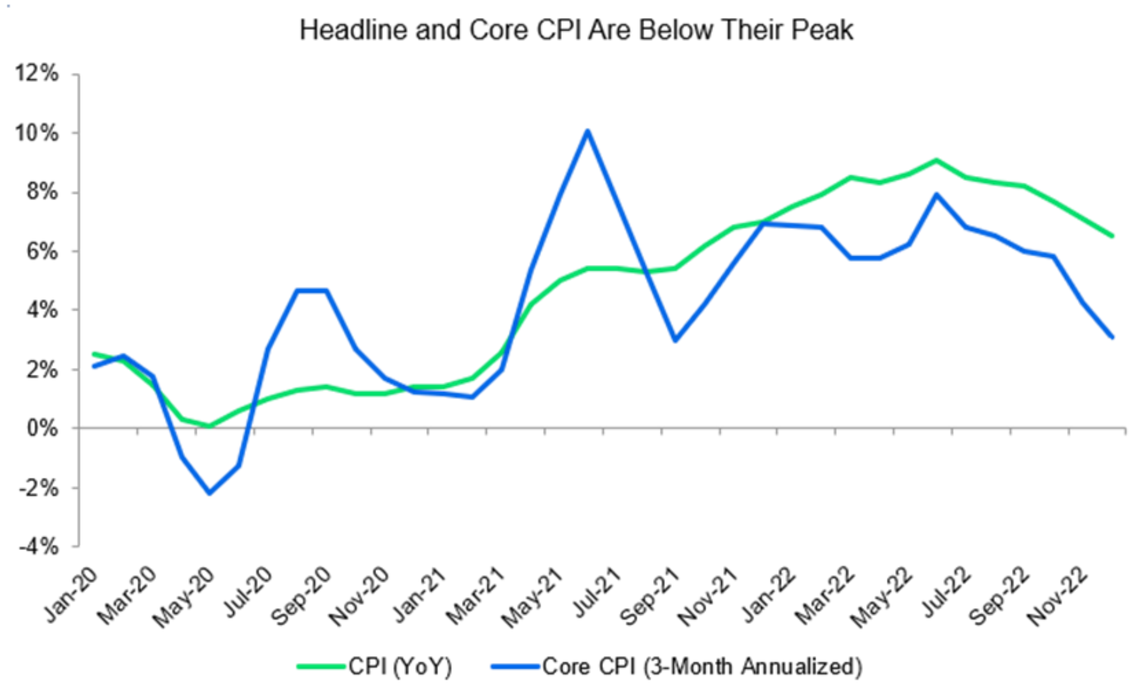
RockCreek

JANUARY 13, 2023

IS TIMING ALWAYS EVERYTHING?

Ahead of the Martin Luther King, Jr. Day holiday weekend, our commentary will focus on this week's CPI print and the market reaction. Please look out for our Quarterly Letter on January 20th; the Weekly Letter will resume on January 27th.

Market watchers are wondering when the Federal Reserve will stop its monetary squeeze, after pushing rates up by a startling 4.25 percentage points in just 9 months. What may matter more is not when the tightening cycle turns, but why.



Source: RockCreek, Bloomberg

Inflation is the key

Optimists are banking on a better outlook for inflation than seemed likely some months ago, notwithstanding a still strong US economy and vibrant jobs market. On this view, the Fed will adjust its rate hiking plans – in a mirror image of last year's race to push rates up. A softer landing would be the benign result.

A different view is that the monetary squeeze already in the pipeline will show up in a much weaker economy. While the official data is still strong, there are signs of weakening in announced lay-offs and concerns about earnings. A pessimistic take on why the Fed might pause – or even pivot – sooner would be that it is trying to avoid an overshoot that drives unemployment up and crashes the economy: a hard landing.

The good news so far this year is that the first scenario now looks more plausible than it did for most of 2022. But it is early days. The easing of supply chain blockages and a reduction in extraordinary demand for goods are helping. But service inflation remains high, and the jury is out on what lies ahead for wages; can workers do well enough this year to see real wage gains, without pressing prices higher?

