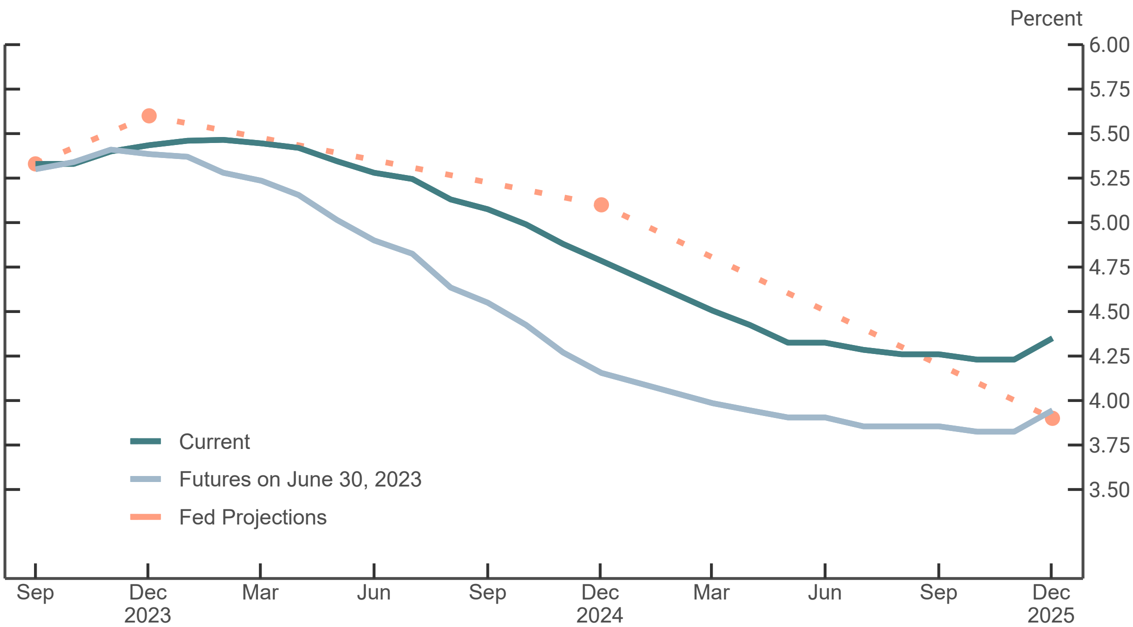
(DOT) PLOTTING THE WAY AHEAD

The news from central banks this week was not so much in what they did as in what they said. Or, in the case of the Federal Reserve, what they wrote down. The message from all developed market central banks, except Japan, was “higher for longer”. Neither bond markets nor equities liked the message. Unnerved by the prospect of another hike this year and fewer cuts next year, 10-year Treasury yields surged to 4.5% - the highest level since 2007 - while the S&P 500 sunk to lows last seen in June.

The Fed’s ”dot plot” of the future path for interest rates showed that while rates may or may not go up again this year, the odds of a cut any time soon just got worse. The Fed decided not to move its policy rate up now, leaving it at the 22-year high of 5.25-5.5% reached in July. But it left open the possibility of a further hike this year. And a stronger-than-expected US economy has central bankers signaling rates are likely to stay at elevated levels for longer than they thought back in June.

Other major central banks have delivered a similar “higher for longer” message this month. Some – like the European Central Bank (ECB) and the central banks of Sweden and Norway – have done this while also raising rates. Others

Higher for longer is sinking in



Note: The current effective federal funds rate is 5.33%.
Source: RockCreek, Federal Reserve, Bloomberg. As of September 21, 2023.

– including the Swiss National Bank (SNB) and the Bank of England (BOE) – have surprised by holding rates steady. But they, too, have made clear that easing is not on the horizon. Inflation is still too high.

As Fed Chair Powell put it this week "People hate inflation. Hate it."

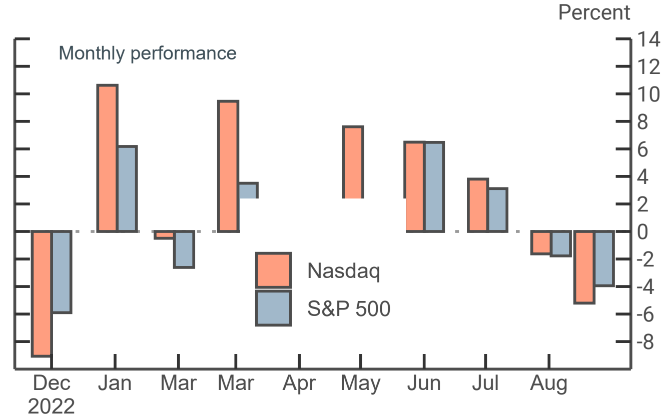
Fed Chair Powell has made clear many times his intention to keep money tight until inflation is on a credible path to the 2% goal (see RockCreek's earlier letter "Hang in There…"). He has linked this to easing labor market pressures and a slowing economy. So far, spending and jobs have been stronger than expected. But market pricing this year has shown that investors thought that the Fed's bark would be worse than its bite. Pricing in the Treasury markets has been consistent with the Fed undershooting whatever rate path it has projected in the dot plot and cutting rates sooner than later.

