RockCreek

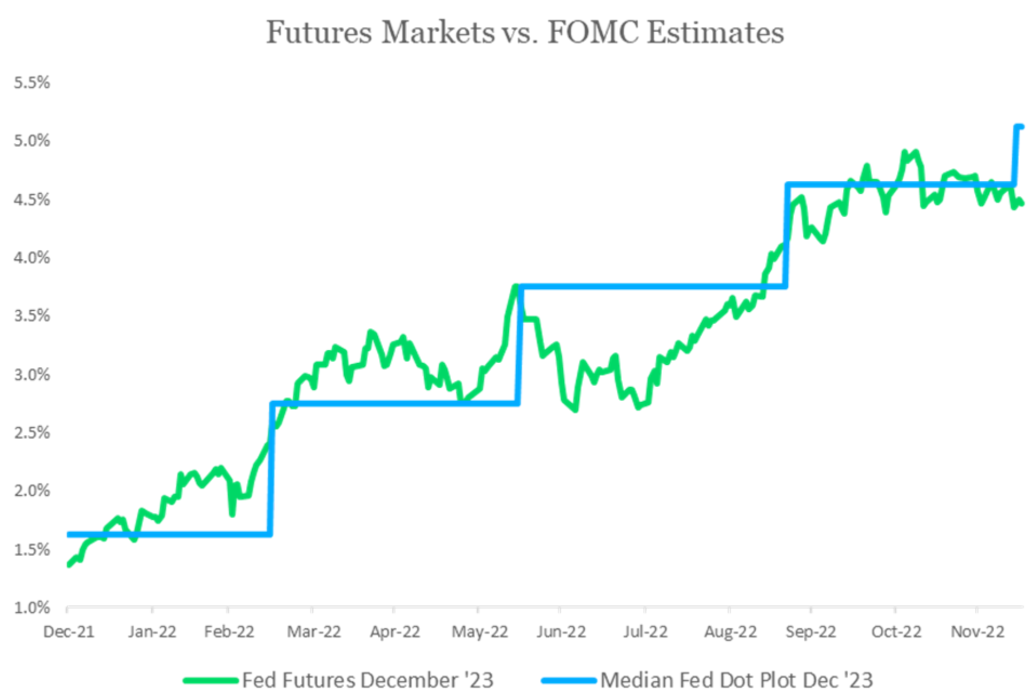
DECEMBER 16, 2022

HOLD TIGHT!

The Federal Reserve has been very clear since Chair Jerome Powell's short, sharp speech at Jackson Hole in August. It is committed, above all else, to fighting inflation. As we noted last week, 40-year high inflation has been the most notable economic feature of 2022. For the Fed and other developed central banks – equally surprised this year by inflation – the year has been one of catch up. In markets, there has often been a disconnect.

Despite the central bank's efforts to communicate its intentions, markets have repeatedly underestimated its resolve. At any sign of good news – and Tuesday's consumer price index report for November was certainly that – markets take off, in hopes of an early easing or pivot. This week's good cheer was short-lived. The Fed was responsible. After rising 0.7% on the promising inflation news, equities plummeted by 3% in the 24 hours after Chair Powell spoke.

Although the Fed did slow down the pace of rate hikes, with a 50 basis point move after four consecutive rises of 75 basis points, the central bank issued a gloomier projection for the economy than three months earlier, with higher interest rates expected next year. The Fed consensus for where interest rates will peak has now topped 5%. Just three months ago, the peak was expected to be 4.6%. A year ago, 2.5%. On top of that, Chair Powell noted that an end to rising rates was still "a long ways off."



Source: RockCreek, Bloomberg

Investors are right to be wary. The inflation peak may be behind us, and a soft landing – with no contractionary recession – is still just possible in the US. But even without a formal recession, jobs and earnings will be hit by slower growth next year. That is, after all, the current aim of Fed policy.

