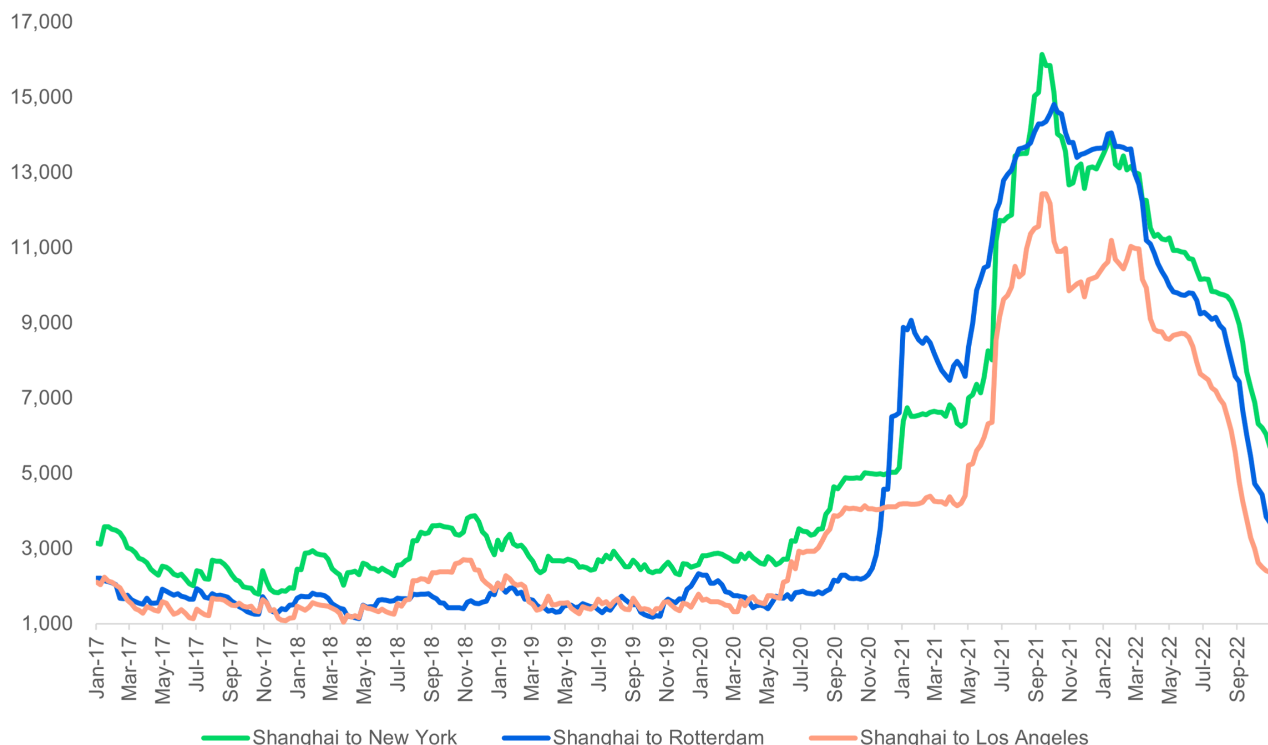
RockCreek

NOVEMBER 4, 2022

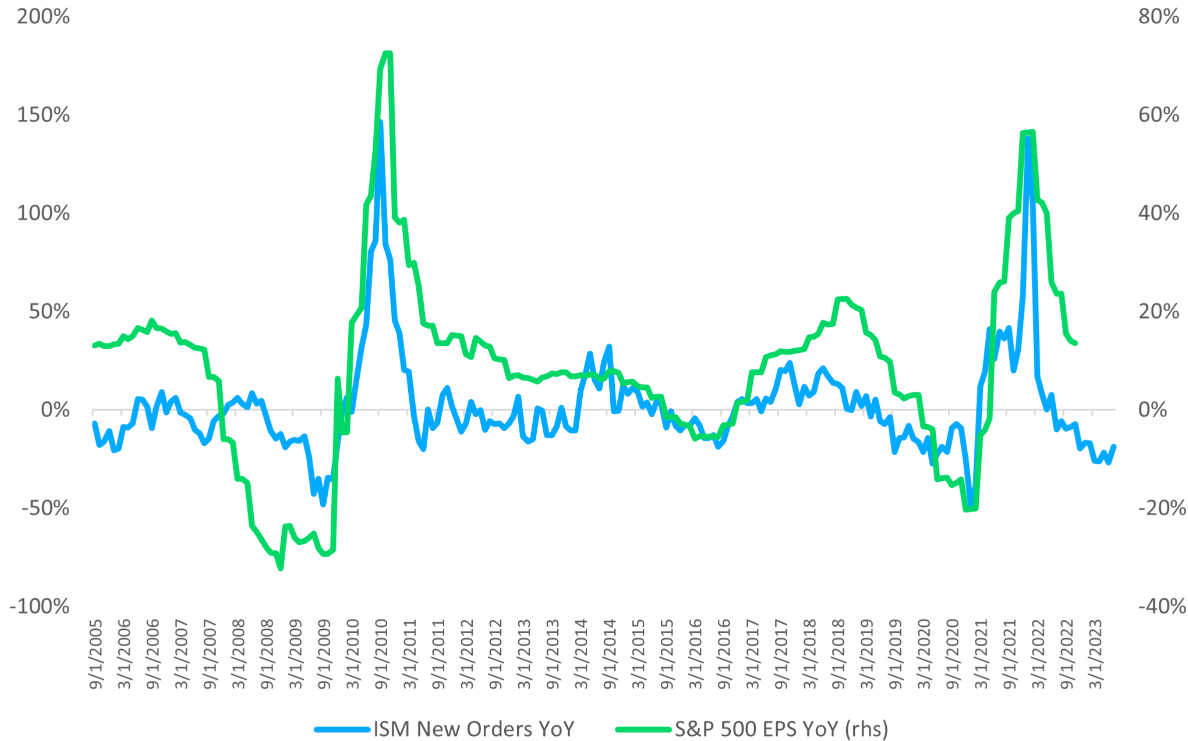
MICRO MESSAGING

Federal Reserve Chair Jerome Powell's mission has gotten more complex. Not only is he steering monetary policy in a world of uncertainty and change, but he has been trying to deliver a message to markets that they are reluctant to hear: the Fed intends to tighten further, for longer. And since market prices affect financial conditions, the Fed does not want investors to grow too cheerful. Rising asset prices could undermine the fight against inflation. And that has been the Fed's absolute priority for some months now.

Chair Powell has been searching for the words to reconcile this message with the Fed's desire to preserve room to slow the pace of tightening, after a record 3 percentage point jump in policy rates over four successive Fed meetings. He may have found them – but only in time for his press conference this week. Hence Thursday's market gyrations between the 2 pm release of the Fed's official statement – with the expected 75 basis point rate rise and hints of a slower pace of hikes going forward – and the end of the Chair's press conference, by which time equities had plunged by roughly -2.2%. During the Q&A session, Chair Powell noted that inflation had responded less than hoped to the tightening so far and – most importantly – pointed to the likelihood of a higher terminal rate than markets were anticipating.



Source: RockCreek, Bloomberg



Source: RockCreek, Bloomberg

This week's labor market reports helped to show why the Fed is so cautious. Once again, they showed a robust jobs market – albeit with signs of slight loosening from what Fed Chair Powell had described over the summer as "very, very tight" conditions. Friday's release showed payrolls grew by a healthy 261,000 in October, with wage growth at an annual rate of 4.5%, a little higher than in recent months. Unemployment crept up to 3.7% as labor force participation also rose. Earlier in the week, the closely watched data for vacancies and turnover (JOLTS) showed a partial September reversal of the August drop in vacancies. Openings still far exceed the number of Americans looking for work. The labor market may be cooling – but it is still too hot for the Fed's comfort.

What's wrong with low unemployment?

