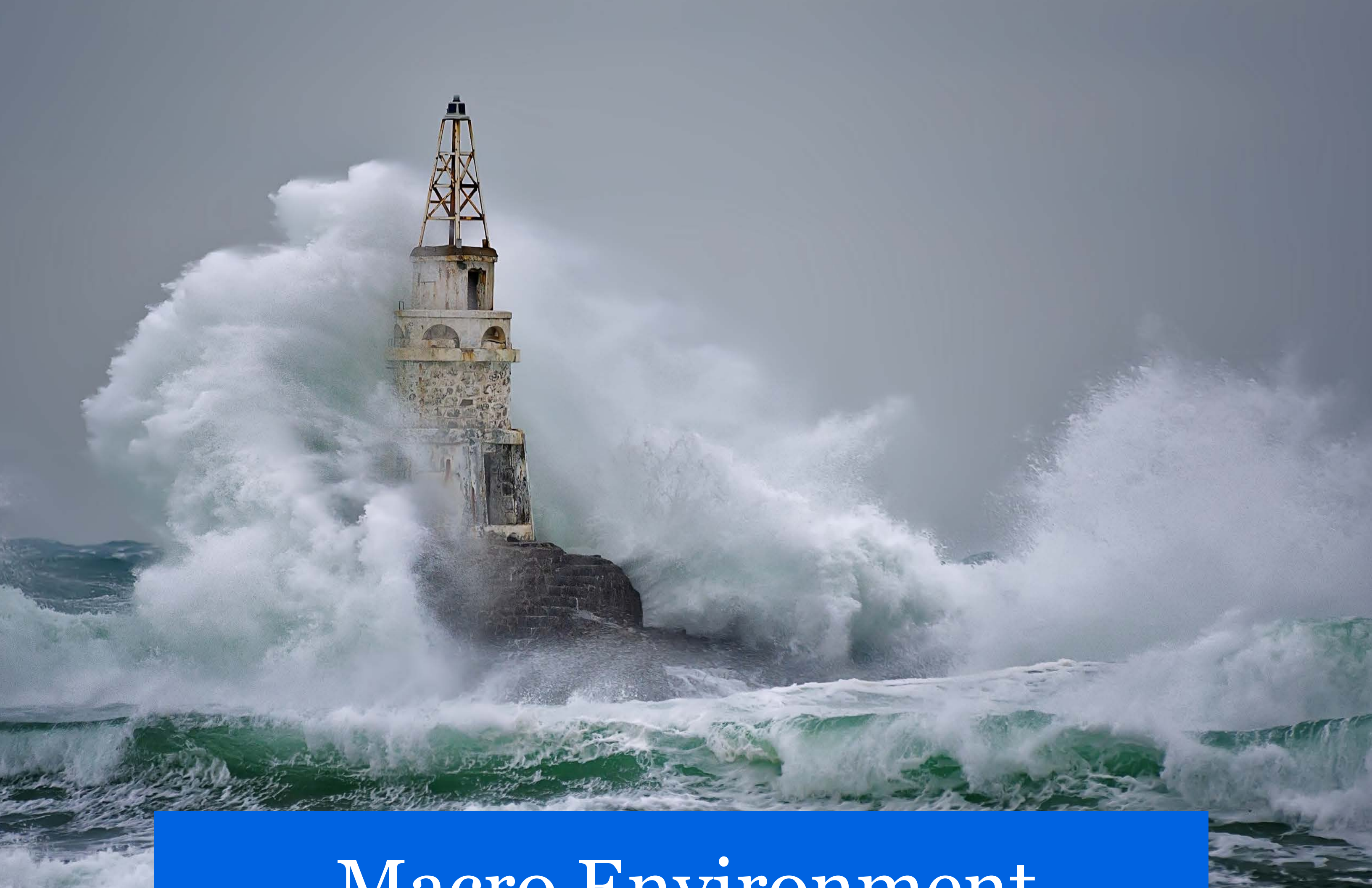

Macro Environment

The summer began with a strong rally in US markets. By quarter's end, that bounce was but a distant memory.

As interest rates marched higher, and the Federal Reserve grew steadily more hawkish, both equities and bonds suffered. By the end of the quarter, the S&P 500 finished down 5%, bringing the overall year-to-date drop to nearly 25%. For US equities, this marked a third consecutive quarterly fall – a first since 2008.

Will this outlook tempt central banks to ease up? Our short answer is no. At RockCreek, we continue to believe the Fed will keep its focus on fighting inflation, waiting for clear evidence – and consensus – that price stability is in sight.

Reaching the Fed's 2% inflation target will take some time and will likely involve economic pain, as Chair Jerome Powell acknowledged in September. He and his colleagues spent Q3 trying to shore up their inflation fighting credentials in both words and actions. They want no doubts about their commitment creeping back into markets.

In July, financial markets shrugged off the battering of the first half of 2022, hoping for a pivot to easier money. By September, reality had set in: central banks have a lot more tightening to do.

