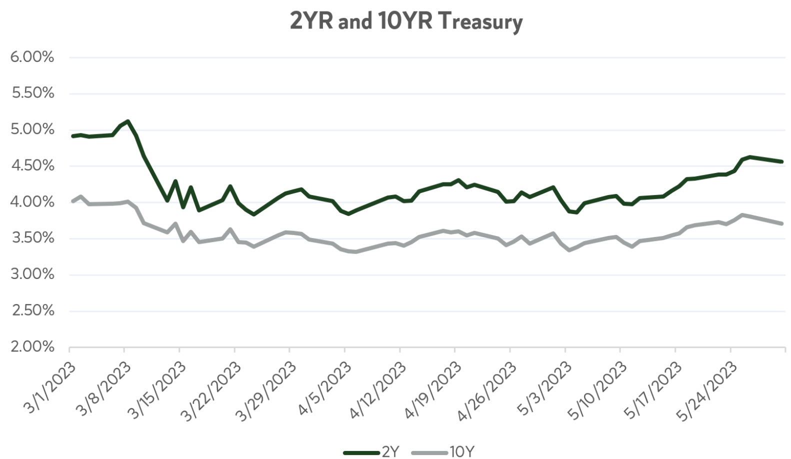
MARKET UPDATE

Are we there yet?

Last month, significant attention was directed towards whether the Federal Reserve (Fed) would pause the ongoing tightening cycle, following the 10th consecutive interest rate hike on May 3rd.

There are compelling arguments supporting a pause in the tightening cycle. Firstly, it takes approximately 8 months or more for the full effects of interest rate hikes to be reflected in monetary conditions. Given that the Fed has implemented a total of 500 basis points of rate increases in the past 15 months, it seems reasonable to take a brief pause and assess the economic data in the coming months. The intention is to avoid over-tightening conditions, which could potentially lead to a severe recession. Taking a cautious approach by monitoring conditions before further action may be considered prudent by the Fed.

On the other hand, despite the aggressive pace of rate hikes during this cycle, core Personal Consumption Expenditures (PCE) inflation has only declined by 70 basis points from its peak of 5.4%. This indicates that inflationary pressures persist, and there is a long way to go before inflation falls to the Fed's 2.0% long run average. Additionally, the labor market continues to exhibit resilience, with monthly nonfarm payroll data consistently surpassing expectations for over 12 months. This suggests that the job market remains robust, further influencing the decision-making process.

