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Investments

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CIO Strategy Bulletin

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The Fed Isn't Satisfied and Markets Aren't Listening

SUMMARY

- The recent rally in financial markets will only compel the Fed to step up its rhetoric and make it more likely to hold peak rates. Though the Fed's next rate hikes are likely to be "only" 25 basis points, the cumulative power of its medicine is still pumping through the economy.
- Policymakers are insufficiently patient with the present decline in inflation. In spite of many data points showing inflation abating, the Fed's focus on a "2%" rate of inflation is narrowing their field of vision. More fiscal restraint in combination with an already slowing economy makes talk of a "soft landing" look far-fetched.
- While we don't expect US employment data to fall until later in the first quarter 2023, we see the recent ISM, retail and housing data as being sufficient to presage a recession that can, for a time, further depress asset prices and weaken credit markets.
- The problem with most future earnings estimates is that they imply 2022's fourth quarter marked the low for profits. This can contribute to a false sense that the economy is out of the woods and it's "all clear" for markets. Indeed, if a recession in corporate profits was already over, we would be far more optimistic about the near-term outlook for equities. Instead, we think analysts will need to cut estimates again later in the year even with "beats" during the quarter just past.
- A recession is on its way. We see signs of it appearing with greater clarity month over month. Thus, we can expect more near term market volatility in the US as well as market corrections to return before anticipating a lasting recovery. We stand ready to position portfolios more positively when we see greater resolution of these contradictory Fed and investor views.

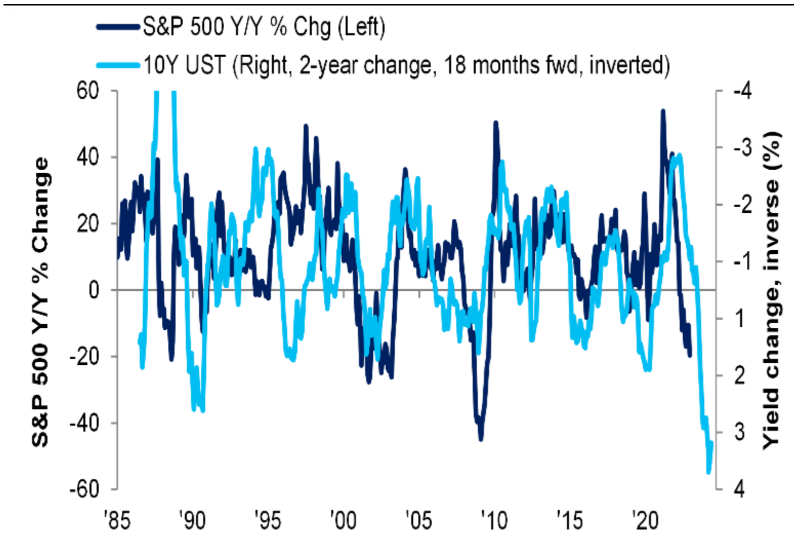
The Fed Will Fight an Inflation War It Has Already Won

In just the past 10 months, the Fed has delivered 450 basis points of rate hikes and reduced its lending to the US bond market by over $450 billion. We doubt that US equity markets fully reflect the forward-looking impact of this monetary tightening on the economy (Figure 1). While inflation is slowing, the Fed continues to believe it must further constrain growth even though many data points suggest the broader economy is trending downwards.

Business confidence and activity measures weakened through the end of 2022, even as pent-up demand remained in the most Covid-impacted sectors (travel, leisure and hospitality). We just recorded two consecutive months of declining industrial production and retail sales – both meaningful recessionary indicators (Figures 2-3). While we don’t expect US employment data to fall until later in the first quarter 2023, we see the recent ISM, retail and housing data as being sufficient to presage a recession that can, for a time, further depress asset prices and weaken credit markets.

Our assessment is that inflation will decelerate and bottom at pre-Covid norms in years to come (Figure 4). While new or worsening supply shocks amid geopolitical conflicts remain the larger exogenous risks, inflation may remain more persistent in a few areas of the US economy.

Figure 1: Change in US 10-year Treasury yield (leading 18 months) vs. S&P 500 Y/Y%



Source: Haver Analytics as of Jan. 18, 2023. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment.

