RockCreek

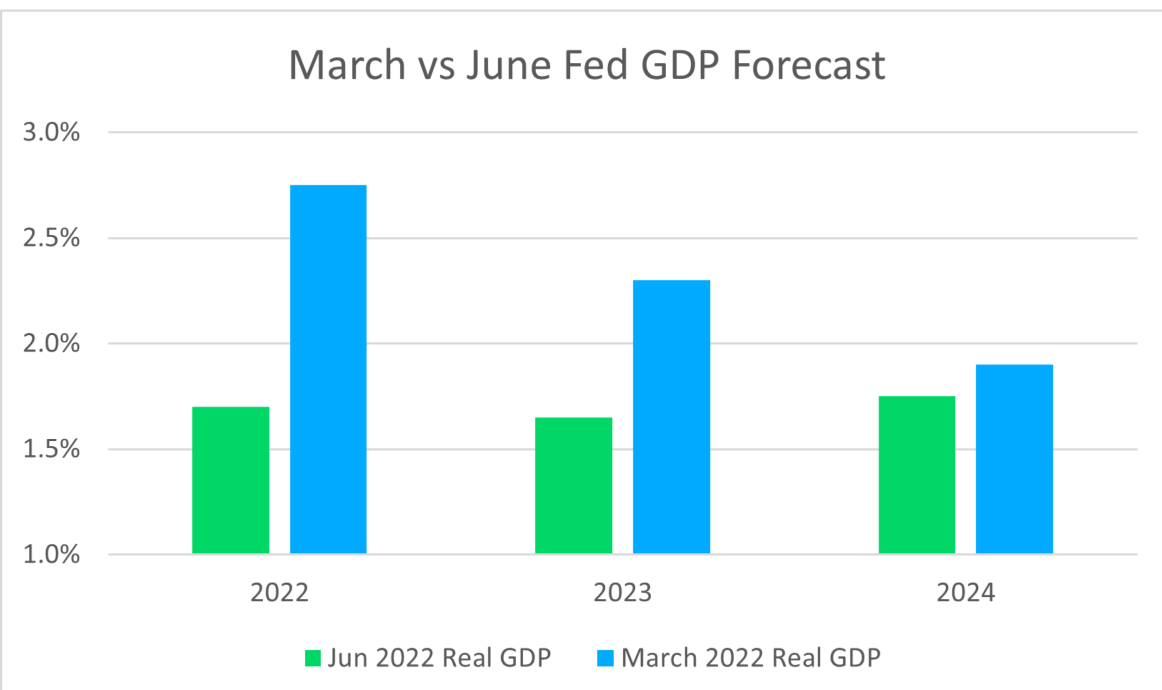
JUNE 17, 2022

KEEP YOUR SEATBELTS FASTENED: THE RIDE'S NOT OVER YET

The Federal Reserve got more serious about inflation before this week, as we noted. But until now, it held out hope of an "immaculate" disinflation – or soft landing – that would bring down inflation without hurting the labor market or the economy.

That was too good to be true. Still, market participants grabbed on to the hope. Bond yields, spreads, and equity valuations mirrored the Fed's own too-benign projections for growth and inflation. In the past week, both the Fed and financial markets have caught up closer to reality, at least as regards 2022.

The trigger was last Friday's dismal consumer price reading for May. That, together with a rise in consumer expectations of inflation, spurred Fed policy makers to reassess their planned – and already signaled – 50 basis point rate rise. Carefully placed suggestions that a 75 basis point rise was coming instead gave the heads up on Monday. Markets duly plunged. They fell sharply again on Thursday, after the reality of the Fed's hawkish shift sank in, and see-sawed Friday, for a dismal weekly performance. Policy interest rates at year-end are now seen by Fed officials as centering on 3.4%, sharply higher than the 1.9% central "dot plot" at end-March.



