graph from Bloomberg Finance LP

• Powell says a 3.8% fed fund's rate is "certainly in the range of plausible numbers" for the policy rate to get the job done in terms of taking down inflation. But also noted that many of the inflation pressures are out of the Fed's control: things like the Ukraine war and China lockdowns exacerbating supply chain issues.

• The yield curve steepened after Powell said the next meeting was likely to hike 50bps or 75bps. Before the meeting, the market had almost fully priced in a 75bp hike in July. (He also said the 75bp move was "unusually large" and that such a move won't be common...)

Market Expectations

The futures market is currently pricing in about 1.75% of additional tightening this year, putting fed funds at 3.5% by year-end, largely in line with the Fed's forecast. Interestingly, the market is also pricing in 0.50% of rate cuts in 2023.



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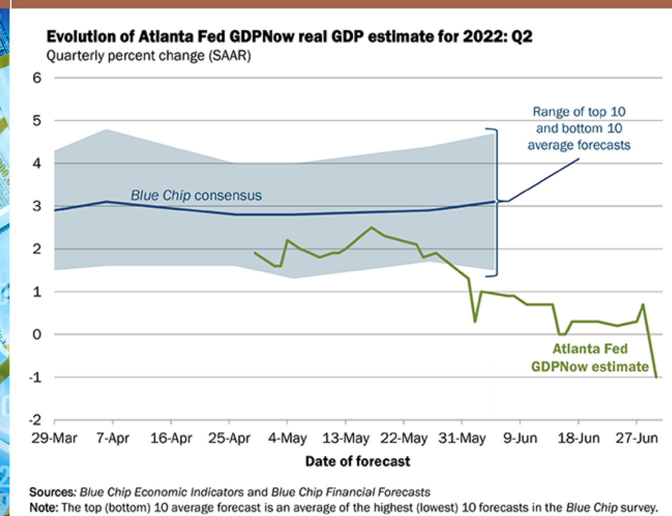
While we believe the Fed will eventually push the economy into a recession, remember that two consecutive quarters of negative GDP doesn't determine if we are in a recession. It is usually the case, as the National Bureau of Economic Research (the group in charge of defining US recessions) defines a recession as "a significant decline in economic activity that is spread across the economy and that lasts more than a few months." That sounds a lot like GDP contracting for about two quarters... But the 2001 recession only had one quarterly GDP contraction...and in the late 1940s GDP contracted for two consecutive quarters without a recession. Those periods are certainly the outliers, as the vast majority of time we've seen two consecutive quarters of negative GDP we also have a recession.

We mention this as the first quarter of this year saw GDP contract by 1.6%, and the Atlanta Fed's GDPNow is currently estimating real GDP to contract another 1.0% in Q2. Are we already in a recession?



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