Figure 2: Purchasing managers showed contraction in both manufacturing and services for the first time since Covid hit in 2020

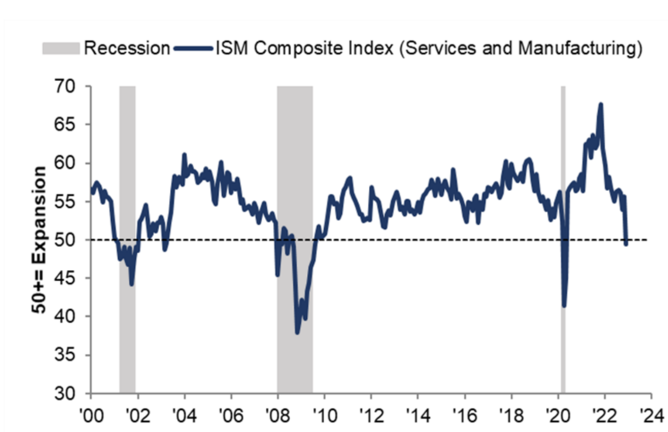
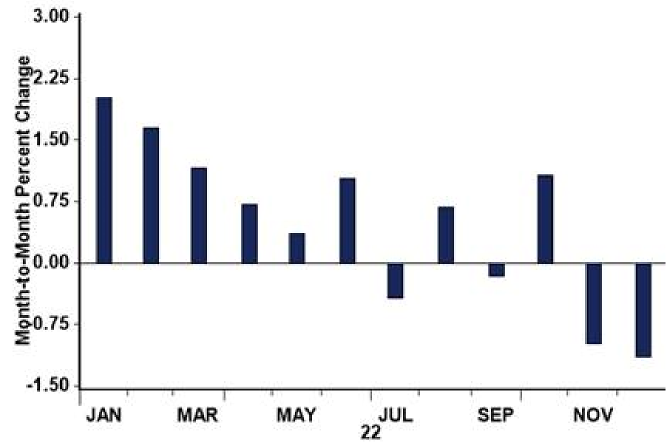


Figure 3: US retail sales month/month % change



Source: Haver Analytics as of Jan. 18, 2023. Note: grey areas are recessions. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment.

Lots of "Fed Meds" Means No Soft Landing

To drive domestic sources of inflation sharply lower, the Fed believes it should persist with restrictive monetary policy. We believe the reduction in US credit supply and demand will drive the first decline in broad money supply since 1948. With rapid reductions in lending to the US bond market (Quantitative Tightening) and the end of Covid-related fiscal stimulus, US broad money supply (M2) declined over the course of 2022 and is poised to contract further in 2023.

And as we discussed two weeks ago (see our CIO Bulletin, 2023's Higher Hurdles), the recent rally in financial markets will only compel the Fed to step up its rhetoric and make it more likely to hold peak rates. In short, this is a lot of medicine for the economy to handle. It makes talk of a soft landing look a bit far-fetched.

Inflation Heading Downward

As Figure 4 shows, the Fed's preferred inflation measure known as "Core PCE Deflator" peaked at a 5.4% pace in 2023 and is now at running at 4.5% year/year. Core PCE likely rose at an annualized pace of just 3.2% in Q4 2022 (December data will be reported on Jan. 27). We think more progress in the inflation fight is likely, even if the Fed left rates as they are. Fed officials know that inflation measures lag movements in the real economy, but have chosen to largely look at backward data to justify further action.

It is becoming clear that Fed policymakers are now more narrowly focusing on getting inflation, however defined, down to their "hard target" of 2%. A slowdown to the 2% pace is most likely to be hit only in 2024 after a drop in US employment. Sadly, the loss of jobs and economic growth will have relatively little impact on inflation. Stimulus and supply disruptions of the past two years were the primary sources of inflation.

Seeing More Evil

Fed Chairman Powell recently noted that shelter price measures will keep rising even as new rental agreements will show lower rents. He also noted how wage gains remain inconsistent with 2% inflation (Figure 5). Other Fed policymakers appear likely to keep warning markets about the need to build up labor market "slack."