Some hope that inflation will now drift down further and faster than expected, allowing the Fed to pause without inflicting more damage to the economy. Others expect that the tightening already in the pipeline is going to push up unemployment more sharply than policymakers are bargaining for. Again, this would lead the Fed to stop raising rates sooner than its current trajectory. But, as Chair Powell said – and most economists believe – continued tight money and a less buoyant labor market are likely needed to achieve low inflation.

In contrast, a shift in the opposite direction is now underway in the world's second largest economy. Following China's surprise U-turn on zero Covid in early December, this week brought news that US regulators will be allowed to inspect the work of Chinese auditors. This brings to an end a 10-year standoff between the US and China. (See more below) It is another sign that the new administration in China, taking office for President Xi's third term, is looking to boost China's economy after dismal growth this year.

Roller coaster ride

Stocks initially rallied in the wake of Tuesday's US CPI release, which followed a positive surprise in October. But Chair Powell's words after this week's Fed policy meeting, including a warning that policy would likely stay restrictive for a "sustained" and "substantial" period of time, sent stocks sliding. The selloff in equity markets continued Thursday, as investors became gradually more concerned that the Fed is pushing the economy into a recession. The sell-off occurred across the board – fewer than 30 stocks in the S&P 500 traded in positive territory. "The Big Five" technology companies were some of the hardest hit, trading down 3% to 5% on average.

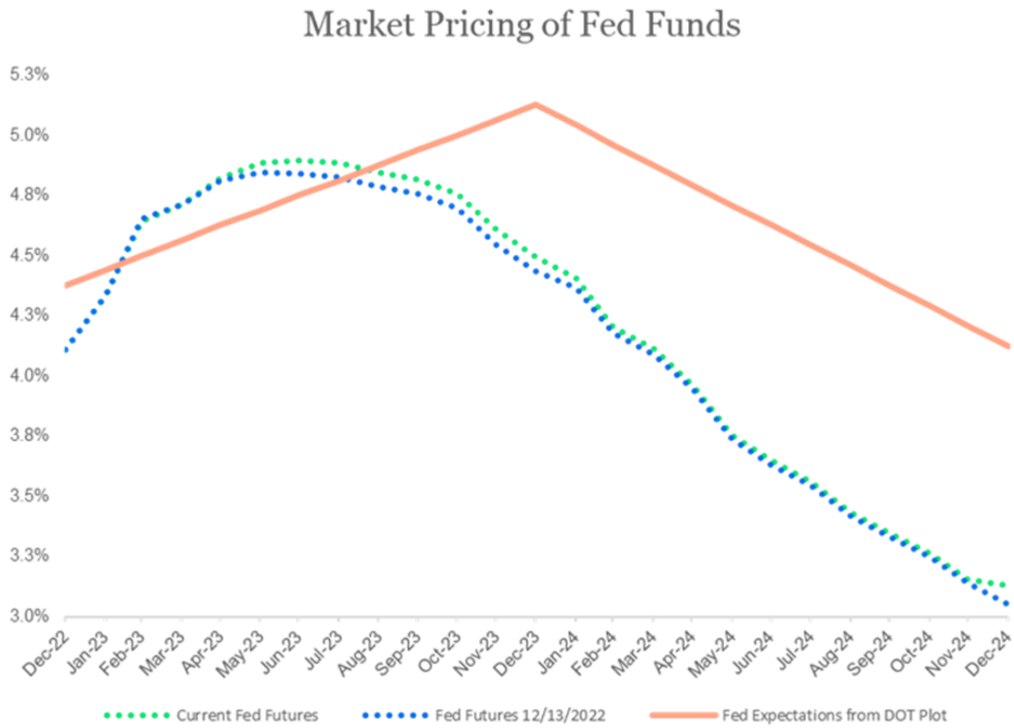
The price action indicates equity markets were again reminded of the Fed's intent to quash inflation and the impact that will have on valuations. Broadly speaking, in a theme that has played out all year amid rising rates, growth underperformed value. The Nasdaq fell 3.2% on the day vs. a 2.5% fall for the S&P 500. "Unprofitable tech" as measured by the ARK Innovation ETF was hardest hit, falling 4.9%.

