Good news on inflation overshadowed by debt ceiling concerns

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Welcome news for US inflation

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Disinflation could halt rake hikes

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Investors remain wary

The looming X-date for the debt ceiling, as well as lingering concerns about banks, has investors concerned about what's to come.

This past Sunday was Mother's Day. I think most moms, including myself, have visions of sleeping late, being served breakfast in bed, and being feted and pampered all day long. However, the reality was somewhat different. I woke up at 6 a.m. to drive my daughter to a basketball tournament two hours away, while my husband stayed home to take my mom to church. When we finally got back home, we were too tired to go out for dinner to celebrate. But while the day may not have looked like the "picture perfect" Mother's Day we see in TV commercials, it was a day that I'm grateful for: I got to spend most of the day with my daughter, I saw my mom, and two out of three of my children gave me very sweet notes and thoughtful gifts. (The third, my wayward college-age son, texted to ask what a good price is for a queen-sized mattress for his senior year apartment rental – but he remembered to follow up after midnight with a sweet text.) I hope all the mothers and mother figures out there had good days, even if they weren't perfect.

Now, let's get to the macro/market picture, which I'd also categorize as "not perfect, but still good."

Welcome news for US inflation

Last week, we got welcome news in US inflation data, which has become arguably more important following the Federal Reserve's de facto conditional pause in early May.

Both the Consumer Price Index (CPI) and Producer Price Index (PPI) data for April confirmed that the strong disinflationary trend continues. US headline CPI rose 4.9% year over year, while core CPI rose 5.5%.[1] Headline CPI has seen a substantial decline in the past year, since its 9.1% peak in June 2022.[1] Core CPI is proving stickier, although core typically follows headline.

Disinflation could halt rake hikes

It's important to note that, because headline CPI continues to move down and the fed funds rate rose 25 basis points in early May, we're now at a point where the fed funds rate exceeds inflation. Historically that has signaled the end of rate hikes. I will make a bold pronouncement: I believe inflation is largely in the rear view mirror, and the Fed will not be hiking again. (In fact, we're hearing language from other central bankers that suggests tightening could soon come to end in other parts of the world, including this from European Central Bank Vice President Luis de Guindos: "We have now entered the home stretch of our monetary policy tightening path."[2])

Of course, not all Fed officials seem to agree. In the last week, Fed Governor Michelle Bowman shared that, "'In my view, the most recent CPI and employment reports have not provided consistent evidence that inflation is on a downward path."[3] She seems predisposed to continue tightening. However, I take her comments with a grain of salt. I do think there's a desire on the part of Fed officials to talk down markets and not let them get ahead of themselves. But when push comes to shove, I think the Fed will not hike again. That is certainly the case if history is a guide.

Investors remain wary

But then why are investors so apprehensive if we're at the end of the tightening cycle and the economy seems quite resilient? I think there are a few reasons:

1. Regional banks continue to be a concern, especially after PacWest's revelation about deposit losses last week. The fear is clear enough – several regional banks and one major global bank (Credit Suisse) have now come under pressure and have had to be taken over, generally with central bank support and calls on deposit insurance. However, these concerns continue to be isolated among some US regional banks and are reflected in their stock prices. Given tightening credit conditions and the substantial percentage of commercial real estate loans made by regional banks, concerns also include commercial real estate. It is true that significant debt is scheduled to mature in 2024 and 2025. However, I think the rate environment will change a lot between now and then. I expect longer-term rates to be significantly lower by the time most debt needs to be refinanced. The silver lining is that the tightening in bank lending conditions is likely to be reflected in lower loan growth, construction, and other kinds of activity, which in turn should further slow inflation.
2. Markets are starting to worry about the damage the Fed has done, that we could see growing weakness in the labor market given the spike in jobless claims. These fears were exacerbated by the substantial drop in the University Michigan preliminary reading on consumer sentiment for May. Consumer sentiment has dropped significantly, from 63.5 in April to 57.7 in May (preliminary), which was well below expectations.[4] Markets reacted negatively, assuming it reflects a rapidly deteriorating economic picture. However, I think the drop in consumer sentiment is being driven largely by the US debt ceiling standoff. A similar situation occurred in 2011, when we saw consumer sentiment fall from 71.5 to 55.8 between June and August of 2011 because of that year's debt ceiling dispute.[5] However, the good news is that back in 2011, poor sentiment was short-lived; it quickly rebounded to pre-debt ceiling standoff levels. And as for the labor market, the spike in jobless claims as well as the slowdown in job openings is just what the Fed is looking for to slow wage increases, overall growth and indeed, inflation.

The X-date looms for the US debt ceiling

And that brings us to the current US debt ceiling standoff, as we hurtle towards the X-date — the day when the US would default on its debt — without any resolution.