Source: RockCreek, Bloomberg

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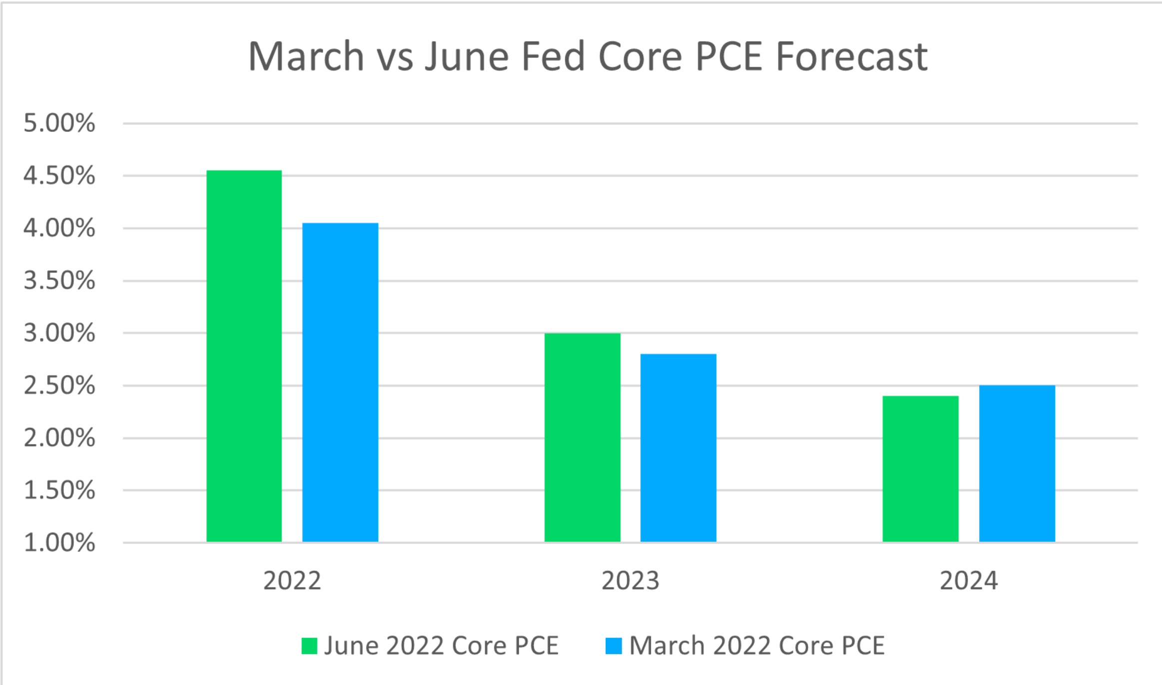
Are markets – and the Fed – still too optimistic? That depends on whether the elusive soft landing that the Fed has been hoping for – a slowdown in inflation that occurs without a sharp rise in unemployment – can be achieved. If not, then valuations built on still growing earnings will crumble in the face of a stalling economy.



Source: RockCreek, Bloomberg

Watching for Cracks

As markets continue to tumble, it would not be surprising to start seeing unusual liquidity or pricing action across different securities. High yield spreads and yields are starting to move toward levels that are increasingly interesting for distressed investors.

There is also a notable shift away from direct origination to secondary market opportunities. Credit fundamentals have not yet deteriorated – default rates are low and are projected to remain low by historical standards, leverage levels remain modest, and maturities and debt service – for now – seem manageable. The key to monitor is how much will rising rates and inflation challenge these fundamentals, particularly for corporates with long only debt structures and very high fixed costs.

Who is going to keep up spending?

