RockCreek

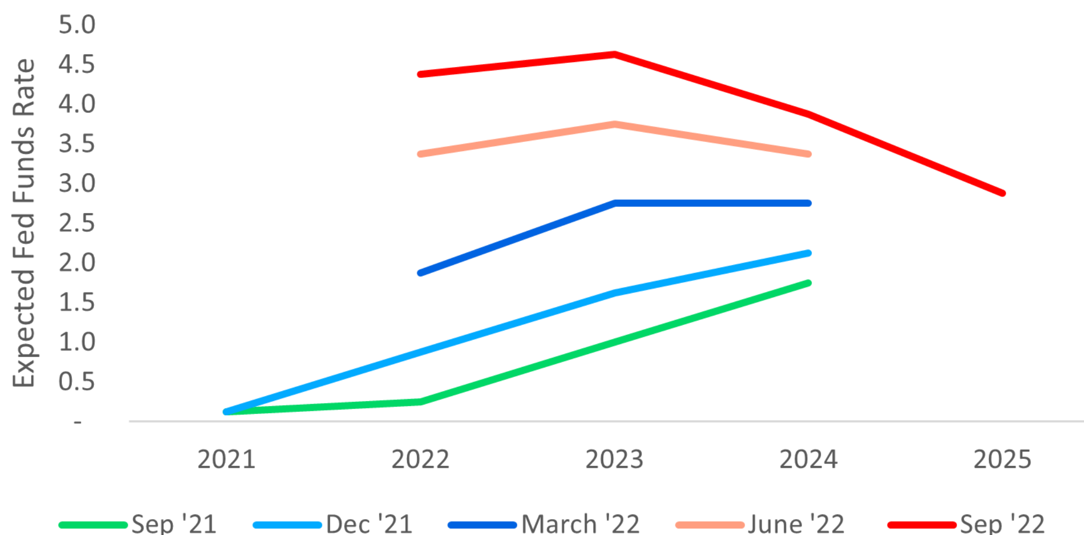
SEPTEMBER 23, 2022

MESSAGE RECEIVED?

Markets finally got the message this week. Major central banks, led by the Federal Reserve, are determined to wring inflation out of the system, even if doing so is painful.

For some weeks now, Federal Reserve Chair Jerome Powell has been delivering the same message: the Fed's number one focus is on fighting inflation. But markets have been reluctant to believe him. At the slightest hint that policy might pause or reverse, equities have stabilized or rallied. This week, Chair Powell seemed to get his message across, reinforced by tightening moves by other central banks around the globe.

The Chair's remarks on Wednesday were brief and pointed. Whatever happens, the tightening ahead "will be enough" to deliver 2% inflation, he said, as he and his colleagues again ratcheted up the rate hikes they envisage will be needed. The latest "dot plot" shows most expect another 125 basis points this year, bringing rates above 4%, with no relief in 2023. The warning of pain ahead was confirmed by a sharp increase in the Fed's projection for unemployment. This week saw conversations about increasing wages, in particular, being a positive force for sustained growth in the long run, with a possible adjustment in earnings slated to gain more attention. Afsaneh Beschloss highlighted this point in a Bloomberg Wall Street Week interview with David Westin last Friday.



Source: RockCreek, Federal Reserve

It WILL be enough

Federal Reserve policy makers have already moved swiftly and sharply to tighten policy in the past six months. They now believe that still more, maybe much more, tightening will be needed to combat inflation.

First in his Jackson Hole speech in late August, and now with even more determination, Chair Powell has made clear that the central bank will not stop or reverse this cycle of monetary tightening until "confident" that price stability – 2% inflation – is assured. Short-term pain is likely, but it will not change the goal or the Fed's actions. He acknowledged that pain – slower growth and higher unemployment, maybe recession – will hurt Americans, particularly those on lower incomes and most vulnerable to job losses. But persistent inflation would be more damaging. The economy can only run smoothly and meet the other part of the Fed's dual mandate, the Fed is saying, if businesses, workers, and investors can make decisions with some certainty about what costs and prices mean. High and variable inflation leads to shifting relative values and consequent uncertainty; not a recipe for achieving maximum employment over time.

