BUMPING ALONG?

The US economy is doing considerably better overall than bumping along. But Federal Reserve Chair Jerome Powell was right when he commented this week that the path to the Fed's goal of 2% inflation is bumpy. February's consumer price report released last week showed that US inflation is still running well above that goal. It topped 3% over the year. And with gas prices turning up again, albeit only marginally so far, there is plenty for the consumer to worry about.

So far, the central bank is not too worried. At this week's eagerly awaited Fed meeting – which included new projections for the economy – Chair Powell and colleagues held steady. As expected, they left the policy rate at the 5.25-5.5% level that it has been at since last July. They also stuck to the December view that interest rates have peaked and are likely to be cut three times this year. Investors saw this as good news. Markets that had been concerned by the recent disappointing inflation numbers were relieved that the Fed was not signaling a tighter path. Equity markets continued their strong run with the S&P 500 and Nasdaq ending the week up 2.5% and 2.9% respectively.

Few central banks have yet moved rates down – the Swiss National Bank is an outlier with this week's surprise decision to cut rates. But the mood music is clearly shifting in that direction – at least in much of the Western world. The Bank of England held rates steady on Thursday, but two hawks on the monetary policy committee changed their previous call to raise rates and supported the majority. In Canada, newly released minutes of this month's policy meeting showed the central bank expects rates to go down later this year.

On the other side of the world, Japan's central bank also pleased doves this week by being less hawkish than feared. The bank executed an historic change in policy as the Bank of Japan raised its policy rate for the first time in 17 years, into positive territory. But the BoJ indicated that it may be a while before it hikes again. Unlike in the US and other advanced economies, Japan has been waiting and hoping to see inflation climb up sustainably rather than come down.

Governor Kazuo Ueda, marking his first year in office next month, waited longer than some had expected. He was determined to avoid earlier mistakes when Japan moved away too soon from easy money and saw deflation tighten its grip. Although price inflation moved into positive territory, briefly hitting 4.3% in the immediate post-Covid era, Governor Ueda was waiting for wages to start rising. That has now begun. As described below, investors have cheered.

Governor Ueda's counterpart in Europe, European Central Bank President Christine Lagarde, has also signaled the importance of wages. But she is waiting for wage rises to decelerate, in a lasting fashion.

WHEN IS A BUMP MORE THAN A BLIP?

The Fed's message was not unambiguous. Some caution about inflation has crept in. Although the average expectation for rate cuts this year stayed the same, at 75 basis points, fewer of the policy making committee members expected a bigger drop. The expected rate declines in 2025-2026 were also shaded down. And for 2024, the central bankers now anticipate slightly higher growth and inflation than projected three months ago.

This combination of a stronger economy with unchanged rates expectations has led some to question whether the Fed's focus on getting to 2% has lessened. That is not the case. Chair Powell remains convinced that allowing inflation to rebound would be a big mistake. His willingness to hold steady now instead reflects a view that current policy is already restrictive and will thus contribute to a continued easing of inflationary pressures. As he put it in his Wednesday press conference, "risks are really two-sided".

THE OTHER RISK

So far, the risk of recession and sharply rising unemployment has not materialized. Strong US growth and continued hiring have confounded the pessimists who thought that a growing economy could not be combined with declining inflation. The latest employment data showed an uptick in unemployment last month. But at 3.9% it is still historically low – and below the level that the Fed and most economists predict for the end of this year. And job growth remained healthy in the first months of the year, according to employer payroll reports.

However, there is a risk that special factors that kept post-pandemic spending high – notably stimulus checks and higher government spending more broadly – may have merely delayed the impact of tight money. On this view, the hit to incomes and spending of higher interest rates on auto loans and credit cards, higher rents, and higher mortgage costs may still be coming. There is some evidence that those on lower incomes are finding it more difficult to keep up payments. Some slowdown in growth is likely after the economy outperformed in the second half of last year. But the odds are still favorable that recession can be avoided. And, as the Fed has indicated, if an "unexpected" weakness in labor markets shows up, it has the scope to address that risk.

