MARKET UPDATE

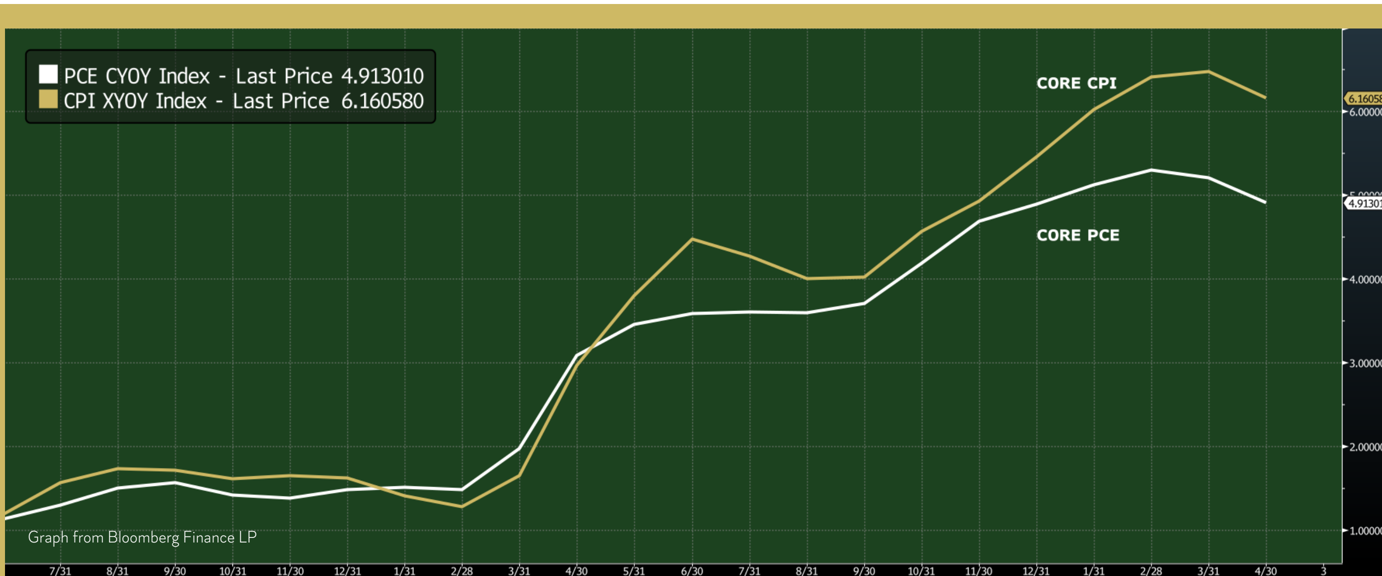
Inflation.
Has it peaked?

May 31, 2022

Too soon to tell.

Rates across the curve moved 10-15bps lower for the month, ending May with the 2T at 2.56% and the 10T at 2.85%. Inflation has moved slightly lower over the past couple of months, with Core PCE at 5.2% for March and 4.9% in April (year-over-year). While we are finally seeing a slight improvement in inflation, we will need further downward movement before confidently claiming we're past "peak inflation."

The futures market is pricing in a faster pace of tightening over the next two years than the Fed, but are also projecting rate cuts to begin in 2024. Based on fed fund futures, traders are forecasting just over 8 hikes this year, putting fed funds at roughly 2.58% in December.



Graph from Bloomberg Finance LP

The second estimate of GDP for Q1 came in at -1.5%, slightly lower than the first estimate of -1.4%. Equity markets have been getting slammed the past couple of months (though they rallied this past week). Europe may already be in a recession, and China's zero covid policy keeps millions of people locked down. Combined with inflation continuing to run hot and a hawkish Fed, the fear in the market is a least somewhat justified. The Fed can hike us into a recession even in a thriving economy; it's that much easier with a slowing one.

The Fed will likely be able to get 50bps hikes in at its June and July meetings, putting the upper bound of fed funds at 2.0%, but how much higher they will be able to push rates moving forward is up for debate. And while Chairman Powell has said the committee will raise rates above neutral if needed, his estimate for the neutral rate is only between 2.0% and 3.0%.

The market and the Fed have come to a consensus.

The market and Fed agree that the central bank has been behind the curve and should have started tightening financial conditions last year.

Bill White, the former chief economist for the BIS, succinctly summarized the issue with the central bank's overconfidence:

They've got the wrong model, the wrong framework, and I've said and written this a number of times. I think they have made what I call a profound ontological error. It's almost a philosophical error that they have misunderstood the nature of the system that they're trying to control and what all of these models are based upon—and not just the Neo-Keynesian models, but the big structural models too—they're based upon the idea that the economy is actually very simple and it's static, essentially. It is understandable because it's simple and static and, therefore, it is controllable. The models have all got that as fundamental assumptions, but there's a problem. And the problem is, it's not true. Because the economy is not simple, it is complex; it is not static, it is adaptive. Everybody's constantly reacting to all the stuff that's going on and changing their behavior.