This time may be different. The initial reaction suggests so. This may reflect the fact that the Fed itself acknowledged in its quarterly Summary of Economic Projections (SEP) that the economy has been stronger than expected, that growth this year and next will be above its earlier projections, and, as a result, that interest rates may well be higher for longer than policymakers had earlier believed. The median dot plot now has the Fed funds rate 50 bps higher than expected in June, at 5.1% and 3.9%, respectively, in 2024 and 2025.

UNSETTLING WEEK FOR EQUITIES

The latter part of the quarter can be a little precarious for returns in the short-term given news of company performance is relatively sparse leading up to the next earnings season. This is when you might see the most drift away from micro fundamentals as macro considerations grab the market's attention. This was the backdrop for the market's reaction to the Fed's 'higher for longer' messaging. The S&P 500 ended the week more than 2% lower and is now down almost 4% on the month so far. As expected, growth stocks and other longer duration investments were hit harder, with the Nasdaq losing about 2.6% this week and bringing its performance this month down by 4.7%.

US stocks are heading towards biggest monthly loss since end-2022



Source: RockCreek, Bloomberg.

The STOXX Europe 600 gave up nearly 2% this week, pulling its September performance modestly into negative territory. Europe has been a significant laggard this year, gaining just 6% versus 13% for the S&P. As a net importer, oil's rally over the past few months has been challenging for the region with household disposable income further pinched by higher energy costs. Europe needs a meaningful respite from inflation before it will be able to turn a corner. In addition to oil, defense stocks have been among the few areas of strength in recent weeks. Meanwhile, industries with strong ties to China like luxury goods and semiconductors have been falling out of favor.

Japan's Nikkei 225 is down modestly this month after falling just over 3% this past week. Although the market reacted negatively to the Fed's announcement, sentiment remains quite positive as Japan continues to offer an attractive combination of economic, political, and social stability. Stable GDP growth and benign inflation increases have helped the BOJ to sustain its accommodative monetary policy. Japan's fiscal situation has been a bit thornier historically, but right now, the Japanese current account is positive and growing. As the largest net creditor in the world, the country is able to leverage higher global rates. Japan has the equivalent of a full year of its GDP invested offshore, primarily in bonds, and those holdings are - finally - generating more interest rate income. Meanwhile, the job market remains strong with the country seeing youth unemployment of just 4%, a very sharp contrast to China's most recent data.

BREATHING SOME LIFE INTO IPOS?

The IPO market got some wind in its sails recently with the listings of three high profile firms in the last week. Arm Holdings – a semiconductor design manufacturer – led the charge, followed in quick succession by grocery delivery company Instacart and marketing platform Klaviyo.

The performance of these IPOs had been poor to date, Arm and Instacart have fallen back down to their IPO prices after an initial bump. But investors should be encouraged by the fact that these companies operate in a broad swath of industries. Many investors will point to the significant re-pricing of Instacart from its prior valuation of $39 billion to an IPO price of $10 billion. But the company's IPO milestone is still worthy of celebration. The company achieved a profitable exit for early venture investors and is currently on track to generate nearly $3 billion of revenue in 2023. Klaviyo is perhaps the most notable of the group, as many of the private technology companies that are queuing up to go public are B2B software businesses with similar growth and margin profiles. The recent $500 million Series I raised by Databricks at a $43 billion valuation, which is higher than its most recent private valuation, and the $28 billion acquisition of Splunk by Cisco, adds to the evidence that demand for the highest quality technology assets remains quite strong.

IS TIGHT MONEY HURTING?

Economic developments in the US have been better than most expected this summer. Inflation has declined – albeit not as much in August as had been hoped – while unemployment has stayed below 4% and consumer spending has outperformed. Does this mean that the Fed's sharp monetary tightening did not pack as much of a punch as expected? Or that the impact on rates is still working its way through the system?

Views on that question differ. But one thing is clear. Economic pessimists were wrong to believe that inflation could only be brought down significantly with a sharp rise in unemployment. Inflation this summer has been running at between 2.5% and 4%, depending on how it's measured (for a discussion of the measures, see last week's RockCreek letter). This is far below the 9% headline peak in mid-2022. Meanwhile, job vacancies continue to outnumber those looking for work and unemployment has risen only slightly. New unemployment insurance claims dipped in the latest weekly data and job growth has remained robust, albeit at a lower rate than in the early months of the post-pandemic recovery.