We need to look at 2011 as a guide of what might happen to markets this time around. Back then, both US and international stocks began to meaningfully deteriorate well before the projected X-date as credit ratings agencies put US debt under review, and S&P ultimately downgraded US debt. For example, between July 1 and Sept 30, 2011, the S&P 500 Index fell 15.1% while the MSCI Emerging Markets Index dropped 23.1%.[6] However, it is important to stress that these indices rebounded within several months.

Today, I would expect a significant stock market sell-off to begin soon if there are no signs of real progress in negotiations. Ultimately, we do not expect the US to default on debt or delay payments of Social Security and other important programs – both sides clearly have a strong interest in avoiding extreme financial instability – but it is a more politically charged environment than even 2011. And that means that markets will likely remain on edge.

And so, the much-anticipated end of tightening is far from perfect. But, much like a Mother's Day that starts with a too-early wake-up alarm but ends with hugs and warm well-wishes – I will take it all the same.

What does this mean for investors?

For tactical allocators, I believe this may be a time to be positioned defensively in the near term.

- Within equities, I would favor technology, health care and consumer staples. I'm most positive on tech as I believe it will be the biggest beneficiary of rates coming down.
- Within fixed income, I would favor investment grade corporates and municipal bonds.
- Within commodities, I would overweight gold and underweight oil. Looking back to how these assets performed during the 2011 debt ceiling saga, from July to September 2011, US investment grade corporate bonds rose 3% and gold rose 9.2%.[7]

For strategic allocators, I believe this may be a time to maintain long-term positions and, if stock prices fall, look for opportunities to add exposure to equities, especially international equities, in order to position for the future.

We need to recognize that this period of turbulence is likely to be relatively brief. I expect stocks to start discounting an economic recovery once the debt ceiling has been resolved and the banking mini-crisis appears to have been tamed, which would mean a shift in positioning to a more risk-on environment.

Notes

[1]Source: US Bureau of Labor Statistics, May 10, 2023

[2]Source: Bloomberg News, “ECB Tightening Path Is in 'Home Stretch,' Guindos Tells Sole,” May 13, 2023

[3]Source: Federal Reserve, “The Evolving Nature of Banking, Bank Culture, and Bank Runs,” May 12, 2023

[4]Source: University of Michigan Survey of Consumers, May 12, 2023

[5]Source: University of Michigan as of Sept. 1, 2011

[6]Source: Bloomberg, L.P.

[7]Source: Bloomberg, L.P. Gold spot price in US dollars per troy ounce. Bonds based on the Bloomberg US Corporate Bond Index, which measures the investment grade, fixed-rate, taxable corporate bond market, including USD denominated securities publicly issued by US and non-US industrial, utility and financial issuers.

Important information

Past performance is not a guarantee of future results.

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.

An investment cannot be made directly in an index.

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

Many products and services offered in technology-related industries are subject to rapid obsolescence, which may lower the value of the issuers.

The health care industry is subject to risks relating to government regulation, obsolescence caused by scientific advances and technological innovations.

The risks of investing in securities of foreign issuers can include fluctuations in foreign currencies, political and economic instability, and foreign taxation issues.

Fixed-income investments are subject to credit risk of the issuer and the effects of changing interest rates. Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa. An issuer may be unable to meet interest and/or principal payments, thereby causing its instruments to decrease in value and lowering the issuer’s credit rating.

Municipal securities are subject to the risk that legislative or economic conditions could affect an issuer’s ability to make payments of principal and/ or interest.

Fluctuations in the price of gold and precious metals may affect the profitability of companies in the gold and precious metals sector. Changes in the political or economic conditions of countries where companies in the gold and precious metals sector are located may have a direct effect on the price of gold and precious metals.

Investments in real estate related instruments may be affected by economic, legal, or environmental factors that affect property values, rents or occupancies of real estate. Real estate companies, including REITs or similar structures, tend to be small and mid-cap companies and their shares may be more volatile and less liquid.

The Consumer Price Index (CPI) measures change in consumer prices as determined by the US Bureau of Labor Statistics. Core CPI excludes food and energy prices while headline CPI includes them.

The Producer Price Index (PPI) is compiled by the US Bureau of Labor Statistics and measures the average change over time in the selling prices received by domestic producers for their output.

The University of Michigan’s Consumer Sentiment Index is published monthly, based on a telephone survey designed to assess US consumer expectations for the economy and their personal spending.

The MSCI Emerging Markets Index captures large- and mid-cap representation across 26 Emerging Markets (EM) countries.

The federal funds rate (or fed funds rate) is the rate at which banks lend balances to each other overnight.

Tightening is a monetary policy used by central banks to normalize balance sheets.

A basis point is one hundredth of a percentage point.

The opinions referenced above are those of the author as of May 15, 2023. 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.