JULY 29, 2022

SUMMER WHIPSAW

This week brought a lot of news – but not a lot of clarity about the biggest question facing the US and global economy: how weak does the economy need to be in order to bring inflation back under control? The Federal Reserve has another two months of price and jobs data before it makes its next move in late September. Just as well, given today's economic uncertainties.

Thursday's news that US GDP declined again in Q2 was widely predicted. But whether this meant that we are already in recession depended on who you listened to. The Administration, and Federal Reserve Chair Powell, pointed to other indicators – most notably employment – that still showed signs of a strong economy last quarter. The reported Q2 contraction of 0.9% was also less bad than Q1's 1.6% decline, although consumption data were weak: so, are things getting better or worse? Friday's inflation numbers also left uncertainty about what is to come. Disappointingly, they showed that June PCE or personal consumption expenditure – the Federal Reserve's preferred inflation measure – accelerated again. Headline and core inflation registered 6.8% and 4.8%, respectively. The widely used CPI, or consumer price index, that came out earlier this month also showed inflation up in June, by 9.1% from a year earlier. Will there be any improvement for July and August? Lower gas prices should help, but wages will be key.

And as for the likely path for interest rates, analysts couldn't agree on whether the Fed's message this week, when it raised the Fed Funds rate another 75 basis points and abandoned forward guidance, was hawkish or dovish.

In the end, markets rallied, helping the S&P 500 to notch up a rise of over 9% in July. After the dismal performance in the first half of 2022, when equities declined by 16%, at least Q3 began on a better note for investors. It may not last. After all, the two key indicators that came out after the Fed meeting – GDP and prices – were both disappointing.

Source: RockCreek, Bloomberg

The economy is changing - just the way that you would expect

Tightening financial conditions are showing up. The economy may or may not have been in a formal recession in the first half of 2022. With payrolls increasing by more than one million in Q2 and unemployment still only 3.6% in June, the Administration's argument against, as laid out by the President's Council of Economic Advisers (CEA), has something going for it. But there can be little doubt that we are in the midst of a slowdown. Soon enough, that will weaken the labor market. It is already hurting consumer and business confidence. The channels through which monetary tightening operates most directly are housing and business fixed investment – and to a lesser extent, the stronger dollar. The data show weakness in all these areas. House prices have not yet fallen, but activity is being curtailed with new and existing home sales well off their highs. The GDP numbers show sluggish investment in Q2. The hope for investors and others: employment costs moderate quickly even as underlying strength in the labor market keeps consumers spending. Friday's news on employment costs was concerning. The Employment Cost Index rose 1.3% in the second quarter, marking the fourth consecutive quarter where compensation rose 1% or more. The average quarterly increase was approximately 0.7% between 1996 and the end of 2019. The strong dollar should help to moderate inflation pressures. But, as noted in our Q2 letter, it also hurts companies' dollar earnings from overseas. and. As Powell admitted, the path forward is difficult.

What are central banks signaling?

Perhaps the most surprising outcome of this week's Fed policy meeting was that there was little surprise. This contrasted with the drama surrounding the previous meeting, when bad inflation numbers for May pushed the central bank into a last moment shift to raise rates by 75 bps instead of 50.

This month, the 75 bp move was expected. And although there had been another disappointing inflation release since the monetary policy makers last met, Chair Powell did not want to change the economic message. During the press conference, he repeatedly pointed back to the summary of economic projections released six weeks earlier as the best indication of where Fed policymakers stand today. Powell accurately characterized the two consecutive 75 bp moves as "aggressive" – this year's tightening is already the steepest since the 1980's. But he left room for another rate increase of that size in September – or a smaller one.

Some analysts saw this as a message that the monetary screws on the economy will continue to tighten sharply. Others, that the Fed may shift to a slower pace in September, after two more months of data on jobs and inflation. The bottom line: no one, not even the policy makers themselves, knows yet. One interesting clue to the Chair's thinking: he mentioned that rates are now neutral, which has prompted much discussion among economists.

Forget Forward Guidance

One thing that is clear: forward guidance is gone. Last week, the ECB and now the Fed have formally put aside the tool deemed so useful when inflation was low and central banks feared the zero lower bound made rate cuts impossible or ineffective. In another sign of the Rorschach world we live in – the ECB move was widely viewed as hawkish, while the Fed's was dovish.

