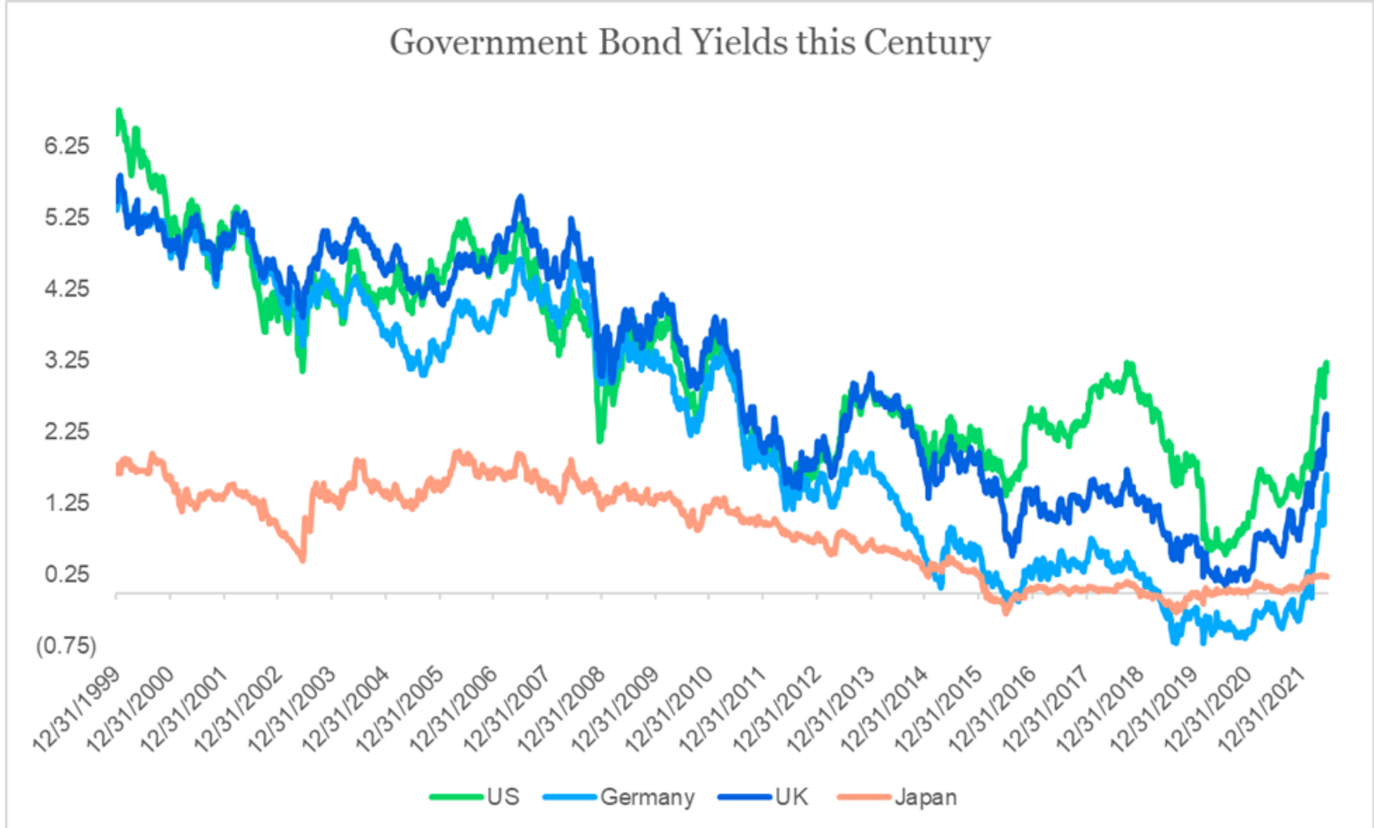
JUNE 24, 2022

UNCONDITIONAL FED

The US central bank is trying to make up for lost time. After delaying monetary tightening for too long, Federal Reserve Chairman Jerome Powell and his colleagues have implemented the steepest interest rate rise in nearly two decades. And on top of last week's 75 basis point jump in the Federal funds rate, this week Powell warned of a possible recession and told Congress that his commitment to reducing inflation is unconditional.