As Chair Powell noted this week, the data make clear that inflation is now broad-based and running month after month at a rate far above the Fed's goal of price stability – and twice as fast as the Fed had expected a year ago. Initial hopes that inflation would begin to subside over the summer were dashed earlier this month by disappointing data for August. Headline inflation appeared to peak in June and was flat in July from the previous month. But in August, the consumer price index (CPI) ticked up again from July, even though falling gas prices were pulling in the opposite direction.

Some believe that the central bank is still too optimistic about how high rates must climb to wring inflation out of the system. Former Chair of Obama's Council of Economic Advisers Jason Furman noted approvingly that expectations were being moved "towards something more realistic" but added that he still expected the Fed Fund's policy rate "to max around 5.25%" well above the level implied by the latest dot plot. With this week's announcements, the Fed has made clear that what the central bank does to rates will not necessarily follow its expected path. In a declaration reminiscent of former ECB president Mario Draghi's famous "whatever it takes" the Fed Chair said this week that what the Fed does "will be enough. It will be enough to restore price stability."

Markets got the message

The Fed was joined by central banks around the world as it hiked rates this week. That - together with sabre rattling from Russia and a defiantly expansionary mini-budget from the new UK government – helped to darken the market mood.

A falling stock market is not going to stop the Fed in its tracks – in fact the opposite was true this summer. The market's resilience in July was undermining the Fed's tightening and strengthening its resolve to raise policy rates and stress its focus on inflation. Even this week, there was a five-minute blip up during Chair Powell's press conference after he mentioned that at some point in the future, they may pause at a level they feel is sufficiently restrictive.

Coming into this week, the institutional investor community had mostly settled into two camps: those who believe we are entering a mild recession and those who believe we are headed for a hard landing. And yet, markets were still not pricing in a recession of any sort. The S&P had been trading around its mid-point valuation of around 17x forward P/E – pretty fully valued for a recessionary scenario. The only thing holding the S&P 500 up seems to have been the view that the Fed will pivot.

This week was another example of what happens when reality sets in and more investors rotated into the hard landing camp. The Dow fell to its lowest level of the year by the week's close with Treasury yields rising to their highest level in more than a decade. Oil, gold and bitcoin all traded down on Friday along with equity markets. Banks started to further cut their forecasts for the year and no sector was left unscathed in a very red day for markets – in the US and globally.

Will enough for the Fed be too much for the world?

The Fed is far from alone in tightening. Almost all major central banks, whether in developed or emerging markets, are hiking rates, and by significant amounts.

In just the last two weeks, the Bank of England, the European Central Bank (ECB), Norway's Norges bank, and the central banks of the Philippines and Indonesia have pushed up their policy rates by 50 basis points. Sweden surprised this week with a move of a full percentage point, the first of this size in the 30 years since the Riksbank adopted its current inflation targeting regime. And Switzerland, a pioneer in holding rates below zero to reduce capital inflows and stop currency appreciation, moved its policy rate into positive territory, raising it by 75 basis points to a positive 0.5%. South Africa, despite suffering from energy shortages that have hit its economy, also raised rates by 75 basis points for the second time. Policymakers around the world explained the moves as necessary to fight inflation, which has surprised most of them by its persistence.

Combating inflation is, indeed, the right thing for central banks to do at this juncture. For many, price stability is their single mandate. But there is growing concern among some economists that the simultaneous tightening could be overkill. To the extent that inflation is a global phenomenon, tightening in one economy will have spillover impacts on others. The dollar's strength is lowering price pressures here but pushing them up elsewhere. Is there a case for more explicit coordination?

As former IMF Chief Economist Maurice Obstfeld put it: central banks "should take into account how the forceful actions of other central banks are likely to reduce the global inflationary forces they jointly face" when making their monetary policy decisions. He believes that better coordination could allow central banks to "collectively pursue a gentler tightening path" and thus "avoid excessive sacrifices of output and employment" while still achieving their inflation goals.

Chair Powell pushed back on that notion in his press conference, noting that central banks already meet and talk plenty and that the Fed sees no room for erring on the easing side.