In Europe, Christine Lagarde is playing a difficult hand. She agreed to tighten into what definitely looks like a recession with last week's 50 bp rate rise. And the ending of forward guidance makes a softening message more difficult. In exchange, Lagarde won support from Germany and other Northern European countries for the new "anti-fragmentation" tool, TPI, that is aimed at limiting the rise in spreads as markets grow nervous about what tighter financial conditions will mean for Italy and other weaker economies in Europe. The fall of Prime Minister Draghi's government has only increased the uncertainty around Italy's reform agenda, and this will complicate Brussels' plans to release badly needed EU Recovery funds. With European gas prices shooting up again this week, and restrictions on supply – the city of Hanover this week had the unenviable honor of passing Germany's first restrictions on the use of hot water in public buildings – pressures on inflation and growth will continue.

For the Fed, abandoning forward guidance may give more scope to slow the rapid tightening now underway if the labor market weakens unexpectedly. But doubters of the Fed's inflation fighting resolve should note: Powell this week stressed again the Fed's focus on inflation. In his press conference remarks, the Chair pointed to the importance of price stability as a "bedrock" for the economy – and reaffirmed that price stability means 2% inflation. Both the Fed and the ECB are switching from quantitative easing to selling down securities. These sales will also feed through to tighten financial conditions. But judging the impact of quantitative tightening remains tricky: nothing of this magnitude has been tried before.

In today's uncertain –and rapidly changing – global environment, it makes sense to be flexible. The Fed might have moved more quickly to raise rates in response to unexpectedly persistent inflation if it had relied more on signals from current data and less on sticking to a longer-term view.

There is nevertheless a danger in a shift to greater "data dependence". As we know, monetary policy works with a lag – and data tends to get revised. Shifting policy too quickly in response to a striking set of numbers could leave central banks confusing markets and investors rather than clarifying their goals and reaction functions.

Global weakness, almost global inflation

Adding to global gloom, the International Monetary Fund (IMF) put out a new forecast this week that shaved nearly 1 ½ percentage points off its April projection for US growth in 2022 and just over 1 percentage point for China. The reasons for gloom are very different: tight monetary policy in the US and zero Covid policy in China. Growth downgrades of this magnitude for the two biggest economies in the world are unusual. Moreover, risks are to the downside, according to the IMF. As we pointed out in our Q2 note, the biggest risks come from non-economic quarters: the war in Europe and the progression of the pandemic. The two factors that have injected such uncertainty into the global economy this year.

The IMF now sees US GDP growth at 2.3% this year, falling to 1% in 2023. China is still projected to grow more rapidly than advanced economies, at 3.3% this year and 4.6 % in 2023. But this is far below China's official target, nevermind its historic growth record. The leadership seems now to accept that growth will fall short of the official 5.5 % target. The quarterly Politburo statement on the economy released on Thursday suggested that there would be no dramatic policy shift to boost growth. While the meeting emphasized the need to stabilize the property market and underscored the importance that local governments can play in easing restrictions on home purchases and settling disputes, it did not announce a major top-down policy package. While property sales may stabilize gradually in Q3 and Q4, the risks are skewed to the downside. The woes of the property sector, which began last year with Evergrande, may very well be with us for some time.

The growth slowdown is global. Inflation is widespread – with the EU again notching a record 8.9% for headline inflation last month – but not universal. As 75 central banks around the world are tightening policy, China's central bank is easing. China's central bank is now in the position of the Fed and other advanced economies in the pre-pandemic years: lowering interest rates – to below 1% – but with little success in boosting demand, or inflation.

Start of Earnings Season

The S&P 500 recorded its second straight weekly win, with now four out of the last six weeks positive for US equities. We are now a bit more than halfway through reporting season with approximately 280 companies reporting. This season has certainly been a mixed bag of results, with some surprises sprinkled in across sectors.