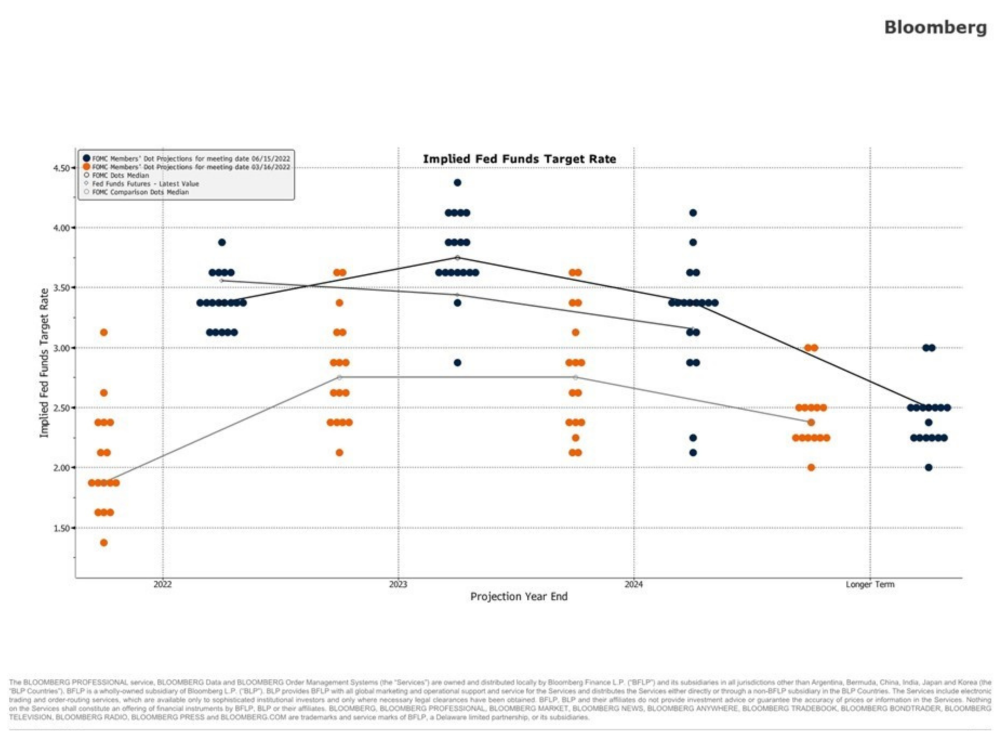
As if rising interest rates were not enough to upset markets, there was also a troubling sign this week that American consumers may be slowing down their spending. The economy's ability to evade recession, even with tighter money, depends mostly on the consumer.

Retail sales figures are not adjusted for inflation. Even so, they showed an unexpected drop between April and May. On the optimistic side, this could reflect a continuing rebalance toward spending on services, as pandemic fears recede. Today's hot labor market is still a source of support. As Fed Chair Jerome Powell noted in his press conference, vacancies outnumber job seekers by 2 to 1, and initial claims for unemployment insurance were little changed this week.

But rising inflation and plunging markets were already weighing on sentiment before the shock of this week. If consumers pull back out of fear of what is to come, their concerns could become self-fulfilling. Perhaps surprisingly, corporate executives continued to be optimistic. Most likely, this week's market debacle has them rethinking.

Of course, the purpose of the Fed's actions is to curb demand. That is what is needed to combat inflation. The tricky part is calibrating how much tightening will turn the tide on inflation, without causing consumers and businesses to draw back so much that the economy tips into recession. The US Administration – including President Biden to Treasury Secretary Yellen – have reassured Americans that recession is not inevitable, pointing to the strong jobs market. They want to keep spirits up. But striking the balance between employment and inflation depends on supply as well as demand – and that is not in the Fed's hands.

Monetary policy mistakes over the past two years owed much to central bankers' insistence on fighting the last war – of low inflation – and their consequent resistance to evidence that they were losing control of inflation on the upside. That error is now being corrected: as Powell recognized this week: low inflation is the "bedrock" of a strong economy. But one of the most crucial, and perhaps understandable, mistakes was simply to underestimate the impact of external factors at a time when the world has been pummeled with surprises, from pandemic to war. Russian ambitions in Ukraine and China's Covid lockdowns already did much this year to push up inflation and curb global production and supply. Chair Powell acknowledged this week that success or failure in achieving a soft landing depends at least as much on these political actors as on decisions by his own central bank and monetary officials around the world.



Monetary mythmakers

This week's central bank actions – and the market reaction – may have put to rest the notion of omniscient, powerful monetary policy makers. At least since Alan Greenspan was nicknamed "the Maestro", it has been common to laud the importance and wisdom of independent central banks. Greenspan – a skilled economic observer and policymaker, whom RockCreek is fortunate to have as an advisor – indeed steered monetary policy well.

With hindsight, however, it looks as if he and others in the post-1970s era of lower inflation were also helped by a benign political and economic environment. Of course, there were serious problems to address – from emerging market debt crises in the 1980s and 1990s to the global financial crisis. But after the decisive attack on inflation from Fed Chair Paul Volcker, other global events – and decisions – worked to keep it in check.

