HIGHER FOR – HOW MUCH – LONGER?

The mantra “higher for longer” has been everywhere this month in discussions of US interest rates. Economic strength and higher than hoped for inflation have both contributed. This week, good news was bad. Robust data for orders in May outweighed the boost from Nvidia’s spectacular Q1 earnings to send US equities down by 1% on Thursday. Market participants worried that interest rate cuts would be postponed with central bankers wondering whether today’s monetary policy is not as restrictive in curbing demand as they had thought. By Friday’s close, however, markets were higher, ending the week flat.

Despite better inflation data for April, when consumer prices rose by 0.3% in the month and 3.4% from a year earlier, US central bankers have used their latest speeches to caution against hopes of early rate cuts. In their last meeting, some Federal Reserve policymakers went even further. Minutes released this week showed some were sufficiently concerned in the April 30/May1 meeting to indicate a willingness to consider hiking rates if inflation did not improve.

In Europe, expectations are quite different. Earlier this week, President of the European Central Bank (ECB) Christine Lagarde confirmed that there is a “strong likelihood” of a rate cut at the ECB’s next meeting in early June. That makes sense. The European economy has been weaker and inflation lower, at 2.4% in April, than in the US. Rates have been high enough for long enough on that side of the Atlantic.

Politics will likely interfere in the UK. Prime Minister Rishi Sunak’s surprise decision this week to call an early election, on July 4, makes it more difficult for the Bank of England (BoE) to begin easing in late June. There is also an economic reason to delay. Commentators trying to understand Sunak’s timing pointed to a better inflation report released this week, showing prices up by just 2.3% in the year to April. But markets and BoE economists had expected better, given a cut in (regulated) electricity prices.

The stronger US economy does not rule out some easing this year. The Federal Reserve is still on balance, likely to cut rates in September, with clearer guidance after the mid-June meeting. By then, there will be more data to mull over – including the Fed’s preferred inflation measure for April, due out next week, a wealth of labor market indicators in early June, and the first indication of consumer inflation for May, to be released just as the central bankers meet.

THE LAST MILE … AND THE LONGER TERM

What does “higher for longer” mean for investors? At RockCreek, we have been focused on this theme for some time. The shift in market expectations for rate cuts this year has been in line with our view that the Federal Reserve will remain focused on inflation until a credible path close to 2% is assured. But this may be a slower process than seemed likely late last year. The reason for that is the surprising resilience of American consumers and business in the face of rapid – and sustained – monetary policy tightening.

The so-called “last mile” issue, with disinflation sometimes compared to the effort to lose weight, is not a mystery. Early in the disinflation process in the US and elsewhere, an easing of supply conditions triggered sharp declines in prices of

goods that had been in short supply – and high demand – during the pandemic lockdowns. Energy prices that shot up in the aftermath of Russia's invasion of Ukraine two years ago also came down as demand in Europe adjusted to the relative price change and supply shortages. This unwinding of the pandemic (and war) related price increases could be compared to initial weight declines after ending excess holiday eating. Not so hard.

The disinflation phase we are in now depends more on underlying price moves in the services that make up the bulk of the US economy and for which demand spiked as lockdowns were lifted. These prices are harder to shift without impacting jobs and growth. Labor costs play a critical role in determining "underlying" service inflation. Perhaps more like the tough phase of a diet when newly restrictive eating patterns have to be sustained, although hunger is biting – in this case higher prices cutting into real incomes.

Concerns of a wage-price spiral weighed on the Fed at the peak of the inflationary surge. Chair Jerome Powell pointed repeatedly to the various measures of tightness in US labor markets, as vacancies opened up and job-seekers remained scarce in the immediate aftermath of the 2021/22 inflation. As we now know, labor supply has come back with surprising vigor, partly due to increased immigration. The feared spiral did not take off. And more recent jobs data suggest that the labor market is now cooling down, with vacancies dropping overall and employers reporting less demand for college graduates. But while not accelerating, wage growth has remained higher than is consistent with the Fed's 2% goal of price stability. Housing costs, a big part of the cost of living, have also stayed stubbornly high, despite the rapid climb in interest rates over the past two years.

Some now wonder whether tight money does not impact as quickly or broadly on demand as in the past. The channels through which higher interest rates affect demand have always been somewhat narrow, with the impact bearing initially on housing, investment and trade, mostly of goods, through a stronger dollar and weaker net exports. With US consumers and most companies quite liquid – at least until recently – and services less affected by international trade, the Fed's monetary squeeze may need to last longer or bite more deeply to bring inflation back down.