The two big holdouts

China and Japan stand out for their easy monetary stances. There are reasons in both cases: weak growth in China and still low inflation in Japan. One common feature: sharp weakening in their currencies, which has caused curiously little commentary in the rest of the world, notably the US, although it has worried Japan, at least.

In China, there was a major event as the yuan moved beyond 7 to the dollar, previously a point of trade conflict with the US. The authorities are controlling its decline. If they let go and allowed capital to leave freely, a currency collapse would likely ensue. The yen's decline so far has been more dramatic – and led to the first intervention in currency markets since the late 1990s, and the days of former Treasury Secretary Robert Rubin's "strong dollar" mantra. This time, Japan acted to support its currency without the help of the US.

For China, this year's growth performance has been dismal and shows little sign of improving. China is experiencing a "Slow-motion Financial Crisis" according to an expert commentary from the Center for Strategic and International Studies (CSIS). Consumer spending is dampened by the shadow of a devastating property collapse, as well as by strict and sudden Covid lockdowns under the government's zero-Covid policy. The lockdowns have also hurt exports, as evidenced in recent announcements by major auto companies – this week Honda joined with Toyota and Ford in blaming a shortage of supplies for lower-than-expected production. Ford said it expects to have 40,000 to 45,000 unfinished vehicles in its inventory at the end of the quarter.

In Japan, Central Bank governor Haruhiko Kuroda is holding firm to his promise not to tighten monetary policy despite a marked rise in prices. He argues that the 3% inflation now being experienced in Japan does not yet reflect the wage increases that he believes necessary to pull Japan decisively out of years of deflation. Governor Kuroda is increasingly out of sync with the Japanese government, which is worried about the plunge in the value of the yen. Policy has now become contradictory. Look for something to give – likely the yield curve control on long rates – by the time Governor Kuroda leaves office in April 2023, if not before.

Fiscal hole

In response to the largest tax cuts in 50 years, announced by the UK government on Friday, 10yr UK rates rose by 33 basis points, the most since 1989. The Pound Sterling fell 3.5% on the day. GBP is now only 3% away from its weakest level ever against the dollar set on February 26th, 1985. In equities the FTSE 250 fell 2% in local currency terms as cyclical sectors underperformed. Former Treasury Secretary Larry Summers said of the package, "It makes me very sorry to say, but I think the UK is behaving a bit like an emerging market turning itself into a submerging market."

Emerging Markets

Emerging markets have not been immune to the pain of global markets over the last few weeks. As investors de-risk and prepare for potentially greater uncertainty ahead, emerging markets as a whole remain uncertain. This past weekwas no exception with the global risk-off sentiment penalizing emerging and frontier markets alike. Although flows have been negative for six weeks straight and show no signs of abating, pockets of opportunity continue. We remain constructive on pockets within emerging markets including ASEAN and Latin America where a combination of ever cheaper stock valuations and relatively stable currencies are creating a nice setup for the regions going forward.

RockCreek Update

Climate Week

As part of our continued conversations about climate investment opportunities this week as part of Climate Week, we held meetings with climate leaders to break down the policies and ideas that will help decarbonize the economy.

Longtime RockCreek climate investor Justin Heyman spoke with Kerry Duggan – a member of the Secretary of Energy's Advisory Board, RockCreek Senior Advisor, and former deputy policy director for Vice President Biden – about how the largest climate bill in US history will shape the investment landscape in the years and decades to come.

Watch the discussion here.

RockCreek Private Markets and Venture Capital team member Drew Reid spoke with venture capitalist Andrew Beebe, head of Obvious Ventures' investments to scale renewable energy adoption, about investing in great ideas to create a safer, more efficient, carbon-free economy. They discussed accelerating innovation across cleantech, from carbon capture to the electrification of everything. Watch out for the full video next week.

Markets digest Fed raise

Alifia Doriwala joined Bloomberg Markets: The Close to break down the market reaction to the Fed's interest rate hike. "It's clear that the message has been received by markets," Alifia said. "The Fed has been guiding us to this all along, and yet markets have been slow to price in the possibility of a recession. We've seen everything you'd expect if the markets are really taking what the Fed says seriously."

Watch the full segment here.