Some are wondering why the Fed is so focused on the jobs market. So far, wages have not been responsible for the inflation dynamics that have rattled investors and upset Americans. Indeed, real wages have declined nearly 7% since April 2020 as price increases have outstripped earnings. This has helped to support company earnings, at least so far. The Fed is looking ahead and worrying that if labor demand continues to exceed supply, wage rises will stay at this pace – or even accelerate. And with somewhat sluggish productivity growth, wage increases at the current 4.5% annual rate are still running at a pace that is 2 to 3 percentage points higher than is consistent with the Fed's 2% inflation target.

In any short-term period, there can be sectoral specific reasons for price increases. But as inflation spreads and becomes a macro-phenomenon – which is now the case in the US – the pace of general wage increases becomes the main underlying determinant of the inflation rate.

The global inflation puzzle: why are we here, and how do we get back to price stability?

The conventional way to measure inflation-unemployment trade-offs may be flawed, according to BIS economist Claudio Borio, who discussed the issue at a superb recent panel debate organized by the American Enterprise Institute. Instead, it may be better to think of two inflation regimes, which function differently with complicated transitions from one regime to another. When inflation is low, wage and price setters act independently, and with myriad different decisions there is no generalized expectation that inflation will rise. As prices settle independently, the regime is "self-stabilizing". Central banks can use forward guidance reliably and most economic agents can treat inflation with "rational inattention."

By contrast, in a high inflation regime, which may be triggered initially by a shock like the pandemic or war, wage and price decisions become linked across the economy. Inflation is self-reinforcing, as workers and companies now have a sharp focus on economy-wide prices and try to avoid falling behind a generalized rise. In such a regime, monetary action needs to be timely and forceful enough to affect psychology, but sufficiently flexible to react to changes in an uncertain world.

Pandemic-induced supply shocks that helped to drive up inflation – from Covid lockdowns to unexpected bottlenecks in shipping and transport, difficulties in switching suppliers, slow rehiring by airlines and travel companies – have been easing. Unmet demand for goods and consumer durables has given way to overstocked inventories, according to reports from companies as diverse as Qualcomm and Walmart. But as this happened, global inflation, especially outside the US, has been fired up by energy and food shortages caused by Russia's war on Ukraine.

The strong dollar means that many countries in Europe and emerging markets are importing inflation, just as the dollar is helping to hold down US price increases. As Bank of England (BoE) policy maker Catherine Mann explained in the AEI panel, imported price increases mean that the BoE must compress domestic wage and price pressures all the more to reach its inflation target.

The debate remains fierce over just how much unemployment has to rise in order to curb inflation. Some believe that a "soft landing" with unemployment staying below 4.5 percent is still possible in the US. Chair Powell noted this week that the window for such a benign outcome had narrowed. Unfortunately, that is probably true.

Past experience suggests that squeezing inflation down a further 2 or 3 percentage points, to meet the 2% target within a year or two, will take higher unemployment than the Fed – and markets – currently expect, says a new NBER paper. Some analysts conclude that the Fed's timeline may stretch out, with interest rates higher as inflation takes longer than anticipated to come down. This seems likely. Other recent research finds that while inflation takes off quickly – often unexpectedly – it tends to persist. The disinflation process after an inflationary surge is typically a slow grind.

Another option for central banks facing today's inflationary surge would be to raise rates further, faster. But at a time of high debt levels globally and considerable leverage lurking in the financial system – albeit outside banks – this could trigger financial breakages. The quandary for monetary policymakers would then be how to manage an emergency intervention without simply reversing the tightening stance of monetary policy and inviting more inflation. The recent experience in the UK suggests that a narrowly focused and time-limited intervention, with plenty of information flow between regulators and financial institutions, may be a way forward.

Investors should note that the circumstances facing today's policymakers are particularly difficult. The shocks to the real economy from the pandemic, coupled with an energy crisis, mean that central banks are tightening into a recession, when financial vulnerabilities will inevitably rise. That may lead to longer term opportunities for the nimble and well-capitalized who can manage the risks along the way.

Equities Roundup

As we noted last week, big tech stocks were punished for failing to meet consensus expectations. However, news from other sectors has been more encouraging. Energy continues to benefit from high oil prices and many consumer companies continue to reflect strong pricing power. Prospects are also looking brighter further down the market cap spectrum. US mid-caps are more exposed to the US economy which continues to reflect a healthy job market and a relatively strong consumer.