The key to remember: Fed's overriding goal remains the fight against inflation. The central bank wants to bring inflation down – all the way to 2% in a reasonable period of time. To this end, Chair Powell and colleagues are not only willing to tolerate rising unemployment, but they have expected to see the labor market deteriorate. They have not forgotten the other part of their dual mandate. But they believe that sustainable "full" employment requires a foundation of price stability. The shock of unexpectedly persistent and accelerating inflation in 2021-22 will not be easily forgotten. Premature easing that causes inflation to rebound remains their biggest concern.

Prices, but also wages

This week's data for consumer prices confirm what we said a week ago. Inflation has peaked and is now trending down. The headline rate for December came in as expected at 6.5 %, as prices actually slipped from their November level. Of course, that is still far above the Fed's 2% target – which Chair Powell has repeatedly said remains the goal. Measures of core inflation, which strip out energy and food costs, have also slowed in recent months, reaching 3.7 % at an annualized rate in the final quarter of 2022.

Perhaps most importantly, the pace of wage gains appears to have slowed as well. Revised average earnings reported a week ago showed wage increases running at an annual rate of 4-4.5 % at the end of last year, despite a still strong labor market. The Fed remains concerned that the "very very tight" labor market, as Chair Powell has characterized it, will lead wages to rise, jeopardizing the inflation goal.

So – what's next?

Another slowdown in the pace of rate rises – from December's 50 basis points to a more usual 25 basis point – is likely when the Fed meets in just under three weeks. One member of the policy committee – Patrick Harker of Philadelphia– has come out in support of a 25 basis point move, as has Boston Fed President Susan Collins (who will not have a formal vote this year). A slowdown in the pace of tightening makes some sense. There is still a lot of monetary tightening that has yet to feed through to the economy. Housing is slowing, and layoffs have begun in some sectors. Indicators to watch for ahead of the Fed meeting include retail sales next week, and the start of earnings season. In particular, given the Fed's concern about wage pressures and recent puzzling data, the central bankers will also pay close attention to the quarterly report on labor costs, due just as the policy meeting begins on January 31.

Strangely, as inflation gets closer to the central bank's goal, markets are indicating that the Fed lacks a certain kind of credibility. Chair Powell and colleagues have repeatedly said that they are focused above all on fighting inflation. They expect to raise rates further in 2023, to a level above 5%. They do not expect to pivot toward easing until next year. In contrast, financial markets have consistently priced in an earlier pivot, and at a lower terminal rate than the Fed consensus. Raghuram Rajan, top notch economist at Chicago's Booth school and a former central bank governor himself, wrote this week that central bank efforts to combat disinflation after the global financial crisis mean that they now find themselves "with the wrong kind of credibility" for today's inflation fighting regime "namely, the assumption that they will tolerate inflation." We do not believe that they will.

Market Reaction

This month's CPI print was in line with the market's expectation for a further deceleration in inflation.

The market was positioned aggressively for this outcome so risk was to the downside if we got a disappointing print. Accordingly, the market reaction was fairly muted as compared to the prior two months' sharp responses, but financial assets still added to recent gains. On a year-to-date basis, 10-year Treasury yields have fallen -40 basis points to below 3.5%, S&P 500 and Eurostoxx 50 have rallied +4.4% and +7.0%, respectively, while the US Dollar Index is down -1.2%.

Underlying the headline equity index moves has been sharp factor moves as long duration growth stocks and high beta cyclicals (i.e., last year's losers) have rebounded as the drop in yields coincided with the turn of the calendar when tax-loss pressures ease.

RockCreek Updates

As we pause to celebrate Martin Luther King, Jr. Day to commemorate and honor Dr. King's life, legacy, and impact, we remind ourselves that, in the need for progress, "We are confronted with the fierce urgency of now. In this unfolding conundrum of life and history, there is such a thing as being too late."

We're proud of the work our team members do to strengthen their communities on MLK Day and throughout the year.

We wish you a joyful long weekend. We will return with our Quarterly Letter on January 20th, and the Weekly Letter will resume on January 27th.

With more to come,

Team RockCreek

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