Understanding these factors will be critical to determining the longer term challenges for central banks – and investors. In the short-term, it is safe to bet that inflation will come down, albeit at a cost to jobs and growth. The Fed has signaled its determination. Falling equity and bond prices will not be enough on their own to change its path. Although a crack in the system would give pause, most major financial institutions appear confident that they can survive a downturn.

So for the time being, rates are set to rise. What happens afterwards is less clear.

Some analysts believe that the forces of secular stagnation – aging populations and a glut of savings – will return once inflation cools from present levels. Slower growth and investment in major economies, including in China if recent policies are maintained, would limit demand. In this scenario, interest rates will again drift down and central bankers will again worry about the zero lower bound limit on their power.

There may also be trends that keep inflation – and rates – higher. After China's entry into the global economic system and the end of the Cold War, costs were held down by global competition. Trade barriers came down and capital investment flowed more freely across borders. The shift towards protectionism, partly in reaction to popular unhappiness with shifting patterns of output and diminishing labor power, has grown stronger during Covid pandemic. Essential energy transition holds opportunity. But price pressures as economies are reconfigured are likely to continue.

Europe – fighting inflation, or fragmentation?

The reality of high inflation and the difficulty of monetary policy management is not confined to the US.

Trade-offs and tensions look most troubling in Europe, where central bank officials may be forced to choose between holding the euro together or moving decisively to curb record high inflation. After warning last week that rates would need to rise and asset purchases end soon, European Central Bank (ECB) President Lagarde was forced this week to hold an emergency meeting to calm fears that tightening financial conditions would threaten the cohesion of the euro. The ECB charged its technical staff with resolving the fragmentation fears that sent Italian yields climbing.

What is more important than a technical plan will be the political will to use monetary means and the ECB to support Italy and others with high debt burdens. Germany's unwillingness to do that after the global financial crisis led to the euro crisis and economic mayhem in a number of Euro area countries, before the famous words of former ECB President Mario Draghi.

Lagarde now has the added pressure of Italian premier Draghi watching her moves carefully. Rumor has it that he won agreement from French and German leaders Emmanuel Macron and Olaf Scholtz to press his successor to reassure markets this week. The difficulty: buying bonds from highly indebted Italy, or others, to hold down spreads against German bunds will be hard to square with the ECB's inflation fighting goal, and the prohibition on monetary financing which is at the core of the euro.

The tightening squeeze

The Fed and the ECB were not the only central banks making news last week. Perhaps the most surprising move was the Swiss National Bank's 50 basis point rate hike. Traditional Swiss concerns to avoid encouraging unwanted capital inflows gave way to stronger imperative to avoid the inflationary trouble that is occurring elsewhere in the West.

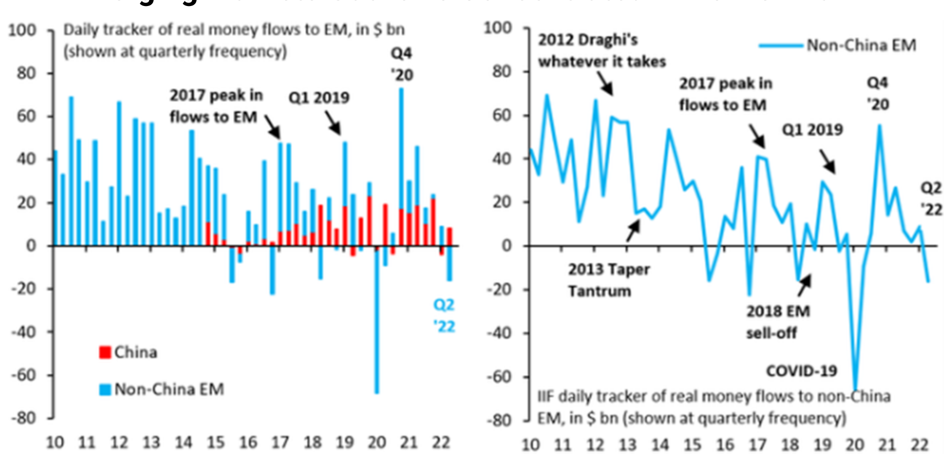
In the UK inflation is already far above target, at 7.8 % in April from a year ago. The May figure, to be released on Wednesday, may top that. But the Bank of England chose to raise rates by only 25 basis points this week. The UK economy is already stumbling, in part as the costs of Brexit feed through. Putting trade barriers in place with the nation's major economic partners was never a good idea for the economy. The Brexit vote, which shocked at the time, was based on disinformation or, at the least, misinformation about costs and benefits. Supporters of the EU failed to take the claims – and the disenchantment of the population – seriously enough to combat these effectively. It may not be politically popular to defend globalization. But it is important to understand and lay out for political debate the costs of moving away from it.