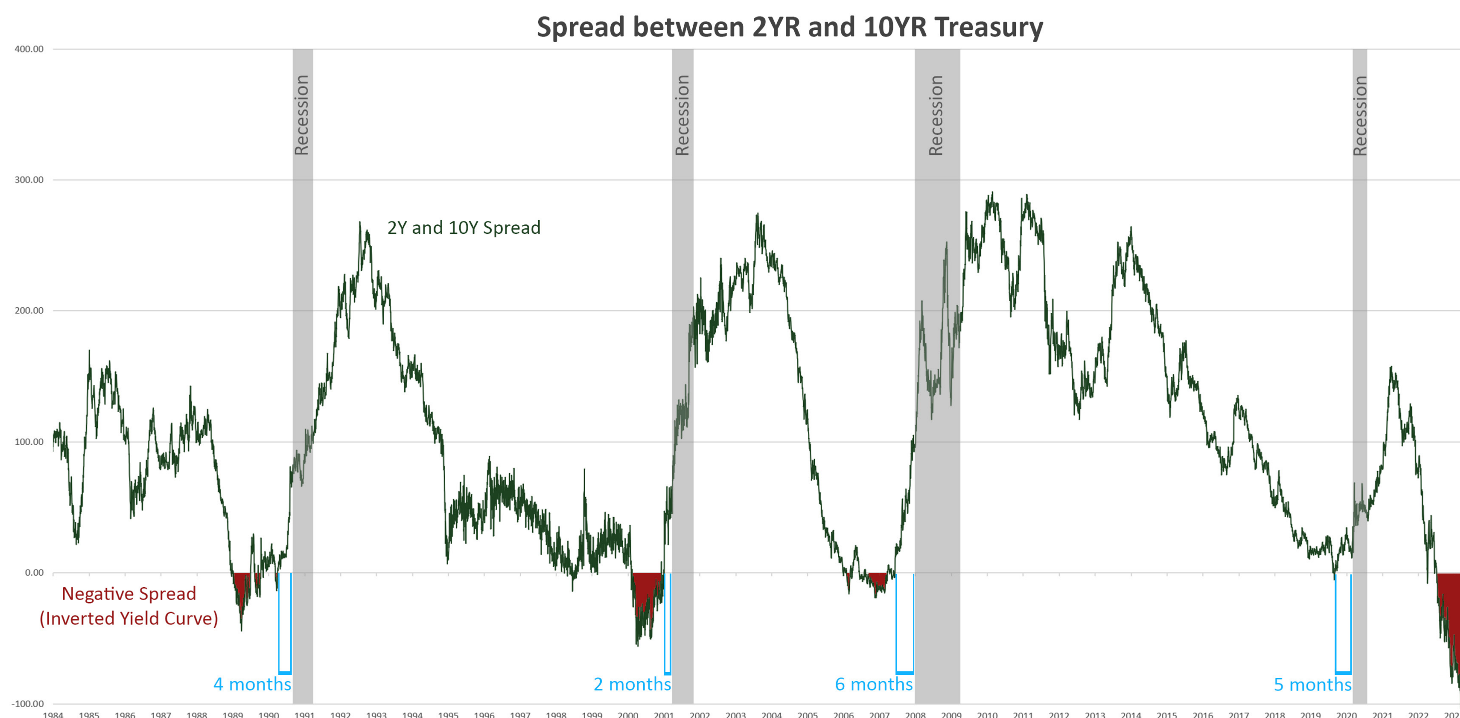


DID YOU KNOW ... over the last 40 years, all 4 recessions began between 2 and 6 months ***after*** an inverted yield curve normalized? (continued)

FLATTENING YIELD CURVE

Economic indicators persistently indicate a high probability of an impending recession, albeit with uncertain timing. One noteworthy indicator worth monitoring is the flattening of the yield curve. Throughout history, this phenomenon has often heralded the arrival of a forthcoming recession. While an inverted yield curve is widely regarded as a robust predictor of a recession, it typically normalizes before the actual onset of the subsequent recession.

Empirical evidence spanning the past four decades reveals that the positive shift in the 10-year and 2-year Treasury (10/2) spread typically occurs approximately four months prior to the commencement of a recession.



The 10/2 spread experienced a notable decline to start the year, reaching a low of -110 basis points in early March. However, recent trends indicate a gradual flattening in the past couple of months. At present, the spread stands at -80 basis points, implying that there is still a considerable distance to cover before transitioning into positive territory. For example if the yield curve were to normalize in four months, it can be inferred that the next recession will occur within a timeframe of six to ten months.

The expected recession could be deep due to concerns of overtightening by the Federal Reserve and other central banks. The focus on lagging indicators like inflation has led to monetary policy decisions that might exacerbate the severity of the recession. However, once the recession is recognized, it is anticipated that central banks will swiftly pivot from tightening to easing measures in an attempt to stimulate the economy.

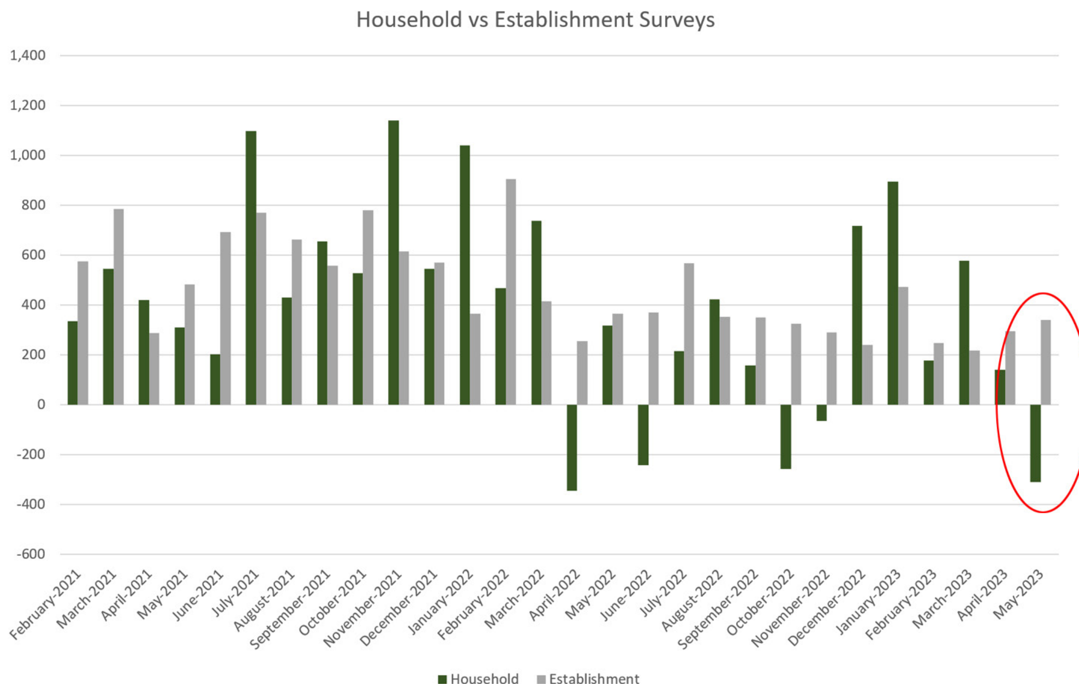
ECONOMIC DATA

Economic data for the month of May presented a mixed outlook, leaving investors in a state of uncertainty as they assess the Federal Reserve's next course of action. Noteworthy highlights from the data are as follows:

- **CPI:** The Consumer Price Index (CPI) increased by 0.4% in April, in line with expectations. On a year-over-year basis, the CPI stood at 4.9%, highlighting elevated inflationary pressures.
- **S&P Global US Manufacturing PMI:** The manufacturing sector expanded slightly in April, with the PMI coming in at 50.2, slightly higher than the survey expectations of 50.4. This indicates modest growth but also suggests some underlying weaknesses.
- **Construction Spending MoM:** Construction spending in March increased by 0.3%, beating the survey expectation of 0.1%. This positive growth indicates ongoing activity in the construction sector.
- **ISM Manufacturing:** The ISM Manufacturing Index for April came in at 47.1, slightly above the survey expectation of 46.8. Although it remained below the 50 threshold, indicating contraction, the index showed some improvement compared to the previous month.
- **JOLTS Job Openings:** The Job Openings and Labor Turnover Survey (JOLTS) showed that job openings in March were 9.59 million, exceeding the survey expectation of 9.74 million. This indicates that there are ample job opportunities available in the US labor market.
- **Unemployment Rate:** The unemployment rate increased from 3.4% in April to 3.7% in May.
- **Nonfarm Payrolls:** In May, the US economy added 339,000 nonfarm jobs, smashing the survey expectation of 195,000.

JOBS REPORT

The May jobs report presents an intriguing mix of data. On one hand, nonfarm payrolls experienced a remarkable surge, expanding by 339k. On the other hand, the unemployment rate rose from 3.4% to 3.7%. At first glance, this may appear perplexing, but a closer examination reveals that the discrepancy stems from the differing methodologies used to calculate these figures.



The nonfarm payrolls metric, derived from the establishment survey, encompasses the total number of jobs added during the month, irrespective of whether they are part-time or full-time positions. This comprehensive approach ensures that all employment additions are accounted for, contributing to the substantial increase observed.

Conversely, the unemployment rate is derived from the household survey, which focuses on individual respondents and their employment status. To avoid double-counting individuals who hold multiple jobs, the household survey only counts multiple jobholders once. Consequently, if an individual secures two new part-time jobs within the surveyed period, nonfarm payrolls would increase by two, while the unemployment rate would remain unaffected.

Therefore, the seemingly contradictory movements in nonfarm payrolls and the unemployment rate can be attributed to the nuances in survey methodologies. While the surge in nonfarm payrolls signifies a significant expansion of job opportunities, the increase in the unemployment rate is likely a result of individuals obtaining additional part-time employment without altering their overall employment status.

RATE EXPECTATIONS

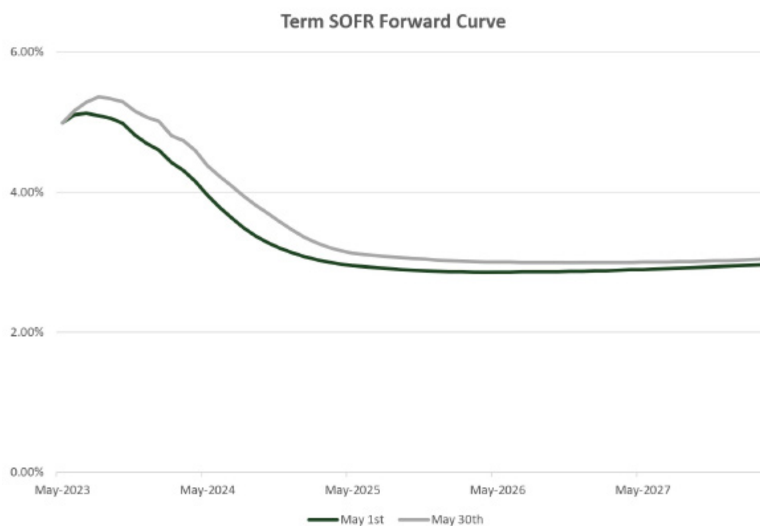
Over the past ~15 months, the Federal Reserve has increased fed funds by 500 basis points. **This marks one of the most aggressive starts to a tightening cycle on record without even considering the added effects of the Fed's quantitative tightening.**

After the last hike on May 3rd, the market anticipated the central bank to pause its tightening cycle. This expectation stemmed from several factors, including the restrictive stance of the current policy and concerns about the potential lagged effects of the tightening measures already implemented. Chairman Powell acknowledged these sentiments during the post-FOMC press conference stating that the Fed had come a long way in policy tightening and that the stance of policy was now considered restrictive.

However, inflation has proven to be sticky and the labor market continues to add jobs, both of which support the case for the Fed to keep tightening conditions.

While the market initially jumped on Powell's hints of a pause, several Fed officials have tried to moderate expectations that the current cycle is over, even if the Fed decides to keep rates unchanged at its June meeting.

"We've been surprised at how high it got, we've been surprised at how persistent it's been. And it's coming down – there is some evidence that it's coming down," Minnesota Fed President Neil Kashkari said. "But so far, it's been pretty darn persistent. That means we're going to keep at it for an extended period of time."



In response, traders are currently pricing in an 83% probability of an additional rate hike at the July meeting, followed by a pause and subsequent rate cuts in the following year. Market expectations indicate six 25 basis point rate cuts priced in for 2024, projecting a decline in the fed funds rate to approximately 3.5% by December 2024.

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