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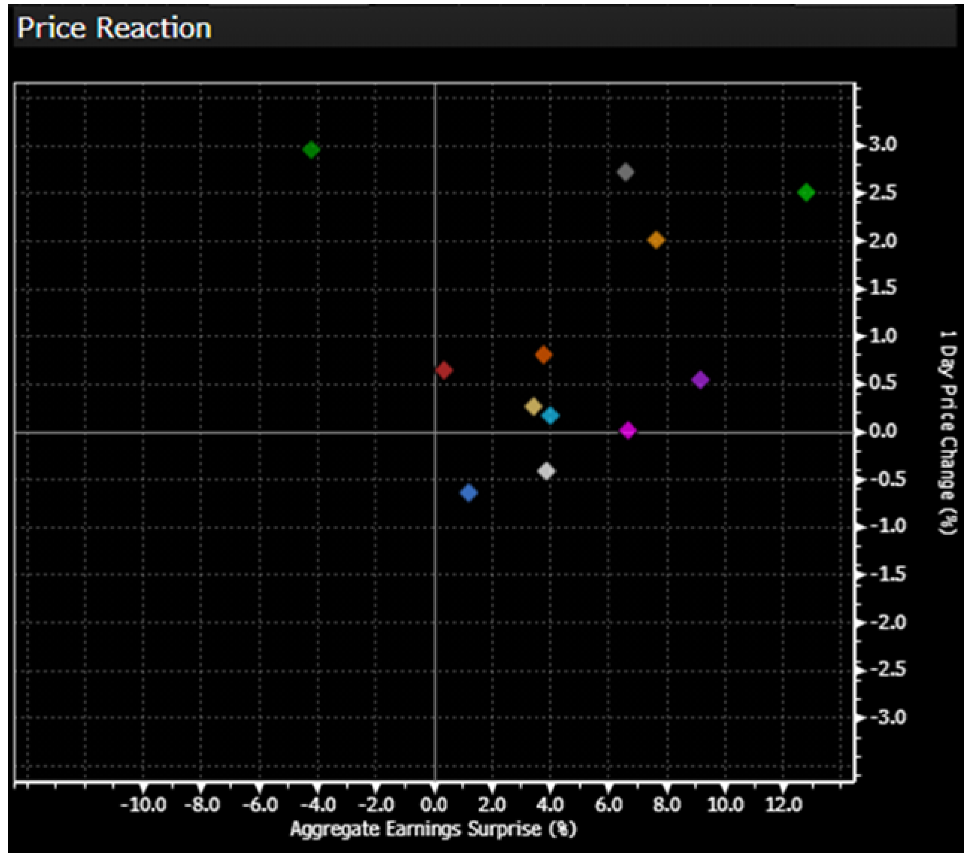

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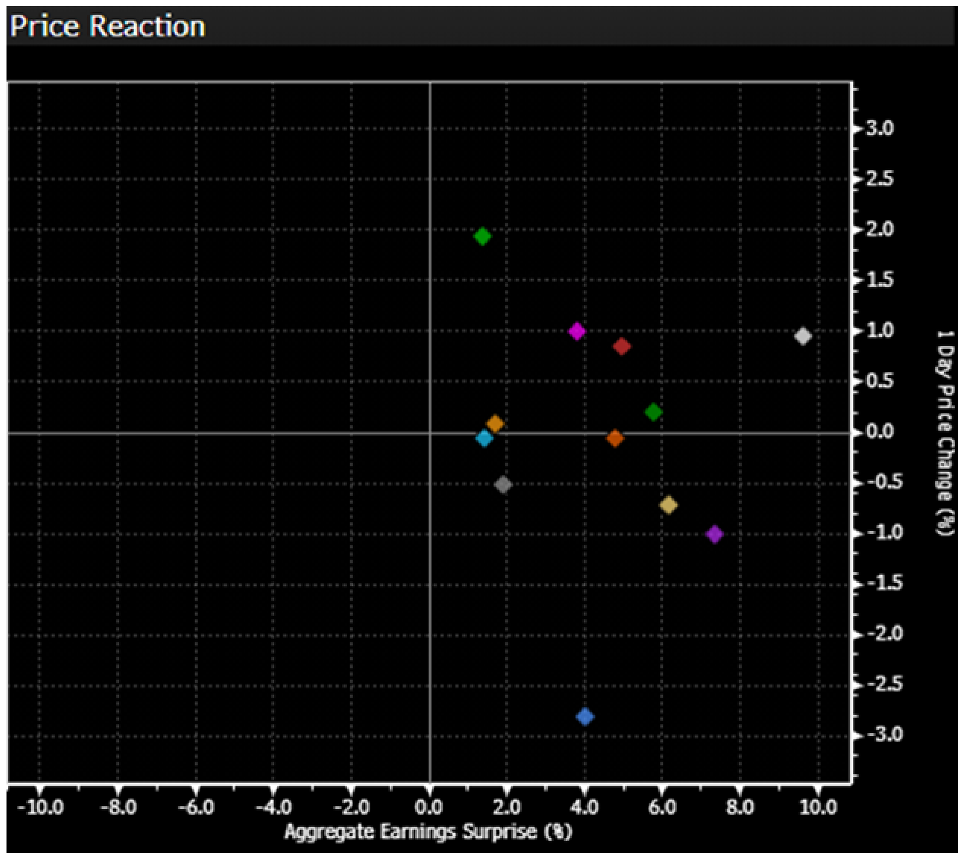