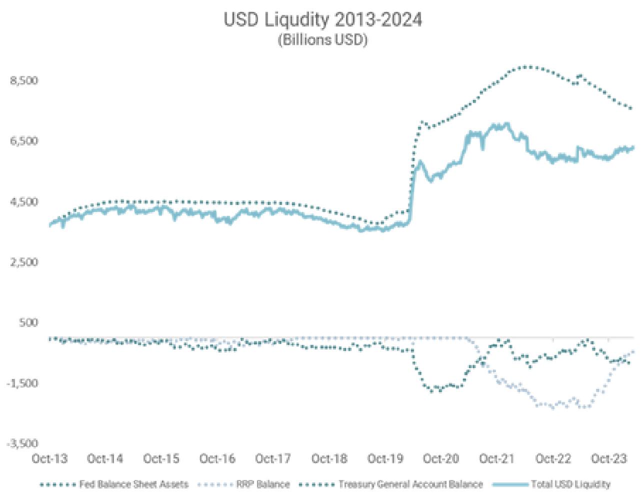
IMMIGRATION IRONY

By now, both strong supporters of immigration and those against it believe that the situation on the US southern border is a problem. Voters, whether in the US or Europe, do not like apparently uncontrolled flows of migrants seeking asylum coming into their countries and then being supported by the state. The irony is that immigration – when those coming are able to work – has been boosting US growth and helping to solve the inflation problem over the past year. A significant increase in immigration helped to meet labor shortages post-pandemic and support US GDP which grew by 3.1% last year, far above expectations. Looking ahead, the demographic challenge of falling birth rates in many advanced – and some emerging – economies is only set to increase. In the long-term, extreme weather events and water shortages will also impact immigration from these countries.

RATES

As discussed above, one of the biggest outcomes of the FOMC was the new set of Dots. The subtle shift in the Fed's projections caused the bond market to reprice in a few notable ways. First the yield curve bull steepened, with 2s10s unflattening by 8bps initially, and ending the week 4bps steeper at an inversion of 38bps. In addition, the standalone probability of a rate cut in June increased to 69% from a bit under 60% going into the meeting. All major points on the curve are marginally lower post-FOMC, and market pricing is generally in line with Fed expectations of three cuts by the end of 2024.

Another major focal point came in the post-meeting press conference and shed some light on the Fed's thinking around quantitative tightening (QT). Since the Fed's balance sheet began to shrink in 2022, this episode of QT has struggled to drain as much liquidity as intended. Assets on the Fed's balance sheet have not rolled off as fast as was hoped for due to slow prepayment speed on mortgages held by the Fed. Additionally, the amount of asset runoff has largely been neutralized by other liquidity mechanisms. The Treasury General Account (TGA) has acted as a buffer on balance sheet runoff as the balance was spent down amid the recent debt-ceiling showdown. More recently a dramatic fall in Reverse Repo (RRP) facility utilization has offset both asset rolloffs and the rebuilding of the TGA account as issuance of treasury bills with more attractive yields draw funds that were originally parked in the RRP.

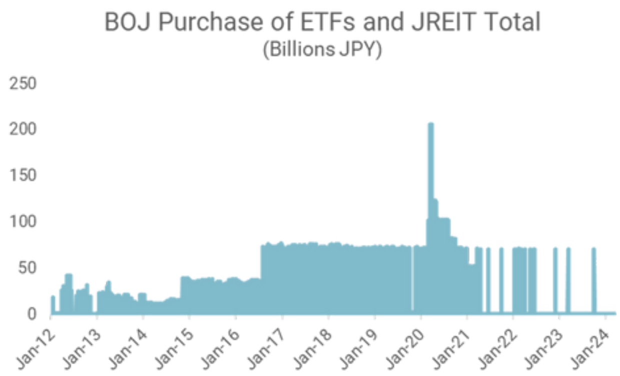


Despite higher-than-expected levels of liquidity in the system due to the above factors, pundits and investors are beginning to keep a watchful eye on the amount of liquidity in the system and, more importantly, the impact that has on bank reserves. Chair Powell mentioned early in his comments that the committee may find it appropriate to lessen the pace of runoff “fairly soon.” When asked for specifics, Powell was reluctant to give additional details on timing as it is an ongoing decision, but he did make clear that the Committee is focused on dialing back the pace as soon as appropriate to avoid impacting bank reserves and triggering another funding crises like the one that occurred in September of 2019.

Asian markets saw some interest rate action this week as well. As detailed earlier, the Bank of Japan took some dramatic steps in adjusting its monetary policy at its most recent meeting. Japanese bonds reacted strongly to the news, but perhaps not in the way most would expect. Upon the official ditching of yield curve control, the 10yr Japanese government bond yield actually fell by 3bps, ending the week 4bps lower. This development shows that the policy had, in effect, ended months ago when the BoJ originally widened the trading band around the 10yr rate to an effective cap of 1%. This cap was never really tested, with the 10yr yield climbing as high as 96bps in November of last year before quickly reversing.