As we enter the final quarter of 2022, investors have again wondered if central banks will stay the course. Signs are accumulating of slowing global growth. Finance officials from around the world shared gloomy assessments of the outlook in October at the annual Washington gathering for the meetings of the World Bank and IMF, where RockCreek took part in the discussions.

But while we see more restrictive financial conditions ahead, we expect that debate may build around the pace of tightening. So far, the Fed has moved with record speed to raise rates, breaking with past practice of gradual 25 basis point moves and delivering three consecutive jumps of 75 basis points each from June to September. Speed was appropriate with credibility at stake and a starting monetary stance of considerable ease.

But rapid changes, whether in markets or in life, are hard to manage smoothly. Sudden pricing shifts can wrong-foot financial institutions and lead to the "selling vortex," with further downward pressure on assets exacerbating liquidity problems and then raising solvency issues. We witnessed this vortex at the end of Q3 with the collapse of sterling and cascading sales of UK government bonds. Triggered by an announced fiscal expansion, the downward spiral gathered pace because of over-leveraged pension funds caught in a liquidity squeeze. It took immediate emergency intervention by the Bank of England (BoE), followed in mid-October by a dramatic reversal of government policy – and the shocking resignation of new Prime Minister Liz Truss – to calm the UK government bond market.

Chair Powell and colleagues are keen to bring down inflation. But they have no wish to see financial instability.

Against this backdrop, RockCreek sees three themes continuing to play out for the rest of this year:

1. **Rising global interest rates.**
2. **Synchronized global slowdown.**
3. **Currency complaints, as dollar strength tests other nations' efforts to curb inflation.**

It's the Inflation Rate, Stupid!

To paraphrase the famous campaign quip of some thirty years ago, today's overriding economic concern in much of the developed world is inflation. And that means rising interest rates.

In Q3, it became clearer that the pessimists were right: the extraordinary circumstances and policy choices of the past two years have dislodged price stability across developed markets. Returning inflation close to the 2% target espoused by most developed market central banks will take interest rates that are "higher for longer" than many had hoped – or positioned – for.

It is true that temporary factors, notably pandemic-related supply constraints and the fall out of war on energy and food prices, accounted for much of the initial price surprises. But during Q3 – as Chair Powell acknowledged in September – US inflation remained stubbornly high, despite slowing economic growth, some easing of supply constraints, and a drop in oil prices from their post-Ukraine invasion peaks. Different price measures – whether monthly, quarterly, core, or median – all told the same disappointing story. In Europe, as well, headline inflation has run far above target, topping 10% year-over-year in September, another record. In the US, the CPI headline figure reached 8.2% in September.

So it is not surprising that central bankers in the West reinforced their commitment to fight inflation over the summer, backing up their words with continued policy rate increases and shifts from quantitative easing to balance sheet reduction. They were not alone: as many as 90 central banks raised rates in the quarter, according to the IMF.

Some emerging markets began tightening early – and have benefited from that. Chair Powell signaled a tougher stance in late August with a short, pointed speech at the traditional Jackson Hole gathering of central bankers. His speech was intended to send a message to financial participants who doubted the Fed's resolve – or to question the need for more restrictive policy. Any hint of an early pivot – or even just a pause in raising rates – had seemed enough in Q3 to buoy spirits, reversing the underlying trends of rising yields, a strengthening dollar, and weakening stock markets. Since financial conditions depend on market prices as well as central bank actions, rising stock prices and falling yields threatened to undo the Fed tightening. By the middle of Q3, officials from Chair Powell on down pointed repeatedly to the risks of "premature easing," guiding markets away from hopes of a pivot.

Message received. Market rates have now climbed decisively. The all-important mortgage rate ended Q3 above 6.5% – its highest level since 2007. And the Fed raised its own expectations of where rates need to go.

Policy rates may need to go even higher. Few believe that the "terminal" federal funds rate can be lower than the 4.5% currently envisaged in the Fed's September dot plot, or that rates will come down rapidly. Indeed, as market consensus has moved to incorporate a 4.7% federal funds rate next year, some analysts now expect the Fed to need to go as far as 5-6 %, as noted by former Treasury chief economist Karen Dynan. The reason: the US economy is still relatively strong.

What could halt the third quarter message, that central bankers will keep on tightening until inflation is vanquished? Financial markets showing systemic cracks. Signs of financial stress appeared across the Atlantic in late September – notably in UK markets as well as a sharp rise in credit default swap prices for Credit Suisse. But despite heightened volatility, increased uncertainty about post-pandemic global trends, and sharp price declines across many investment strategies, Fed officials did not see the kind of problems in US institutions or markets that would cause them to rethink.