It appears clear that the Fed wants a **rise** in unemployment, a clear sign of recession. As we discussed in Outlook 2023 and in prior CIO Bulletins, we believe the housing market downturn and surge in consumer goods inventories will result in US job losses in 2023, including services positions that support the goods sector. Wage gains are already decelerating and the total hours of work fell in the past two months.

Figure 4: US CPI vs. Core PCE Deflator (Fed's preferred inflation measure) Y/Y%

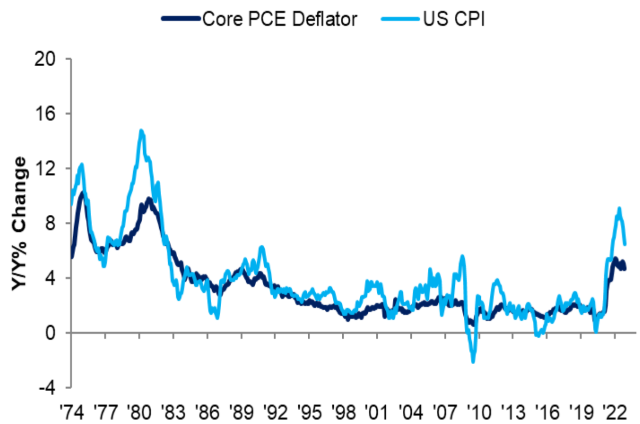
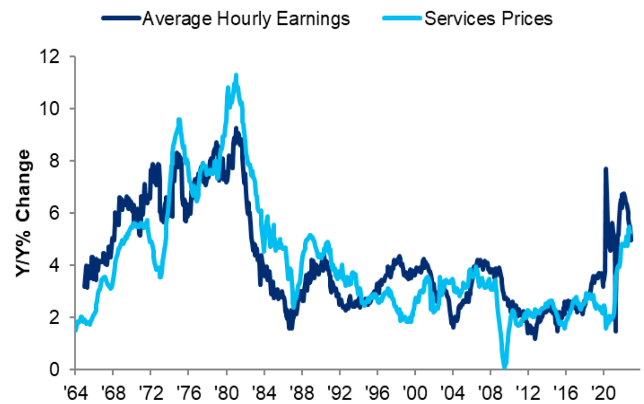


Figure 5: US services prices vs. private average hourly earnings Y/Y%



Source: Haver Analytics as of Jan. 18, 2023.

It's Tougher to See Things Clearly in January

US employment measures in January are particularly difficult to rely on because of significant seasonal adjustments typical at the beginning of every year (Figure 6). That's why we expect a "head fake" in the January employment data likely to demonstrate strong reported job gains. We think the January employment data – which will be released Feb. 3, just after the Fed's next policy meeting – will show gains near 200,000 new positions, a level the Fed will consider unsustainably strong.

Such false positives in the data will revive concerns the Fed will continue its "higher for longer" path. Investors presently relieved by the positive signs pointing to slower inflation ahead may find themselves challenged.

The wild seasonal swing in employment won't end in January. US employers typically hire more than a million workers in February, including numerous seasonal positions. With construction industries and business services under downward pressure, we believe the US employment recovery will end in the months to come.

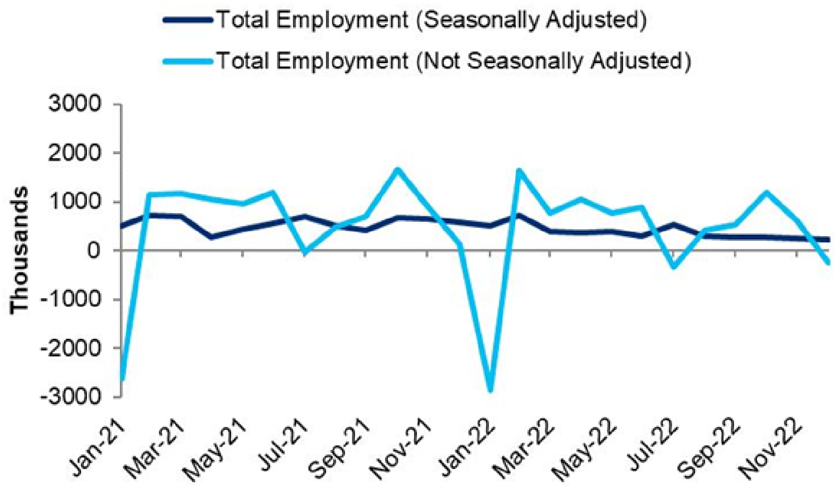
The cumulative impact of negative economic and employment developments will counter the positive views of investors who have felt reassured by decreasing downside risks to the world economy (see the Jan. 15 CIO Bulletin for a discussion of positive news from China, for example).