This is a far cry from the dual concern for full employment embodied in Fed statements and policies in 2020 and 2021. Europe is also struggling, with gas rationing threatened in Germany as war drags on in Ukraine, and interest rates are set to rise. No wonder recession talk grew louder this week.

Can leaders of the major G7 nations, gathering outside Munich this weekend, reassure citizens that the global economy and body politic is in good hands?



Source: RockCreek, Bloomberg

Bear Market Bounce?

Global equities began the week on good footing as investors unwound profitable hedges from the prior week, thus helping boost prices. However, this appeared to be another temporary bear market bounce as increasingly dire forecasts of a possible global recession weighed on sentiment.

Up until recently, the energy sector had been insulated from such worries as stocks in the sector were coming off extremely low valuations and the global supply of energy was far short of demand. Since around the 8th of June, the sector has come under increasing pressure, removing one of the few assets investors have been able to turn to for relief this year. Metals and mining stocks have taken another leg down as well due to concerns on the demand side. Weak PMI data spurred hopes of less aggressive Fed action and a late-week rally, but otherwise defensive sectors, such as health care, utilities, and consumer staples have been the market leaders as investors opt for safe havens.

Despite Friday's rally, there remains widespread reluctance to take on risk and part of the reason is recognition of the sell-side's rosy outlook for corporate earnings. The Street has yet to start revising future forecasts lower. This seems odd with inflation eating into consumers' and businesses' purchasing power. We see no way to square current profit margin and earnings expectations with even a modest recession. With that in mind, we also find it difficult to see a sustained equity rally in the near-term absent the Fed drastically changing course or after we've made it through a turbulent round of earnings revisions.

Bumpy ride

The economic debate has shifted from whether – and by how much – the US economy will slow down this year to whether – and for how long – it will move into recession. Consumer confidence is being hurt by the reality of price increases, notably gasoline, but also by fear of a coming recession.

Already, mortgage rates – a key channel for dampening demand and, therefore, inflation – have shot up more sharply in the last 3 quarters than at any time since the early 1980s. This rise will take time to feed through to housing prices, but it is already putting a damper on mortgage applications and may encourage homeowners to put moving and expansion plans on hold. Commercial real estate is also under threat from the slow and reluctant return to work.

Unfortunately, there are more interest rate rises to come – more than the market is currently pricing in – if the Fed is to pursue an "unconditional" inflation fight to return to its 2% target. Today's data – high inflation and a still-tight labor market – show that financial conditions are still easy in relation to the strength of the economy and inflation. Real interest rates, even those high mortgage rates, are negative when compared to recent inflation numbers.

That is not compatible with fast inflation reduction. President Joe Biden and Treasury Secretary Janet Yellen are right that it is still possible to avoid a US recession, in the technical definition of two consecutive quarters of contraction, or negative growth. But some rise in unemployment and slowdown in growth – what used to be called a growth recession – is inevitable. As Bloomberg commentator John Authers has said, that would still feel unpleasant.

As this is becoming clear, political opposition to the Fed's course is beginning. Democrats in Congress are realizing that as much as they and their constituents hate inflation, they also dislike the economic consequences of an old-fashioned fight to bring it down. They are wrong to oppose monetary tightening: it is needed for the price stability that underpins long run growth and employment.

But they are right to be critical. As Chair Powell has acknowledged, tightening sooner would have been better. Experience suggests that once inflation expectations become embedded in the expectations of consumers, wage earners, and firms, it is hard to wring them out. The costs in terms of lost jobs and output of bringing down inflation may, therefore, exceed those of a slower growth path that would have kept a better lid on price increases.

Few are as gloomy as former Treasury Secretary Lawrence Summers. After correctly predicting the inflation surge of the past year, he is now predicting a sharp and persistent rise in unemployment from today's levels, arguing, "We need five years of unemployment above 5% to contain inflation — in other words, we need two years of 7.5% unemployment, or five years of 6% unemployment, or one year of 10% unemployment."

Avoiding such a costly return to price stability will require both skill and luck, as Secretary Yellen also said. Bad luck has certainly come in spades – with the supply hit from pandemic lockdowns worsened by Russia's extraordinary invasion of Ukraine, and the economic consequences. The war, as we have noted, is likely to drag on, holding up both food and energy prices (see below).

