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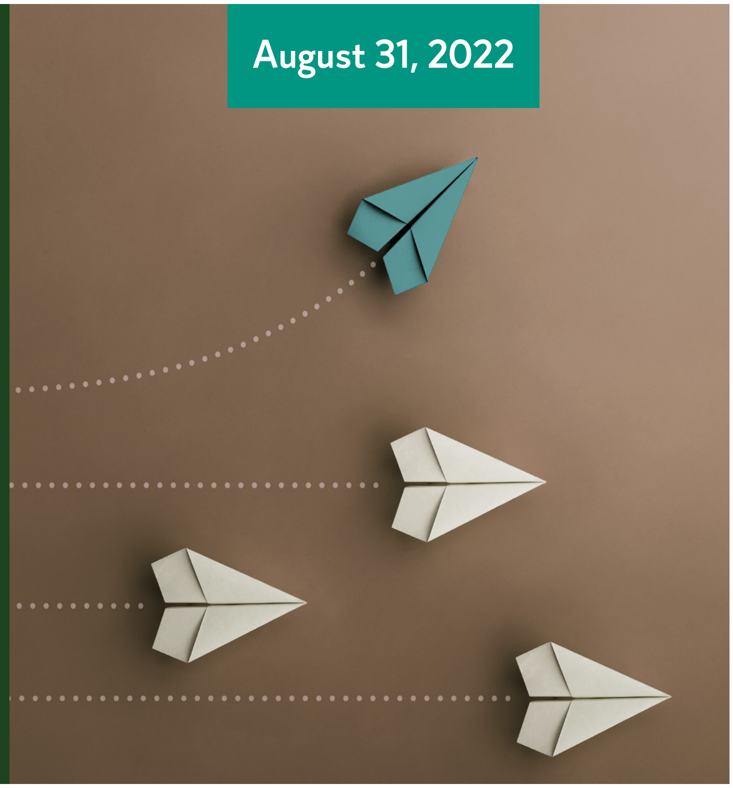
MARKET UPDATE

What Pivot?

August 31, 2022



On the grind.

Rates grinded 50bps+ higher across the curve this month as policymakers from the world's biggest central banks reaffirmed the need for tighter monetary policy to bring down stubbornly inflation. While much of the economic data has come in weaker than expected, with Retail Sales flat and home sales down last month, some of the most significant data came in stronger than anticipated. The jobs report for July pointed to a solid labor market, with nonfarm payrolls increasing by 528,000 and the unemployment rate falling to 3.5%, beating expectations of 250,000 and 3.6%. Consumer confidence also rebounded, advancing to its highest level since May.

Inflation readings improved slightly this month. CPI, PPI (final demand), and PCE all came in below expectations at 8.5%, 9.8%, and 6.3%, respectively, primarily driven by falling energy prices. Though this certainly is an improvement, there is much more wood to chop. And it is unclear if energy prices will continue to decline, as about 2 million barrels per day of Russian crude production stays off the market.

The US inflation prints were followed by inflation data for the eurozone, where headline CPI increased from 8.9% in July to 9.1% in August, supporting the ECB's calls for tighter financial conditions.

Check, please.

With this background, it isn't surprising the Fed is taking a more hawkish stance. Its dual mandate is price stability and maximum employment. Since the jobs market appears solid, the focus is on bringing inflation back down to the 2% range. The consensus is to get inflation in check, the Fed Funds rate needs to be higher, potentially for an extended period of time.

He said. She said.

Chairman Powell essentially said as much at the Jackson Hole symposium, stating a restrictive stance was likely to remain in place "for some time," and "the historical record cautions strongly against prematurely loosening policy." Kansas City Fed President, Esther George, sent a similar signal ahead of the forum, stating, "we have to get interest rates higher to slow down demand and bring inflation back to our target." She also pushed back on the notion the central bank would begin cutting rates next year, saying, "I think we will have to hold – it could be over 4%. I don't think that is out of the question."

Some of the largest investors share the same sentiment. Strategists from PIMCO, Capital Group, and Union Investment agree that markets expecting a rate cut in 2023 are setting themselves up for disappointment.

The path of least recession?

But as we have discussed, will the Fed have the discipline to keep rates elevated while the economy tips into a recession? Markets are still pricing in at least one rate cut next year. We believe the Fed has two paths. **Path #1:** Increase rates aggressively and rapidly to 5%+ to stem inflation. Understanding the economic fallout will be significant but hopefully short-lived. **Path #2:** Increase rates to about 4% and hold the level for a year or two, gradually bringing inflation down to the 2% target range. The second path sounds like it leads to an extended period of stagflation, which nobody wants. The fear is the Fed chooses the second option but does not have the fortitude to hold rates as economic conditions weaken, allowing inflation to pick back up, and thus we repeat the cycle.

Given that it appears the US will have two consecutive quarters of GDP contraction and the yield curve is deeply inverted, all signs point to an upcoming recession. The question is how long and how deep. (See charts below). The Fed will undoubtedly play a role in determining both. The better question may be, do we want the Fed to act in a way that makes the economic pain sharp but for a shorter time? Or do we want to hope half measures are enough to thread the needle?