Despite falling asset prices, US household wealth still remains well above its historical average. In addition, negative real wages and an eventual decline in raw material prices may also contribute to improved profit margins. In environments like this, companies with strong balance sheets and the ability to reinvest free cash flow have typically been able to win market share over weaker competitors with rising funding costs.

Overall, the S&P was down -3.3% during the week, while the NASDAQ was down -5.6%.

Geopolitics is not helping

Central banks are, of course, struggling not just with domestic economics and finance, but also with global tensions. The energy shock from Russia's invasion of Ukraine will continue to reverberate. Hopes of help from Saudi Arabia dimmed last month. And the latest developments in Iran, with women and young girls leading an uprising against the Islamic Republic – one of the first uprisings led by women in the region – make even less likely the prospect, always distant, that global oil supplies will be boosted through a revival of the Iran nuclear deal.

Politics: Do markets care?

Traditionally, investors pay some attention to political developments as these can lead to economically significant shifts in policy. Another peculiarity of present times is that while there is more political upheaval than usual – next week's mid-term elections in the US likely to change the balance of power in Washington, a new Prime Minister in the UK, a new President elected in Brazil (but with the former president not conceding) – there has been little apparent market interest or impact – at least so far. Indeed, the biggest impact of domestic politics on markets has come from the lack of change at the top in China, and all that may signify.

Emerging Markets

This week proved another rollercoaster ride for emerging and frontier markets investors, though it ended on a high note. The MSCI EM was +5.5%, while the Hang Seng was +8.7%.

Chinese equities, for a change, led what was ultimately a strong week for the asset class as the prospect of the world's second largest economy finally reopening boosted market expectations. We would not say we are out of the woods, however. Indeed, while oversold conditions support an EM asset rebound, it won't, in our view, offset the stress of ongoing financial tightening being led by the US. EM currencies are coming under pressure beyond the most vulnerable countries, with EM currency weakness now focused on Asia.

EM Asia FX Weakness

USD / KRW	1,412.6850	+223.8050	↑18.82%
USD / CNY	7.1979	+0.8420	↑13.25%
USD / TWD	32.0290	+4.3119	↑15.56%
USD / INR	82.2689	+7.7548	↑10.41%

Source: Google Finance

For EM Asia, a weaker currency may be a good thing, given their export-oriented economies. However, should energy commodity prices continue their upward trend of the last month, monetary policy makers may have little choice but to tighten or draw down on their reserves. Outside of Asia, currency weakness has kept pressure on EM central banks even as many look to the end of their hiking cycles. EM central banks are signaling a desire to end or slow their hiking cycles, especially since many of them started hiking well before the Fed.

In practice, however, only Brazil, Poland, and the Czech Republic have managed to halt rate hikes. This may delay domestic flows returning to the local equity markets as investors continue to collect attractive yields in less risky assets. Conversely, for foreign investors this may be a good entry point given still low yields in developed markets. World class companies with attractive forward earnings growth are trading at record valuations. Getting in now, while not riskless, may prove a sage decision in the medium to long term.

RockCreek Updates

RockCreek at COP27

The 2022 United Nations Climate Change Conference – better known as COP27 – kicks off on Sunday in Sharm El Sheikh, Egypt. More than 90 heads of state and representatives from 190 countries will conduct negotiations on the way forward for climate finance, decarbonization, adaptation, agriculture, and how much rich countries (which caused most of the emissions that are warming the planet) owe to developing countries (which are bearing much of the brunt of the warming planet) to finance climate adaptation. Many corporate CEOs are no longer attending but sending designated representatives.

RockCreek is hosting a series of discussions from COP with partners focused on climate finance and policy, including Nili Gilbert, Chair of the Glasgow Financial Alliance for Net Zero (GFANZ) Advisory Panel, who joined us from Glasgow last year.

Please click here to register, and stay tuned for details of the entire RockCreek at COP27 series.

With more to come,

Team RockCreek