Looking ahead, the key questions remain the same. Can the Fed bring inflation down the "last mile" to 2% without further tightening? And is a soft landing – without a recession – still in play?

GETTING TO 2 PERCENT

Price and wage data in the upcoming weeks will answer the first question on inflation. A slim majority of Fed central bank policymakers expect another rate rise this year. That will depend on economic developments for the rest of 2023. Don't expect a move at the next Fed meeting, on November 1. Not enough data will be published between now and then – on inflation or growth – to make the economic picture much clearer. By mid-December, when the Fed will again update its quarterly projections for the economy, the central bank will have a slew of additional data.

There are two clear risks to inflation that could darken the picture in the coming weeks. The first is the resurgence of energy prices. Russia this week announced a squeeze on diesel, on top of the oil production cuts agreed with Saudi Arabia. Oil prices are hovering just under $95 a barrel, and some predict they may hit $100. In the US, in particular, energy prices feed through quickly to consumer expectations. Gas prices at the pump are perhaps the most salient metric for guiding American households' views on the economy and inflation.

The second threat comes from the United Auto Workers (UAW) strike, which is set to broaden this weekend if the two sides cannot reach an agreement. Estimates of the costs of the strike depend on the length of the stoppage. According to sell-side estimates, the strike could shave less than 0.1% from GDP or as much as 0.6% if the strike lasts as long as in 1998. As with the energy price increase, the strike is a threat to both output and inflation.

LANDING NOT SO SOFT?

Many interpreted the Fed as buying into the soft landing scenario this week. Chair Powell said that was not his baseline scenario. But, as former Vice-Chair Donald Kohn noted during a discussion hosted by the American Enterprise Institute (AEI), the new Fed forecasts look like a "perfect soft landing", with inflation drifting down to 2% while unemployment hardly rises and the economy grows at close to potential. That makes the stock market response puzzling. Perhaps investors have awakened to the risks to growth from the continued fight against inflation.

Upcoming data will likely show that the long-expected slowdown in the US is underway. Consumer spending will be boosted as usual by the fall and winter holidays. But the burst of travel and services spending that kept consumption strong over the summer will subside. At one of the discussions this week about where the economy is headed, chaired by Official Monetary and Financial Institutions Forum (OMFIF), former New York Fed President William Dudley predicted that the US will be much weaker in Q4. In addition to the dampening effect on output of higher energy prices and the UAW strike, Dudley pointed to the restarting of student loan repayments and the likelihood of a further rate rise as the Fed's 2% goal stays out of reach. This in turn is likely to tip the US into recession, albeit a gentle one, argued Dudley. Once job losses begin to accumulate, consumer confidence will be affected, then business investment and hiring will lead to a "tipping" point into recession.

Other former central bankers also weighed in during the AEI discussion. On whether "the Fed has produced a soft landing", Former Fed governor and critic Kevin Warsh agreed that a soft landing was "unlikely" while pointing out that the Fed alone cannot produce the conditions for strong and stable growth. Former Fed Vice Chair Donald Kohn noted that recent signs were encouraging on a soft landing but remained skeptical that things would turn out as well as the Fed's forecasts. He posited nevertheless that there was a decent chance of a "soft-ish" landing. With dysfunction on Capitol Hill threatening a government shutdown and governments building up deficits and debt, it is fair to question whether the Fed deserves all the blame – or credit – for what happens next to the economy.

