

Markets conclude the Fed needs 'a bigger boat'

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How many hikes are ahead?

Markets believe the US Federal Reserve is going to need a bigger number of rate hikes to try to slow demand and control inflation.

Markets are concerned

More aggressive tightening increases the risk that the Fed could choke the US economic cycle and cause a recession.

The challenge for the Fed

We still think the Fed can negotiate a soft landing, although it will be harder if more aggressive tightening is required to lower inflation.

As a regular reader of this blog might have already realized, one of my favorite movies is “Jaws.” There are so many great lines in it (I am particularly fond of Quint’s command that “Hooper drives the boat, Chief”). But my absolute favorite line is when Chief Brody actually sees the great white shark for the first time. It is then that he realizes they are dealing with a monstrously large creature. He nervously utters, “We’re going to need a bigger boat.”

Friday was that “bigger boat” moment for the US Federal Reserve (Fed), at least as far as markets were concerned. The headline Consumer Price Index (CPI) came in above expectations at 8.6% year over year, exceeding estimates of 8.3% — and exceeding the previous month’s reading of 8.3%.¹ So inflation has yet to peak. What’s worse, even if the next inflation number comes in below 8.6%, some market participants will worry that later inflation prints may again rise, given that oil and other commodity prices are now rising again.

How many rate hikes does the market expect?

The key takeaway is that markets believe the Fed is going to need a bigger boat — in other words, a bigger number of rate hikes to try to slow demand and control inflation. The market is now expecting nine to 10 interest rate hikes between now and early 2023 — with 50 basis point hikes priced in at each of the next three Federal Open Market Committee (FOMC) meetings — and some market participants are beginning to believe that the Fed may hike by 75 basis points at its next meeting.²

Adding to the likelihood that the Fed could get more aggressive, the University of Michigan Consumer Inflation Expectations were also released Friday, showing a big jump in consumers’ expectations for future inflation for five years out. Recall that the Fed wants to see that longer-term inflation expectations are reasonably well-anchored. That’s because when longer-term inflation expectations are not well-anchored, consumers will typically buy today assuming prices will be going up, which only exacerbates inflationary pressures and makes them more persistent.

Five-year-ahead inflation expectations had been holding steady at 3% for the last several months but now have jumped to 3.3% in the June preliminary reading.³ Now, the reading is still not terrible — consumer inflation expectations for five years out were much higher in the early 1980s and even the early 1990s.⁴ But still, this is the highest level for five years ahead inflation expectations in more than 10 years. (It was higher during the Global Financial Crisis but came down quickly) and suggests longer-term inflation expectations are getting less well-anchored.

US market reaction was extreme

Markets are very disturbed by this development because more aggressive tightening increases the risk that the Fed could choke the US economic cycle and cause a recession. There was an extreme reaction on Friday in both the stock market and the bond market given the potential for higher rates and a heightened risk of recession, and that has continued into Monday. The 2-year US Treasury yield rose significantly on Friday, closing above 3.04% — an increase of 23 basis points in one day — and is up another approximately 20 basis points on Monday, as of this writing.⁵ The 10-year US Treasury yield also rose but not nearly as much, up 11 basis points to 3.15%, and then up another 18 basis points as of this writing on Monday.⁶ The result is that the yield curve flattened significantly but has not inverted. A flattening yield curve typically signals an economic slowdown — but not an imminent recession. The S&P 500 is well into a bear market in intraday trading and looks poised to close today (June 13) in bear market territory.

Global markets react

Friday's US inflation print had an impact on markets globally, and that seems appropriate given that the Fed, to a certain extent, is the world's central banker, and could certainly help cause a global recession. European stocks sold off on Friday despite the European Central Bank (ECB) monetary policy committee meeting last week, which suggested the ECB would take a less aggressive approach to tightening than the Fed — but more aggressive than previously expected. UK stocks were also hit hard. In Canada, stocks also sold off but more modestly; that makes sense given the composition of the Canadian stock market with lower valuations and higher exposure to energy and other commodities. Asian markets had already closed by the time the CPI print was released, but markets reacted on Monday with a substantial drop.

It's a tough time to be a central banker

I continue to believe the US will still be able to avoid a recession, although it is clearly heading into a significant slowdown. A slowdown is not a bad thing — it's most likely necessary to reduce inflation and engineer a soft landing for the US economy.

The situation that the US and many other major economies face is that growth needs to slow quickly in order to lower inflationary pressures and expectations. Central bankers are trying to beat the clock — they need to slow demand enough to cool inflationary pressures before they are forced to get more aggressive. The US economy is already slowing with more likely to come. So, I still hold out hope that the Fed won't have to be as aggressive as markets currently anticipate. Admittedly, slowing just enough to cool inflation but not cause a recession is an extremely delicate balancing act given that monetary policy is a blunt instrument, not a surgical tool. So of course recession risks have increased with last week's CPI print and consumer inflation expectations reading.

Outside the US — especially in Europe and emerging markets that rely on imported commodities like energy, food grains and metals — Russia's war with Ukraine has caused a surge in commodity prices on top of the rebound that came on the heels of economic reopening in the West and many emerging markets. The US faces this inflation pressure too but is likely to be less affected than Europe because it is an exporter of energy and food. US consumers are already feeling the pinch in food prices, which may slow US demand for goods and services, helping to reduce headline inflation pressures and slowing the economy overall.