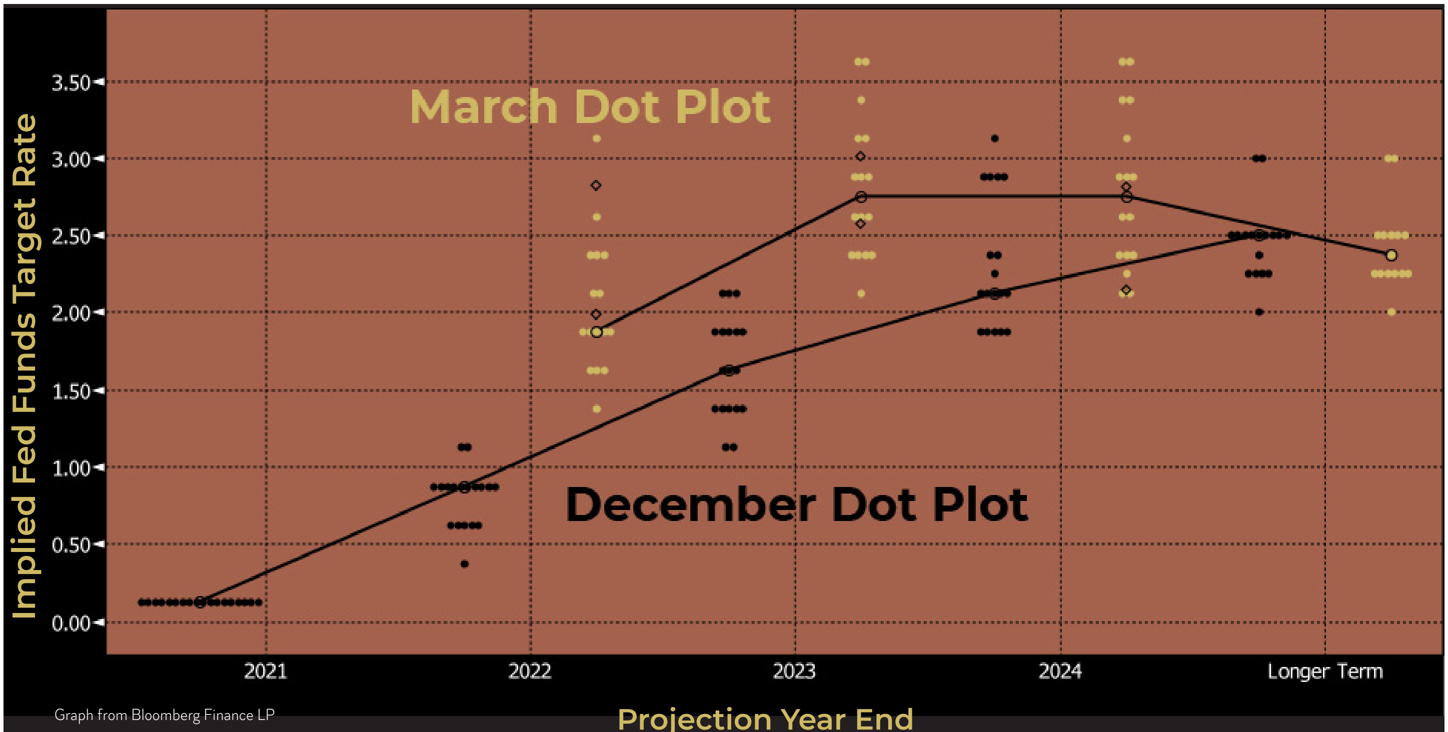
COMMENTARY:
The Psychology of it all.

At Bascom Advisors, we think the long-term and short-term business cycles are as attributable to human psychology as much as anything else. This perspective is not a new idea. Ray Dalio has successfully invested based on debt cycles, which he believes are generally a result of simple human behavior. Our business decisions include recency bias, selection bias, loss aversion, etc. When the economy is cranking, and people are making more and more money, banks become more willing to lend money, increasing the credit in the economy. As long as things go well, people continue to borrow more money as banks become more aggressive and lighten their underwriting standards. Think NINJA loans in 2007 (No Income, No Job, No Assets)...it sounds absurd and an obvious red flag that consumers were overextended, but it was happening. Then something breaks, and sentiment begins to swing in the other direction. Both are self-fulfilling prophecies.

The central bank helps to moderate the large swings in sentiment to which we mere humans fall victim. In a way, the Fed is like a car's cruise control. When the market gets too hot, they slowly apply the brakes (raise rates) to keep things in check. The opposite is true when the economy starts to slow, and they begin to hit the gas (cut rates) to stimulate growth.

The problem with that logic is that the humans who make up central banks are subject to their own biases and beliefs. If it were as simple as applying the Taylor Rule to determine the appropriate monetary policy, we wouldn't have such conflicting forecasts from central bank members.

Consider the Fed's forecast for fed funds ("Dot Plot") from December compared to its latest projections from March. The median 2022 forecast increased by 1.0% in the three months between the meetings, but the range of 'guesses' also widened considerably. One member forecasted fed funds to end 2022 at 1.375%. On the opposite end of the spectrum, another member anticipated fed funds to reach 3.125% over the same period. A difference of seven hikes over the following nine months!



Graph from Bloomberg Finance LP

Howard Marks' Perspective:

To me, the concept of the pendulum is extremely important. Human thinking does not stay centered at what my mother used to call "the happy medium." It usually swings from too much in one direction to too much in the other, from greed to fear, from optimistic to pessimistic, from risk-averse to risk-tolerant, and excessively.

I like to point out that in the real world, things fluctuate between pretty good and not so hot, but in the markets, they tend to go from flawless to hopeless. The swings are overdone. Whenever human thinking and psychology are involved, I think A, the pendulum swings, and B, it usually swings to excess.

Interest rate caps.

In May, the cap cost finally started coming down on both the lower rate environment and volatility settling. While volatility remains elevated from a historical perspective, volatility measures have decreased by about 20% in May. In high volatility environments, reducing the term of cap when possible can significantly impact pricing vs. increasing the cap strike rate.

Have questions about your next cap or anything else in this update? Give us a call at 980.208.1600 or email info@bascomadvisors.com.

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