EQUITIES

Much like their fixed income counterparts, Japanese equities were unfazed by the BoJ’s shift in policy. Since March 1, the MSCI Japan is +3%, bringing the month-to-date return to 5% and YTD 20%, which is handily the best major market equity returns YTD. A continued move higher for Japanese equities is possible given continued supportive dynamics despite the monetary policy adjustment. Most simply, interest rates on cash are still effectively zero, leaving a strong incentive to put an increasing portion of Japanese households’ approximately $14 trillion in savings into riskier assets. Additionally, and quite interestingly, despite the BoJ ending its ETF purchase program as part of this policy tweak, the facility has been little utilized since 2020. From a valuation perspective, Japanese equities are still attractive despite their multi-year strong performance. On a trailing PE basis, MSCI Japan trades at 18x, while ACWI is around 21x, and the S&P 500 at 25x earnings.



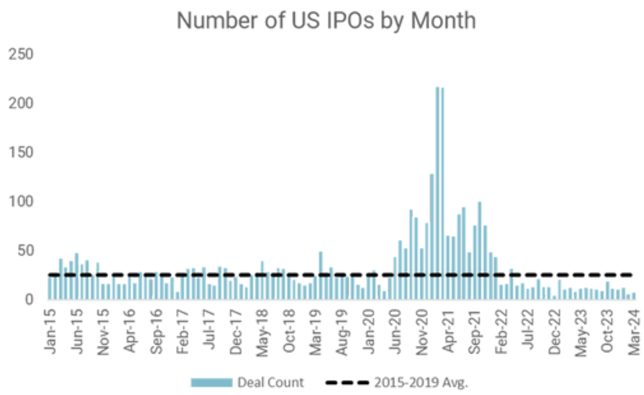
DOJ TAKES A BITE OUT OF APPLE

RockCreek has written recently about the once Magnificent 7 flopping to a Fab Four as Alphabet, Tesla, and Apple have lagged their mega-cap peers and the broader index. In fact, Apple and Tesla are the two largest negative contributors to the S&P 500 this year, and Tesla is the single worst performing stock, lagging even beleaguered Boeing. Apple got more bad news on Thursday of this week as the Department of Justice and sixteen states sued the company on anti-competitive grounds for blocking access to hardware and software features by the company's rivals. This latest suit marks the third time in 14 years that the DOJ has sued Apple, and it comes less than a month after a €1.8 billion fine from the EU for the company shutting out rival music services on its iPhone.

Apple isn't the only tech company making headlines for potentially running afoul of US regulators. RockCreek's private markets team recently wrote a short memo detailing the valuation impacts of a worthless TikTok.

PARTY LIKE IT'S 2021?

Equity markets at an all-time high coupled with expectations for easier monetary policy has sparked speculation that we could be in the early innings of an IPO market rebirth. Two successful and high-profile IPOs this week from AI-focused Astera Labs and social-networking platform Reddit have added fuel to that fire. Should equity markets continue to be supportive of equity valuations there is a decent backlog of private companies that could go public in the coming months. Some of the more high-profile candidates include companies such as Stripe and Databricks. 2021 was a truly exceptional period however, and it should probably not be taken as the litmus test for a standard, healthy IPO market. When looking at a longer time horizon even, if IPOs are poised for a sustained upswing, we are in the early stages.



EMERGING MARKETS, DIVERGENT POLICIES

It has been a busy month for central bankers in the emerging world as well, with a few dramatic policy actions taken this week. First in Turkey, inflation continues to be a problem with YoY CPI running well above 60%. On Thursday the central bank took the unexpected move of hiking rates by 500 bps to bring the policy rate to 50%. Meanwhile in Czechia, an early hiker, inflation has fallen back down to 2% YoY, which enabled the central bank to reduce rates for the third consecutive meeting. Latin America has also seen a spate of easing from its central banks. On March 12th Argentina cut its benchmark reference rate from 100% to 80%. This week saw three major policy meetings. On Wednesday Brazil cut its benchmark Selic rate by 50bps. Mexico followed suit on Thursday cutting 25bps, finally joining its Latin American peers in beginning its easing cycle. Colombia cut 50bps on Friday the 22nd, after cutting in January. We will have to wait until April to see what Chile does after cutting in January as well.

OIL - VOLATILITY AHEAD FOR HEADLINE CPI?

Earlier this month OPEC+ agreed to extend existing production cuts through July of this year. Since October 2022 the group of oil producing nations has reduced production by an aggregate of just over five million barrels per day. Despite the reduction in supply, oil is (with a few jumps and drops) essentially flat over that time period at approximately $85/bbl for Brent. From an inflationary perspective this flat, albeit choppy, price action has been deflationary for CPI due to favorable base effects. Those dynamics are shifting and base effects are becoming more variable and less favorable. Should Oil continue to stay relatively range bound the effect would most likely be to create noise in the headline inflation data, but nothing more. It is worth watching, as always, should prices break out to the upside from here.