This pattern largely held to close out the week as well with S&P falling a little under 2% with growthier stocks lagging by 0.5% to 2.5%.

When the Fed speaks….

….markets don't always listen. A complication for monetary policy makers is that market prices, as well as policy changes, affect financial conditions. As Chair Powell repeated this week, the Fed is aiming to tighten financial conditions. For much of this year, the Fed and financial markets have been signaling past each other. When markets get over-enthusiastic, this automatically loosens financial conditions. That is good news for jobs and spending, but less good news for inflation.

Bond markets, as well as equities, have been disconnected from the Fed. As the central bank has gradually moved up its estimate of the "terminal" interest rate – where tightening will finally pause – bond markets have not followed.



Source: RockCreek, Bloomberg

Despite this week's new dot plot, swaps and futures markets have not risen to match. Instead, they are pricing in an earlier and sharper reversal in monetary policy. This pricing is largely unchanged from the day before the meeting. Interestingly, bets on the terminal rate had been above 5% a few weeks earlier; however, as economic data continued to come in softer, market expectations moved down just as the Fed moved up. It seems that bond markets, as well as equity investors, may be anticipating a slowdown in growth and inflation that changes the Fed's mind.

Why so tight?

There is a reason why markets keep wanting to jump ahead. It is unusual these days for policy makers to deliberately engineer higher unemployment. And the speed of rate rises so far this year has been so rapid that there is pain in the pipeline. But the Fed is determined to avoid the 1970s era mistake of easing too soon. That means, as we have cautioned before, the central bank will continue to tighten policy until economic growth slows and labor markets loosen. And it will keep rates high until it is clear that inflation is heading down – with the 2% target credibly in sight.

This stance risks overtightening. But for the Fed, that risk is preferable to the risk of losing control of inflation, again. Yes, it has a dual mandate. But the central bank believes that price stability – which Chair Powell has repeatedly defined as 2% – is essential in the long-term for sustainable growth and low unemployment. Throughout this year, the Fed – and its fellow central bankers in advanced economies – have had to revise upwards their estimates for inflation, and interest rates. One realistic hope after this week's meeting is that we may now be in a world where new projections foresee a better outlook rather than a worse one.

Not just the Fed

The Fed's mid-week rate increase of 50 basis points was followed the next day by the Bank of England and the European Central Bank (ECB), among others across the Atlantic. Their moves also followed increases of 75 basis points in previous months. As in the US, monetary policy makers were keen to squash hopes that a slowing of the pace of tightening meant that the cycle was nearly over. "We have more ground to cover, we have longer to go, and we are in for a long game," ECB President Christine Lagarde said.

The caution is wise. As in the US, inflation has surprised central bankers in the UK and Europe not just by soaring way above central bank forecasts but also by persisting at high levels. Unlike in the US, inflation in Europe has been driven mostly from the supply side. That means it is less susceptible to central bank policies that curb demand.

The energy shock from the war in Ukraine, as well as lingering supply constraints from the pandemic – in particular China's lockdowns under its zero Covid policy – fueled inflation in Europe. Covid-related price increases may now be phasing out. But the war continues. Winter will put pressure on energy demand and prices. Oil prices have fallen dramatically from the summer peak, close to their pre-war levels. But further supply disruptions cannot be ruled out. And an eventual revival in demand in China will also push energy prices higher.

Unlike in the US, bond markets in Europe were affected by the central bank's words, particularly short-dated European sovereign bonds. Two-year yields on Spanish, Portuguese, Italian, Greek, and German debt rose 20 basis points on December 15th – a three standard deviation move in for a year that has been tremendously choppy. The 3yr note in Italy surged 50 basis points – a four standard deviation event. The trigger for these moves was not the 50 basis point hike out of the meeting, but rather President Lagarde's comments – where she summarized: "Anybody who thinks that this is a pivot for the ECB is wrong" – coupled with the bank's announcement of QT set to begin in March 2023. The run-off size of €15 billion/month is what really caught markets offsides.