Some observers – including Mohamed El-Erian – now argue that the price for returning to 2% inflation in terms of higher unemployment and lower output is not worth paying. Fed officials may privately have sympathy for that view. But they will not be ready to embrace it until they are certain that credibility in monetary policy is assured and inflation expectations for the longer-term are well anchored.

BEYOND THIS CYCLE

Looking further ahead, the more fragmented world economy that is slowly coming into place will put upward pressure on inflation – and interest rates. A new study from PIIE, a well-respected economics think tank in Washington, lays out estimated costs in terms of lost income and growth if former President Trump's tariff proposals were put into effect. The costs – estimated at $500 billion – would fall most heavily on lower income households, the authors argue. Those households are the ones that benefit the most from lower prices of cheap imports and the least from the planned cuts to income tax that would be partly financed by tariff revenues. The study estimates that middle class families would be $1,700 worse off annually under the combination of higher tariffs and lower taxes in the Trump plan.

President Biden has also just announced sharp tariff increases on certain goods from China. He argues that without this action, heavily subsidized Chinese production would undercut American companies' efforts to use green technology and manufacture "green" goods, notably electric vehicles.

Ahead of a meeting this week of leading G7 finance officials, Treasury Secretary Janet Yellen tried to persuade her European colleagues to follow the same path. The reception from European Commission President Ursula von der Leyen was not encouraging for the US view. The EC, which has responsibility for trade for the whole EU, prefers to "de-risk" and pursue remedies through the World Trade Organization (WTO) than to de-couple from China, von der Leyen said.

INFLATION HURTS

Inflation is unpopular. Higher prices cause sticker shock that people remember even if wages then grow to offset the impact on living standards. This is one reason President Biden scores so much less well than former President Trump in polling about economic performance.

Inflation also hurts wealth. A comparison of net wealth changes under the two presidents published in the Wall Street Journal, and based on Federal Reserve bank data that takes account of debt as well as all assets, shows similar outcomes under the two presidents – before adjusting for inflation. But once inflation is taken into account, the increase in overall net wealth in the first three years of President Biden's term shrinks to almost nothing.

There was a high point for many households – in 2021. A broader survey by the Fed of "economic well-being" among American households, released this week, showed that while there was little change in people's overall financial well-being in 2023 from the previous year, both years showed a sharp decline from the high reached in 2021. That was before inflation took off, but after the fiscal boost and stimulus checks that swelled savings during the pandemic. While most Americans feel financially "OK" and able to cover an unexpected expense of $400, many feel hurt by inflation and high interest rates.

RATES AND FX

Inflation and central bank data released in the past few weeks have caused significantly more action in short-term interest rate markets globally than in longer-dated bonds. In the UK, it was the inflation data discussed above that sent bets on future policy rates materially higher. On May 22, December 2024 Sterling interest rates rose by 17 bps. The price action essentially removed an entire predicted cut from the BoE this year. Pricing shifted from at least two cuts to just one, with a slight probability of an additional cut. Expectations for the ECB have remained relatively unchanged, however. Markets continue to price in a 90-100% probability of an interest rate cut in June, as supported by the ECB's president. Ongoing data dependency messaging from the Fed has moved US expectations from greater than two cuts to just under one and a half by year end since the well-received CPI print on May 15. Finally, in Japan, markets are betting the opposite way and are now pricing that the BoJ's policy rate could move from 0.1% to 0.4% by year-end.

The abrupt shift in the short-term interest rate differential has driven strength in the GBP. The Pound has appreciated against both the Dollar and the Euro in the past few weeks. Strength against the dollar started with the US CPI print and continued in the wake of the UK's own CPI print. Euro strength started around the same time but has been more pronounced. GBP is also at a near 20-year high vs. the JPY.

COMMERCIAL REAL ESTATE

The long and variable lags associated with tight monetary policy may be starting to bite as a very rare default occurred earlier this month when a triple-A rated tranche of a Commercial Mortgage Backed Security (CMBS) was hit with a 26% loss. This is the first default of a triple-A tranche since the Great Financial Crises. The CMBS in question was a SASB (single-asset, single-borrower); the only property linked to the security was 1340

Broadway, a midtown NYC office building of which one lessee occupied nearly 80% of its leased space. In early 2022, that lessee abandoned the space. The building was sold a few weeks ago at a steep discount, leaving not enough capital to repay debt investors.