How about skill? Perhaps the most troubling aspect of the monetary policy mistakes was their persistence. Fed policymakers stayed with over-optimistic and, in some ways, contradictory forecasts in the face of growing doubts from observers and mounting evidence from data that inflation was getting out of control.

That suggests that Fed policy makers and the Fed staff – with its many economists – were reluctant to rethink their stance and question their assumptions, despite the unprecedented circumstances of the past two years. Traditional models and earlier experiences are less reliable guides for policymakers.

It was not surprising that supply disruptions were initially blamed for inflation. A new paper from the Federal Reserve Bank of San Francisco shows that headline inflation has been mostly driven by supply constraints. But it concludes that the core inflation the Fed monitors, which matters for the future, mostly reflects demand pressures. With today's uncertainties – both known and unknown unknowns – it is particularly critical to retain an open mind and, as Chair Powell himself said, be nimble.

Chair Powell may take heart from recent comments from two seasoned former colleagues. Former Fed Chair Ben Bernanke said that it was wrong to see today's environment as a return to the stagflation of the 1970s. And former Vice Chair Donald Kohn gave the Fed "Two Cheers "for admitting and correcting its earlier mistake in underestimating inflation.

The ECB has a single formal goal, but an existential issue

Energy troubles are making the ECB's job harder than ever. President Lagarde needs to channel the deft touch of her predecessor Mario Draghi if she is to manage the political, legal, and financial challenges of tightening money to fight inflation while containing "fragmentation" as spreads of Italian – and Greek – bonds rise over German bunds.

Conceptually, the way to do that would be to direct bond purchases at the high spread countries while raising interest rates for the euro area. But this comes perilously close to the monetary financing forbidden under the Euro rules and hated in Germany in particular.

Japan versus the rest – a matter of time?

Japan's central bank has stood firm against market pressure to let longer-term rates rise. That's not so surprising. Inflation has been below target for much longer in Japan than elsewhere, with a debilitating impact on the economy that Governor Haruhiko Kuroda has been trying to overcome throughout his 9-year tenure.

Kuroda will hold to "yield curve control" for at least a little while longer. This is pushing down the yen's value. But that is another mechanism that will push inflation up to target. Kuroda should, nevertheless, keep an eye on how quickly inflation escaped control, even in price conscious Europe.

High oil and gas prices hurt; do they also help?

Talk about policy conflicts.

As President Biden calls for cuts in the federal gas tax and asks energy companies to boost oil and gas production and refining, he also recognizes the need for an energy transition to combat climate change.

This policy tightrope is driven by the global energy crisis – exacerbated by Russia's invasion of Ukraine – that is shaping global energy investment.

The latest IEA World Energy Investment report found that global energy investment is set to increase by 8% amid the energy crisis; however, almost half of the increase in capital spending is linked to higher costs, rather than bringing savings or additional energy supply capacity.

It's no mystery why Biden, and leaders around the world, are desperate to alleviate energy burdens. The total energy bill paid by the world's consumers is likely to top $10 trillion for the first time this year, hitting the poorest parts of societies the hardest. Politically, global leaders have a built-in villain: net income for the world's oil and gas producers is set to double this year to an unprecedented $4 trillion. Practically, the outlook is much murkier.

The energy crisis is also helping drive the sustainable transition. Clean energy investment grew by only 2%-per-year in the half decade after the Paris Agreement, but since 2020, the pace of growth has accelerated to 12%-per-year. "Spending on solar PV, batteries and electric vehicles is now growing at rates consistent with reaching global net zero emissions by 2050," the IEA report found.

But even this good news, like so much else, is hampered by inflation. Following years of declines, the costs of solar panels and wind turbines have risen by between 10% and 20% since 2020. Will concerns about cost inflation cause companies to pump the brakes on renewable energy spending?

Emerging Markets

A renewed lockdown in China's fourth largest metropolis, Shenzhen, was not enough to derail Chinese markets' recent good fortune. Both the Hang Seng and CSI 300 indices were positive for a sixth consecutive week. There is some expectation that third and fourth quarter earnings will surprise to the upside as the government sponsored stimulus measures make their way through the economy. Both active and passive flows have been positive of late, suggesting both a valuation and momentum trade in the works.