But Europe and emerging markets might also face shortages even with higher prices because the supply of some types of energy is being restricted by embargoes, and the supply of food is impacted by a blockade of Ukraine's ports. Sanctions might also limit the availability of potash for fertilizer and fertilizer itself, which Russia and Belarus export in large amounts. And this means that Europe may face more severe inflation pressure and headwinds to growth than the US.

Put all of this together, and it adds up to be a tougher time to be a central banker than in many years, or even decades. It's going to be difficult to balance the competing goals of capping inflation around 2% while ensuring that the economy can still rebalance to the changing post-COVID and wartime relationships among goods, services, and commodities.

Is there any positive news?

So what can I say that can be comforting to investors at this time?

- The not-so-bad news is that core CPI, while still elevated, appears to have peaked. And core inflation, which excludes food and energy prices, is the measure that the Fed pays attention to, rather than the all-encompassing headline inflation. (Although the Fed's inflation measure of choice is core Personal Consumption Expenditures).
- As I've said before, high prices can be a cure for high prices, because they can reduce demand. A very disappointing data point that we got on Friday was University of Michigan Consumer Sentiment — it showed a dramatic drop. But that could represent a "bad news is good news" scenario in that it could translate into lower demand and cooling inflation -- thereby reducing the pressure for Fed hawkishness.
- This headline CPI print was undoubtedly bad news, but I have always believed that one data point does not change a narrative, and it certainly does not materially change our outlook. We think inflation will soon peak and will start to come down — albeit modestly.
- We still think the Fed can negotiate a soft landing, although it will be harder if more aggressive tightening is required to lower inflation. Indeed, we are not looking at the economy through rose-colored glasses. We recognize that the probability of a "persistent inflation" scenario, in which central banks tighten too aggressively and choke off economic growth, remains very elevated.

Because we believe we are in the slowdown phase of the economic cycle, we modestly favor risk assets (equities, high yield) in this environment but recognize that volatility will likely increase in the face of greater policy uncertainty. I believe this is a time for discernment and selectivity with risk asset investing — focusing on higher quality businesses with pricing power and strong fundamentals.

Looking ahead

All eyes will be on this week's FOMC meeting and Fed Chair Jay Powell's press conference. I am very hopeful that Powell will be able to inspire confidence that the Fed will be able to engineer a "soft landing" — by being sufficiently hawkish but responsive to evolving data. From my perspective, the key is the Fed remaining data dependent. It's not just about inflation but growth too; in my view, being flexible balancing those two mandates will increase the odds of a soft landing.

And by the way, for those who may not remember the plot of "Jaws," Chief Brody and his two shipmates never did get a bigger boat — they were able to ultimately kill the shark with their little boat — not without some damage, but they were able to get the job done. Maybe the Fed will be able to achieve a similar feat.

With contributions from Arnab Das

Notes

¹Source: CNBC, "Inflation rose 8.6% in May, highest since 1981," June 10, 2022 ²Source: Bloomberg, L.P., as of June 13, 2022. As represented by fed funds implied futures, financial contracts that represent the market's opinion of where the federal funds rate will be at a specified point in the future. The federal funds rate is the rate at which banks lend balances to each other overnight. ³Source: University of Michigan Survey of Consumers, June 10, 2022 ⁴Source: University of Michigan ⁵Source: Bloomberg, L.P., as of June 13, 2022 ⁶Source: Bloomberg, L.P., as of June 13, 2022

Important information

This does not constitute a recommendation of any investment strategy or product for a particular investor. Investors should consult a financial professional before making any investment decisions.

All investing involves risk, including the risk of loss.

In general, stock values fluctuate, sometimes widely, in response to activities specific to the company as well as general market, economic and political conditions.

Junk bonds involve a greater risk of default or price changes due to changes in the issuer's credit quality. The values of junk bonds fluctuate more than those of high quality bonds and can decline significantly over short time periods.

The Consumer Price Index (CPI) measures change in consumer prices. Core CPI excludes food and energy prices while headline CPI includes them.

A basis point is one hundredth of a percentage point.

The Federal Open Market Committee (FOMC) is a committee of the Federal Reserve Board that meets regularly to set monetary policy, including the interest rates that are charged to banks.

The Survey of Consumers is a monthly telephone survey conducted by the University of Michigan that provides indexes of consumer sentiment and inflation expectations.

The yield curve plots interest rates, at a set point in time, of bonds having equal credit quality but differing maturity dates to project future interest rate changes and economic activity. An inverted yield curve is one in which shorter-term bonds have a higher yield than longer-term bonds of the same credit quality. A flat yield curve is one in which there is little difference in the yields for short-term and long-term bonds of the same credit quality. In a normal yield curve, longer-term bonds have a higher yield.

Personal consumption expenditures (PCE), or the PCE Index, measures price changes in consumer goods and services. Expenditures included in the index are actual US household expenditures.

Potash is the term used to describe potassium-containing salts used as fertilizer.

A "print" is another word for a report, such as "inflation print."

The opinions referenced above are those of the author as of **June 13, 2022**. These comments should not be construed as recommendations, but as an illustration of broader themes. Forward-looking statements are not guarantees of future results. They involve risks, uncertainties and assumptions; there can be no assurance that actual results will not differ materially from expectations.