Nine of the eleven sectors have delivered positive earnings surprises for Q2. Some of the best performers are, perhaps unsurprisingly, Energy, Health Care, and Consumer Staples, while Real Estate and Technology have fared the worst vs. expectations.

This earnings season has been dynamic with a broad range of insights about consumers and the state of the economy more broadly. Prior to earnings, Walmart issued a profit warning on July 25th, indicating that gross margins were under pressure as food inflation is running at a double-digit rate, affecting how consumers spend on higher margin items such as retail. Similarly, results from McDonald’s indicated that investors were trading down menu to cheaper items – sparking management to contemplate introducing more lower priced items.

For now, spectrum luxury auto makers such as Mercedes-Benz and Jaguar Land Rover continued to guide towards a strong outlook and cited record demand - though backward looking. Amazon had a strong quarter and guided to an even better current period.

On the business side, digital advertising platforms are posting difficult quarters. Meta grabbed all the headlines with its first quarterly drop in revenue ever. Alphabet, Snap, and Twitter were all downbeat.

At last, some good news, at least on climate

The surprise from the US this week came from Capitol Hill. And it is good news for the United States goal of reducing carbon emissions, as promised in global accords. Senator Joe Manchin, widely seen by Democrats as a spoiler of their reform dreams, announced his support for legislation that includes some $369 billion of climate and energy-related spending aimed at spurring investment in cleaner technology and electric vehicles purchases. It was hailed by many climate advocates, even as they called for more actions to combat climate change.

The surprise agreement –hashed out with Senate Majority leader Chuck Schumer – also covers additional health spending to extend subsidies under the Affordable Care Act and a measure allowing Medicare to negotiate the cost of some prescription drugs. Called the “Inflation Reduction Act of 2022”, the bill has yet to be embraced by all Democrats – and Republicans will likely oppose it en masse. Manchin was convinced that the proposals taken together would reduce the deficit and inflation over time, with savings on Medicare and some specific tax raising measures, notably ending the so-called carried-interest loophole and enacting a minimum 15 % corporate tax on profits.

Chips and China

Could political gridlock – and even geopolitical tensions – have eased slightly this week? In addition to the Manchin breakthrough, there was bi-partisan agreement on Capitol Hill this week for a bill to support domestic investment in semiconductor chips. This is aimed largely at reducing dependence on overseas suppliers and building up American technology expertise – in opposition to China. But President Biden also reached out to China's President Xi this week. In the first direct interaction for four months, the leaders spoke for more than two hours on a range of issues. The US side pointed to engagement on climate and health in particular, although the trickier topic of Taiwan was undoubtedly covered as well. China certainly indicated again afterwards its strong opposition to the rumored plans for a Congressional trip to Taiwan, headed by Speaker Pelosi. Whatever the outcome of the call, it is better for the world for the leaders to be on speaking terms. Reportedly, this is not yet the case at lower levels.

RockCreek Update

With the Fed and ECB meetings and this week’s data dump out of the way, we plan to pause the weekly note until later in August. In the meantime, look for some interesting insights in your inboxes during the last of the summer weeks.

With more to come,

Team RockCreek