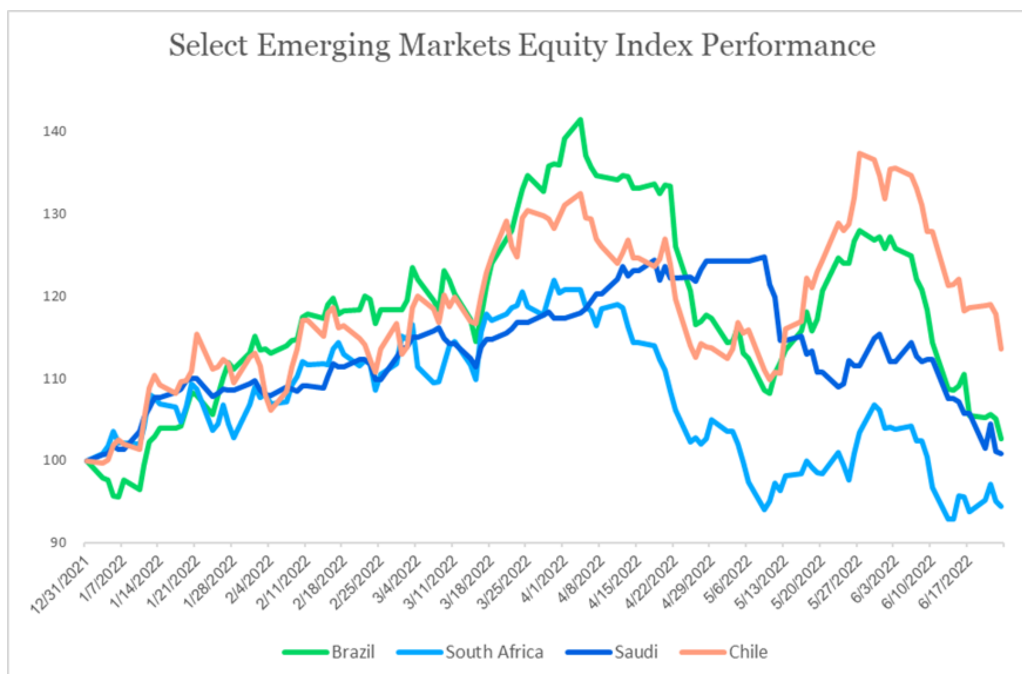
We remain cautiously positioned, given the possibility of a global recession and a domestic consumer beaten down by years long lockdowns and lower disposable incomes. Indeed, consumer confidence levels in China are at record lows and the country's gross savings rate has been inching up despite unattractive yields.

China Consumer Confidence Index

Source: Trading Economics, National Bureau of Statistics of China

Outside China, emerging markets continued to face headwinds tied to inflation, weakening currencies, and higher interest rates. A sobering reminder of how quickly fortunes can change, many of the markets that benefited from higher commodity prices and very positive terms of trade earlier this year, have largely given back gains.

Commodity Centric Markets Have Largely Given Back Gains



Source: RockCreek, Bloomberg

The failure of central banks to bring inflation under control coupled with crippling high interest rates are the Achilles heel of positive terms of trade. Recent election results in Colombia and upcoming elections and referendums in Brazil and Chile have added to a sense of lingering uncertainty over macroeconomic policy frameworks. While corporate balance sheets are largely unlevered, companies are finding it difficult to raise capital given double digit interest rates. Capex levels are therefore expected to come down precipitously, limiting growth rates. Regional or country specific recessions may be the only real antidote to current inflation levels, but much will depend on developments in the US.

RockCreek Update

War Ramifications in EM

Alberto Fassinotti moderated a discussion hosted by the Pacific Pension & Investment Institute (PPI) on how the war in Ukraine has affected emerging markets. Watch the video here.

Pride Month at RockCreek

We held a virtual discussion with Jamison Crowell, Executive Director of DCATS, the DC Area Transmasculine Society, 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. Stay tuned for a video of the conversation.

On June 29th, we will host a 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. Please register here and tune in.

With more to come,

Team RockCreek