Being a SASB, the instrument in question would have been relatively straightforward to underwrite as investors would need only focus on the one building and the associated economics for that property, leaving little room for potential alpha. This contrasts with a conduit CMBS, in which loans for multiple properties are packaged together. To the extent investors are finding alpha opportunities, they are doing so by performing detailed analysis on conduit CMBS, attempting to identify the so-called "fulcrum" tranche. This tranche is estimated to be the one that is in closest proximity to tranches that will receive full impairment, but it will be far enough up in the cap structure to not actually take any losses from the poor performing assets underneath. Hopefully, the combination of a low price for the tranche due to its proximity to danger and accurate underwriting will produce an attractive return for investors.

These past week's events demonstrate why an abundance of caution is still needed when sifting through what appear to be attractively priced commercial real estate-related assets. According to data compiled by Trepp, office CMBS delinquency rates have increased from 1.6% in December of 2023 to over 7% in April of this year. This increase in delinquency rates is most pronounced in floating rate loans which are running at nearly 24% – up 5% from a year ago. Even for exceptional underwriters, increasingly negative sentiment could drive tranche prices even lower from here, causing mark to market drops in portfolio assets. Time will tell if the market has hit a bottom, but for now it seems prudent to proceed with caution.

EQUITIES

While Nvidia continues to power ahead, the past few weeks have seen more mixed performance for equities. The Nasdaq finished the week in positive territory, while the S&P 500 finished flat - this split was even more pronounced looking at the S&P 500 Equal weight, which is significantly behind its market cap-weighted counterpart both for the week and the month. The Dow has performed even worse, falling 2% this week, highlighting the impact of less large-cap tech exposure. Additionally, non-profitable tech companies are down 4% this week. In essence, the repricing of Fed expectations is weighing on many of the equities that are not supported by the fizzy-lifting-drink that is AI.

The likes of Microsoft, Google, and Nvidia are not the only companies to benefit from the continued surge of AI. In emerging markets TSMC has performed strongly, European ASML has also done well as part of the same supply chain. Investors are even starting to look for more ancillary opportunities, including Utilities, to take advantage of the shifting dynamic.

From a macro perspective, Japanese equities have kept pace with the US over the past few weeks, rising 1% vs. the S&P 500 which is +2%. Europe is a similar story, rising 6% for the month of May, the same as the flagship US index. Laggards are the equities most exposed to the negative effects of higher-for-longer rates here in the US. Small-caps have lagged, but are particularly weighed down by their low profitability and debt laden constituents which are down 3% and 2%, respectively, while the broader based Russell 2000 is -1%. One interest rate sensitive sub-sector is bucking the trend, however. A Goldman Sachs basket of renewables is up 5% over the past five days and 15% over the past month. This strong performance is being driven by First Solar, which is up 55% YTD.

COMMODITIES

The creation of yet another financial acronym – BEGS – for Bitcoin, Ethereum, Gold, and Silver begs the question: “Do these four things belong together?” The rationale for grouping these assets together is based on a few attributes: assets that lack any cash flow; the belief that they are an alternative to fiat currency; and their recent price performance.

Working in reverse order, the recent run up in all four assets has been quite surprising at first blush. Monetary policy is tight in most of the world and long-term real rates have risen quite substantially alongside these assets. That is certainly a break from expected behavior and could signal some nervousness about the path of inflation going forward, and in both directions – i.e, un-anchored inflation could drive debasement fears while falling rates could drive investors out the risk curve.

If debasement fears are driving the price moves it is not clear that Ether should be included. While Bitcoin is presented as an alternative to central bank currencies, Ether has a notably different primary function as the functional currency for on-Ethereum chain transactions. While there are many proponents of Bitcoin as digital gold, its short empirical record as a store of value amid runaway inflation and the uncertainty of central bank efficacy falls far short of gold.

It is true that none of the four assets have associated cash flows, but given the above differences, the price action is likely being driven by separate factors. As RockCreek has written about in the past, price action around Bitcoin this year has been supported by the approval of Bitcoin-linked ETFs and subsequent trading of those instruments. It is reasonable to argue that Thursday afternoon’s approval of a spot Ether ETF by the SEC, and the hype leading up to it, has driven the price of the crypto-asset in recent weeks. Support for gold has likely come from its position as a store of value. Data from the World Gold Council shows that central banks have been aggressively purchasing gold as a way to diversify their foreign reserve holdings.

For those interested there is a short (and fun) radio segment from Planet Money in 2010 where a chemist goes through the periodic table demonstrating chemically why Gold is the preferred physical store of value. Two other related tidbits given the focus on precious metals and crypto:

1. In 1929 and today, 10kg of gold is slightly more than enough money to afford the average US home.
2. Fourteen years ago on May 22, a Florida programmer spent 10,000 Bitcoin to buy two Pizzas, inadvertently creating the holiday Bitcoin Pizza Day – he paid with “currency” that would now be worth almost $700 million.