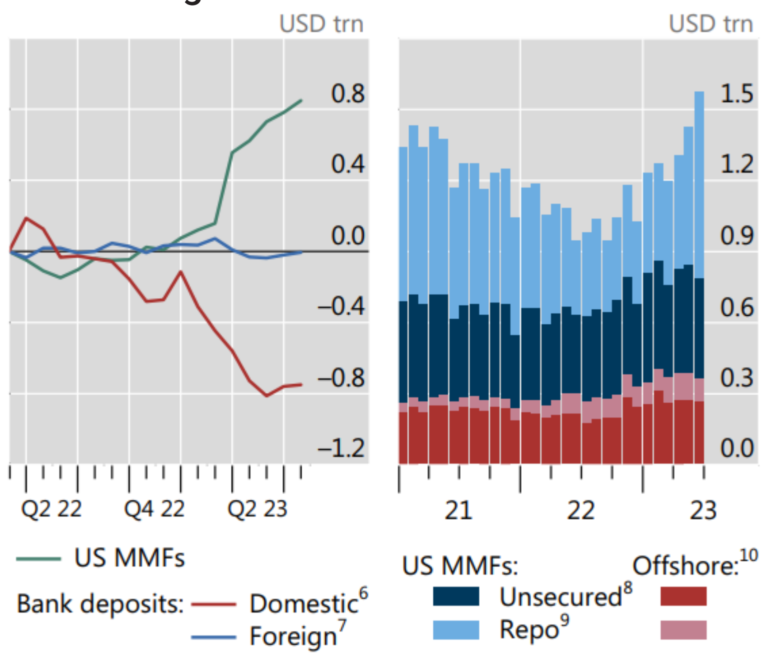
BANKS AND NON-BANKS TIED TOGETHER

We are now six months on from the March banking crisis that saw the collapse of a number of mid-sized American banks and one large European bank. Repercussions from the failure of Silicon Valley Bank (SVB), among others, and the forced sale of Credit Suisse to its rival, UBS, have been contained, contrary to the fears of many observers. This is due at least in part to rapid action by central banks and governments to ring-fence weak institutions, while keeping monetary policy separate, as Rebecca Patterson noted in the OMFIF discussion. The strength of consumer balance sheets has also limited the pain for banks. However, the game is not yet over.

Real estate was at the epicenter of the last pre-pandemic recession in 2008. That is not the case this time around, particularly in the US, where households are less leveraged and rely more on longer-term borrowing than in other countries to finance mortgages. But real estate is still a weak link in the economy.

Another weak link is that between banks and non-banks, as laid out by the Bank for International Settlements (BIS) in [a recently]

US bank deposits decline sharply as MMF assets surge



published research note and summarized neatly by Adam Tooze. Banks are facing a number of headwinds as rising rates put further pressure on margins. Meanwhile, non-banks have been growing in size and importance. These institutions are not subject to the same regulatory requirements as banks and as such can be much more levered. According to research firm Prequin, non-bank credit has grown by more than $100 billion in 2023 and now sits at $1.5 trillion - a 300% increase over the last decade. Meanwhile, the US banking system's total lending has grown a paltry 1.1% year-to-date and 70% since 2013. As banks retreat from the lending arena, other creditors appear to be stepping in to fill the void, which may expose the financial system to additional vulnerabilities.

TRAGEDY OF THE COMMONS

While most agree that climate change is the biggest challenge our planet faces, speeches by world leaders this week seemed to diverge on the urgency in addressing the climate crisis. Leaders at the UN General Assembly highlighted the need for countries to step up their efforts to reduce emissions, but to also increase financing for low- and middle-income countries. But while the US Treasury a new set of voluntary principles to promote consistency and transparency across financial institutions' net zero pledges, UK Prime Minister Rishi Sunak made a sharp pivot away from net zero by announcing a number of changes to the UK's climate policies that critics argue hurt the country's place as a global leader on climate.

Despite the commitments made in recent years, it remains clear that there is a long way to go to reach net zero. There is nearly $200 trillion in assets owned and managed globally by the largest financial institutions. Of course, while not all of it is readily available to deploy, innovative financial approaches and scalable technologies show that it is possible to redirect large swaths of capital towards transformative solutions. But the biggest hurdles for successful climate policy appear twofold: diverse standards on what counts as "green" or "sustainable," and the absence of an enforcement mechanism that provides incentives to maintain the net zero path. This leaves little incentive for stakeholders to make meaningful change. Reaching a standardized, cohesive, and legally binding international agreement will be tricky. And this week's UN Climate Ambition Summit offered a sneak peek of the battles to come.

A MIXED BACKDROP FOR EMERGING MARKETS

Emerging markets were broadly weaker this week, led by underperformance in North Asian markets. Although the Fed took another breather, it also signaled one or two more hikes may be necessary before the tightening cycle can be archived. Equity markets across Asia reacted negatively as investors digested the implication of higher for longer rates. Most Asian currencies corrected against the dollar. Chinese banks and property developers had a particularly tough week given the outlook for property prices. Moreover, commercial banks in China continue to grapple with a rash of mortgage prepayments, which is weighing on earnings. The People's Central Bank of China unveiled new guidance last month, lowering the interest rate burden on outstanding mortgages for first home loans. While this is expected to disincentivize prepayments, the policy will not go into effect until September 25th. In the meantime, prepayments have continued to climb. Estimates suggest nearly $700 billion in mortgages – or 12% of the country's total mortgage balance – has been prepaid since 2022.

Outside of Asia, Latin American markets had a better week, led by Mexico and Brazil. But investors there, too, found themselves grappling with the implications of the Fed's medium term policy stance. In Mexico, higher than expected retail sales data point to consumption patterns that buoyed markets. But the hope that this would give the Mexican Central Bank room to maneuver on rates was dampened by the Fed's decision this week. In Brazil, the central bank cut the reference Salic rate by 50 bps and signaled further cuts ahead - this put pressure on the Brazilian real but boosted sentiment for equities at the local level.