The UK fiasco that led to Prime Minister Truss's resignation after 45 days in office – the shortest period of any leader in British history – has been blamed on the new government's planned fiscal boost. The unexpected and poorly handled tax cuts and energy subsidies were just the trigger. They caused UK government bonds (gilts) to plunge in value as markets anticipated higher government borrowing pushing up interest

What turned the fall into a crisis was over leverage and poor regulation in Britain's large pension fund industry. In a classic liquidity squeeze, collateral calls on pension funds led to forced selling of their gilt holdings, which in turn sent prices down further, causing more collateral calls and so on. The chaos spilled over slightly into US markets, before emergency intervention by the Bank of England kicked in and markets realized that the British pension problem was not mirrored in the US. In the UK, it took a wholesale reversal in mid-October of the new government's initial fiscal plans, coupled with the Prime Minister's resignation, to steady bond markets.

Growth Slow-Down – or Global Recession?

With the world's central banks moving almost as one to raise rates, growth is set to slow. Much of the pain is likely to come in 2023, as tighter financial conditions gradually feed through to the real economy. At the same time, the energy shock delivered by Russia's invasion of Ukraine and its consequences will continue to impact the global economy. The third major factor undermining global growth comes from China, the world's second largest economy. As we have pointed out throughout this year, widespread lockdowns under China's extremely tight zero Covid policy, coupled with a property collapse, have severely undercut growth. In addition to the impact domestically, China's Asian neighbors and trading partners in Europe have felt the loss of import demand.

The supply shock to growth from Russia's invasion and consequent energy crisis is particularly sharp in Europe. We now expect the impact there to be even worse in the spring and winter of 2023. In Q3, it became clearer that Russia's war in Ukraine would be a prolonged and messy conflict, as we have expected from the start. Europe has done well in filling gas storage for this winter, with tanks now nearly full. Cutbacks in demand have helped, amid dramatic price increases, as well as purchases of gas from alternative sources. But there is much to be done to prepare for the long haul.

Continued constraints on energy supply will keep pressure on both prices and industrial production in Europe. OPEC's October decision to cut oil production by 2 million barrels a day will obviously not help. Surprisingly, the initial impact was less than expected. Indeed, oil prices fell shortly after the decision. The decline was a reflection of lower demand in a slowing global economy, including the significant drop in China's growth prospects, rather than a market that is balanced for long-term recovery.

Governments in Europe are trying to soften the economic blow from higher energy prices without completely undoing incentives to curb energy use. Expensive subsidies also carry a fiscal risk. There is little that governments can do to boost economic growth without undermining their central bankers' fight against inflation. The debacle in UK markets is a major reminder to policy makers worldwide about the limitations of what they can achieve fiscally at a time of rising interest rates.

The International Monetary Fund (IMF) did not mince words in its latest economic outlook, warning that "global economic activity is experiencing a broad-based and sharper-than-expected slowdown, with inflation higher than seen in several decades." The IMF did not tip its hand on whether the slowdown would amount to a global recession, although it warned that one-third of its global membership would likely fall into recession next year. What matters more than the name is how it feels to the individuals and companies who lose jobs and earnings as growth slows. So far, consumer spending in the US has remained strong, buoyed by continued demand for labor and low unemployment. That is both good and bad news.

The good news is that spending and jobs remained firm in Q3. Consumers and businesses also had shock absorbers in the form of strong balance sheets going into the tightening cycle.

The downside of this continued strength on the demand side? As markets fear, it will likely require the Fed to push interest rates higher to meet its inflation goal. Over the summer, labor markets – singled out by Chair Powell as a key indicator of underlying risks to inflation – remained tight.

By September, there were only a few signs that labor demand was easing. Vacancies still far outweighed job seekers, and unemployment ended the quarter at its pre-pandemic low of 3.5%. Strikes – including of railway workers – also showed worker strength. The key to a soft landing will be a quick response of wages and prices to higher rates and a slowing economy. The IMF was not optimistic, predicting US growth of only 1% next year.

Currency Moves: Square the Circle?

Flexible exchange rates allow economies to adjust to changing circumstances. In Q3, the dollar raced ahead, climbing 7.1% on a trade-weighted basis, and by an astonishing 9.0% against the pound sterling and 7.0% against the euro. Some governments tried to resist. Japan intervened in currency markets for the first time since the late 1990s.

But unless intervention is matched with fundamental policy change, it does little to affect long-lasting change. By mid-October, the yen was back at roughly 150 to the dollar, already below the level that had triggered government intervention in late September.

As China has struggled, the renminbi has fallen sharply, despite continued government restrictions on capital outflows, declining by 6.3% during Q3 to a level that is now 10.9% weaker against the dollar than at the beginning of 2022.

Looking ahead, dollar strength is likely here to stay, at least for a while. The stronger US economy and higher core inflation than in Europe and elsewhere means that the Fed will probably push rates up higher and faster than in much of the world, making dollars more attractive to hold. The US and the dollar remain the preferred safe haven for investors in today's uncertain world, with war in Europe, potential strains from tight financial conditions, and weakness in China.