Emerging Markets

It was another roller coaster of a week for emerging markets assets with investors finding little refuge in any country, sector, or style biases. The higher 'Beta' markets of Latin America led losses, as higher US interest rates and a stronger US dollar began to outweigh the benefits of higher commodity prices.

As the differential between US and EM interest rates narrows, we are paying special attention to countries' balance sheets and what they say about their ability to cope with the effects of a stronger greenback and higher financing costs. While many of the larger emerging market economies are in an arguably much stronger position than they were in past cycles of dollar strength, we are in the early innings. Decisions made by policy makers now will influence outcomes later. In the meantime, foreign investors are voting with their feet and exiting emerging markets, but not in China.

Emerging Markets Outflows Concentrated in Non-China EM



Source: Haver, IIF

Despite the ongoing lock-down measures and heated rhetoric around Taiwan, Chinese markets are seeing renewed interest by foreign investors, particularly over the last six weeks. It is, admittedly, a bit of a head scratcher. It's true that valuations are cheap but that's been the case for some time. China is not dealing with an inflation issue, but it is dealing with rapidly declining disposable incomes. The currency is substantially weaker which bodes well for the country's exports, but not if the world economy enters a recession.

The answer may simply lie in a belief that as some of the economic pains affecting China are self-inflicted and the result of misaligned policies, they can just as easily be unwound, and all will go back to normal. This type of policy means reversion trade seems more rooted in hope than reason. While we do see pockets of value in China in sectors aligned with Beijing current priorities, there remains too much uncertainty to justify an unqualified bullish stance.

RockCreek Update

Welcome Interns!

We welcomed our 2022 Summer Analyst and Associate class this week. Selected from a pool of over 4,000 applicants, our 15 interns range from high school to undergraduate, masters, PhD, and MBA students and represent 14 universities. They will work across RockCreek teams over the next few months to support RockCreek's mission to apply data-driven technology to invest sustainably and inclusively.

Since 2003, RockCreek has welcomed more than 400 interns, 75% of whom come from diverse backgrounds. They have gone on to careers in finance, banking, consulting, and technology. Eight former interns have founded companies. And several internship alumni have returned to RockCreek, where they are core members of the team today.

Supporting Women in Finance

We were delighted to host the 100 Women in Finance event, *Marco Outlook & Financial Sector Landscape* at our DC office this week. RockCreek has been proud to partner with 100 Women in Finance, a global network of 20,000 professionals in the finance and alternative investment industries that seeks to empower women through peer engagement, philanthropic work, and educational initiatives. Learn more about their mission here.

Happy Juneteenth!

RockCreek is proud to recognize and celebrate Juneteenth – the day that generations of African Americans have historically celebrated to commemorate the end of slavery in the United States on June 19, 1865. Happy Juneteenth!

Pride Month at RockCreek

On June 22, we will hold a virtual discussion with Jamison Crowell, Executive Director of the DC Area Transmasculine Society (DCATS), a volunteer-run DC-based trans-led non-profit organization that serves to provide resources to transmasculine folks that help overcome the social, economic, and health-related barriers to living authentically.

RockCreek Update

To register for this event click this link:
https://rockcreek-info.zoom.us/webinar/register/WN_aRHgGD_NRcKSs_s17-o-UQ

On **June 29,** we will host an in-person conversation with Morgan Jameson, Executive Director of the **Equality Chamber of Commerce – DC Metro Area** to discuss the Chamber's work to advocate, empower, promote, and facilitate the success of LGBT businesses and their allies. Stay tuned for the link.

With more to come,

Team RockCreek