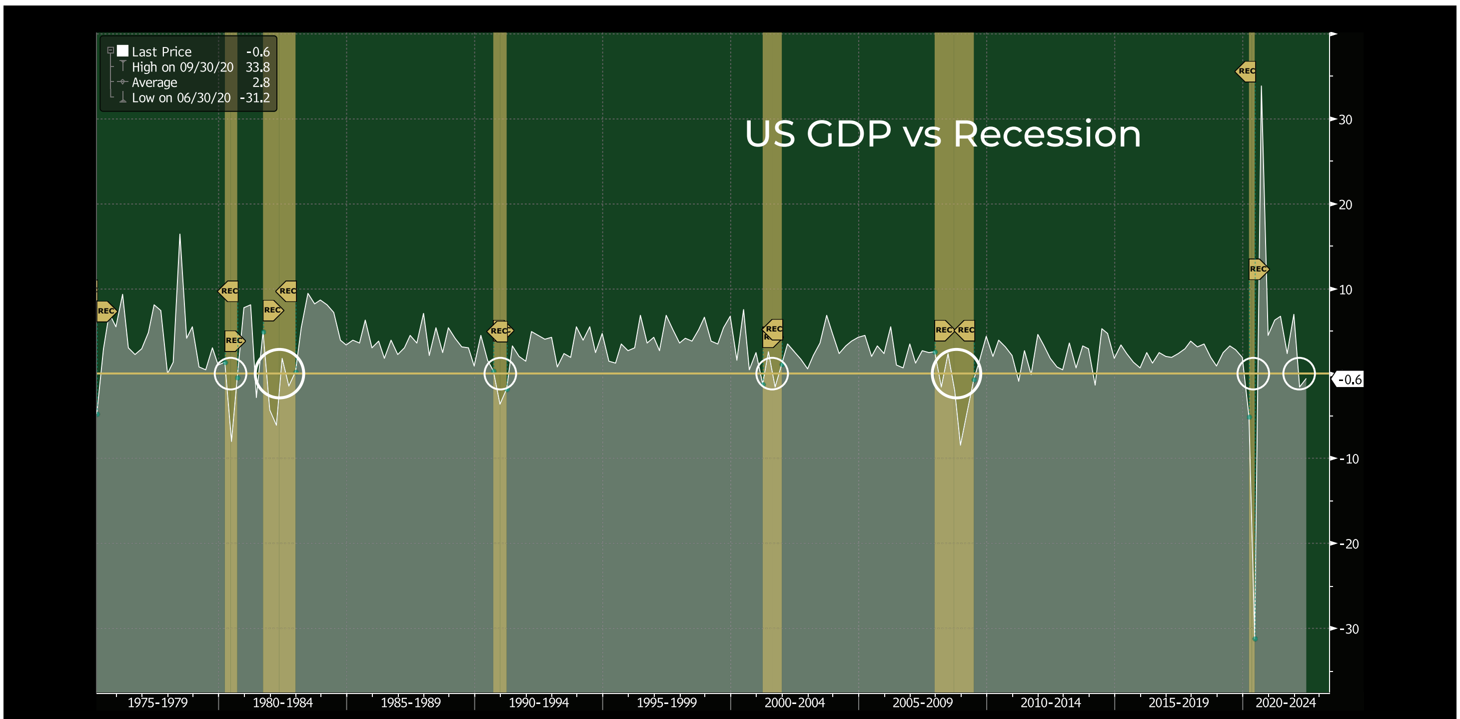


Chart Source: Bloomberg

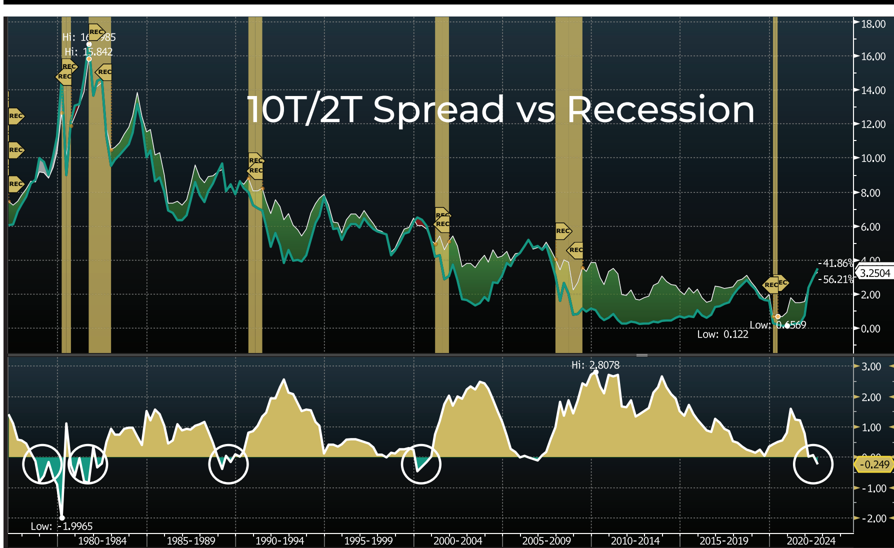


Chart Source: Bloomberg