Analyst Estimates Say the Decline Is All Behind US

With all the signs of slowing growth in the fourth quarter 2022, one might think companies reporting earnings for the period might miss their EPS estimates. Not so. Industry analysts have demonstrated a strong penchant for "lowering the bar" so sharply that the vast majority of firms they cover easily "beat" their revised estimates. It has become routine for nearly 80% of firms to exceed their quarterly earnings estimates. (Assuming no downward bias such estimates would be higher or lower 50% of the time.)

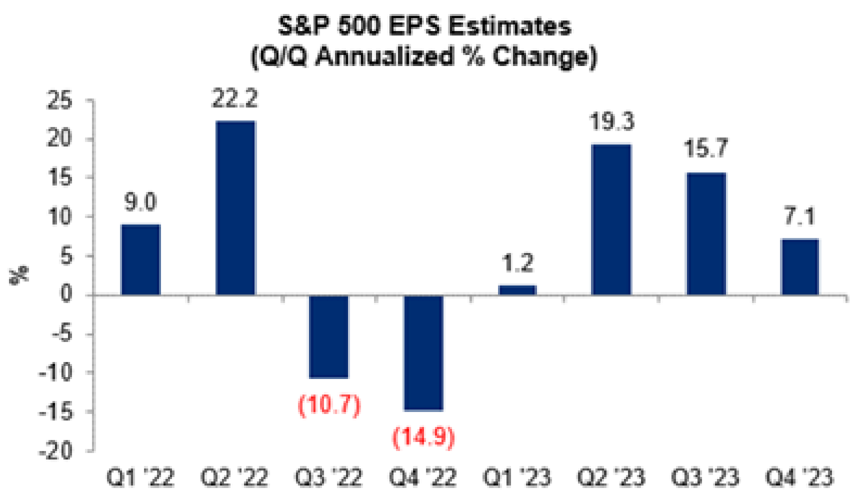
For the fourth quarter of last year, analyst EPS estimates show a nearly 15% annualized rate of decline. The problem with most future earnings estimates is that they imply 2022's fourth quarter marked the low for profits (Figure 7). This can contribute to a false sense that the economy is out of the woods and it's "all clear" for markets. Indeed, if a recession in corporate profits was already over, we would be far more optimistic about the near-term outlook for equities. Instead, we think analysts will need to cut estimates again later in the year even with "beats" during the quarter past.

Figure 6: US employment before and after seasonal adjustment. January usually sees a 2.5M drop for seasonal reasons



Source: Haver Analytics as of Jan. 18, 2023.

Figure 7: S&P 500 EPS and analyst estimates (4Q 2022-2023)



Source: Factset through Jan. 20, 2023. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Past performance is not indicative of future returns. For illustrative purposes only.

Conclusion

The Fed is not repeating the monetary mistakes of the 1970s by accommodating ever-higher inflation. Nonetheless, the medicine it has delivered in 2022 and now in 2023 is potent and long-lived. While the Fed will likely slow the size of future rate hikes to just 25 basis points, it is behaving impatiently claiming that progress on slowing inflation is insufficient. We disagree.

Recent market action could imply that the worst for the economy has passed. Yet, looking just a few weeks ahead, a likely strong employment report for January 2023 may reignite concerns that the Fed will remain aggressive. Short positions in markets at levels above the Great Financial Crisis period create "buying pressure" when bear market rallies gain speed. And with analysts understating earnings estimates to cushion EPS declines likely to come, the current optimism for a soft landing may be short-lived.

A recession is on its way. We see signs of it appearing with greater clarity month over month. Thus, we can expect more market volatility in the US as well as market corrections to return before anticipating a lasting recovery. We stand ready to position portfolios more positively when we see greater resolution of these contradictory Fed and investor views.

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