Source: RockCreek, Bloomberg

UK sovereigns fared better in the wake of the BOE announcement despite hiking rates to a 14yr high and indicating that more may come if the bank's projections prove out. The silver lining may have been two hold-out members of the monetary policy committee who favored no hike. Still six were in favor of the 0.5% delivered and one member even pushed for another 0.75% increase like the bank delivered in November.

The DOJ has come to play

This week, the Department of Justice (DOJ) decided that enough is enough and reminded the world that if you allegedly commit a massive amount of fraud, doing as many interviews as possible saying how sorry you are won't make your jail sentence any shorter. Sam Bankman-Fried, who has had more ink written about him and his spectacular fall from grace than possibly anyone else in the financial world this year, has been on an epic apology tour trying to stave off an oncoming wave of litigation. But this week, SBF's legal troubles became very real as the DOJ levied a series of charges, including wire fraud and conspiracy to commit money laundering, with a maximum prison time of 115 years.

And as the House of Representatives is holding hearings trying to discern exactly what happened with FTX, it is important to remember that Crypto is not the defendant; fraud is on trial. It is unlikely that markets and investors will heed this sentiment, as there has already been a mini-run on the Binance Exchange. But just looking at the number of years that the DOJ is charging SBF with, it is clear that they are trying to send a message that misuse of client funds, whether it be in the crypto or fiat space, will not be tolerated and will be prosecuted to the fullest extent of the law.

Emerging Markets

It was a difficult week for emerging market equities, particularly for EM ex-China markets. After a strong November, some profit taking was to be expected, particularly nearing the close of the year. But the divergence between Chinese equities and the rest of emerging markets continues unabated – in the last month, Chinese equities have outperformed the rest of EM by over ten percent.

China's re-opening has consisted of a series of measures that aren't just about easing restrictions on the freedom of movement. Indeed, as mentioned above, this week Chinese markets were buoyed by the news that US regulators had been allowed to analyze company audits of Chinese firms, easing fears that up to 200 Chinese companies would be delisted from US stock exchanges, including tech behemoths Alibaba, JD.com, and Baidu. EM investors welcomed this long-awaited news, given the targeted companies are a meaningful part of the MSCI China Index and ballast of most EM portfolios.

At RockCreek, we suspect that China's capitulation on this audit access issue is at least partly in response to push back from the impacted US-listed businesses. Delisting would have deprived these very large Chinese businesses of direct access to the US capital markets, a difficult proposition to tolerate. Statements issued by Chinese authorities indicate that the audit oversight work that has taken place so far has been limited to reviewing the work of local auditors and, by implication, not focused on stealing secret/proprietary information, which may well be a way for Chinese authorities to 'save face' and move on.

RockCreek Updates

Happy Holidays

For the holidays this year, RockCreek gave the gift of trees. Through the Arbor Day Foundation, RockCreek supported planting thousands of trees in Superior National Forest, part of our commitment to help shape a more sustainable tomorrow.

Looking Back at 2022

Throughout this year's 36 letters – from the *New Year Slump* to the *Chronicle of a War Foretold (with a nod to Gabriel García Márquez)*, followed immediately by *The Dogs of War, Unleashed* (that's about how things went in 2022); the *Hawks Crowding the Sky* who sent the *Doves on the Run*; throughout the *Summer Blues* and the *Summer Whipsaw*, which gave way to *Stormy Weather* and *Holiday Cheer [that] Came Too Soon*, it has been a privilege to chronicle the stories that shaped markets, policy decisions, and lives around the world.

We captured the 11 stories that shaped the world in 2022 with our *Year in Review* letter last week, which can be found along with the entire newsletter archive on RockCreek's website.

Each week, we have striven to provide insights and analysis that challenge assertions, shape decisions, and help navigate the turbulence of these uncertain times. Thank you for sharing your valuable time with us each week.

After a short holiday break, we will be back on January 6, 2023. We wish you a wonderful holiday, and a happy, healthy, auspicious start to the new year.

With more to come in 2023,

Team RockCreek