Some clarity emerges as markets remain in a holding pattern

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I wrote last week about being in a holding pattern as we wait on developments in a number of different spheres. Well, in the last week there have been a few developments that shed some light on the bigger questions we were asking.

Is a global recession coming?

We've been waiting to see whether we go into a global recession next year. While that remains to be seen, the International Monetary Fund's (IMF) updated economic growth forecasts were not encouraging. The IMF warned that "the worst is yet to come, and for many people 2023 will feel like a recession."[1] It anticipates 1% gross domestic product (GDP) growth for the US, 1.5% GDP growth for Canada, and 0.5% GDP growth for the euro area in 2023.[1] While not surprising, it's still jarring to see the IMF forecast of -0.3% GDP growth for Germany in 2023[1] (although the silver lining may be that Germany may be more supportive of euro area stimulus and more flexible in general on fiscal prudence at a difficult time economically).

When will the Fed pivot?

We've also been waiting to see when US inflation would be brought under control, and therefore when the Federal Reserve (Fed) would pivot. After last week, it's clear that the Fed isn't ready to pivot in the near term. There are several reasons why:

US inflation is still persistently high. The Consumer Price Index (CPI) print for September was released last week, and it was hard to find anything to celebrate in the data. While goods inflation has been coming down, services remain stubbornly high, as do rents. And this is the second bad CPI report in a row, adding to the sentiment that inflation is very persistent. This print is hawkish for the Fed; it gives no incentive for the central bank to get less aggressive about monetary policy tightening (and it increases the uncertainty around the monetary policy path from here – particularly what the terminal rate will be).

Inflation expectations remain relatively well anchored but have ticked up in recent surveys. Last week the NY Fed released its most recent Survey of Consumer Expectations, and the University of Michigan released its preliminary Surveys of Consumers results for October.

- The NY Fed results showed improvement in short-term inflation expectations, with one-year ahead expectations dropping to 5.4%, its lowest reading in a year.[2] Three-year ahead inflation expectations rose, but only slightly, from 2.8% in August to 2.9%.[2]
- The University of Michigan preliminary results showed increases for both the one-year ahead and five-year ahead inflation expectations. One-year ahead inflation expectations rose substantially – in contrast with the NY Fed Survey – from 4.7% to 5.1%. The five-year ahead inflation expectations saw a smaller uptick, similar to the NY Fed Survey, from 2.7% to 2.9%.[3]

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As I have said before, I believe measures of inflation expectations – especially consumer inflation expectations – are a critical factor for the Fed in determining the path of policy tightening. We will want to follow the survey results closely, as it would be troubling to see further upticks in longer-term expectations. In fact, I think the Fed will be more comfortable pivoting when longer-term expectations fall materially from here – and are closer to their inflation target of 2% than they are to 3%.

The September Federal Open Market Committee (FOMC) meeting minutes were decidedly hawkish, in my opinion. The Fed reaffirmed a "strong commitment" to getting back to its 2% inflation target; the Fed seems laser-focused on that goal, and seems unlikely to be deterred by a meaningful rise in unemployment. The Fed wants to "purposefully" move to a restrictive stance in the near term, and many FOMC participants wanted to keep rates restrictive "for some time." In addition, the Fed is still pushing forward with quantitative tightening. The one positive was that several participants noted that "particularly in the current highly uncertain global economic and financial environment, it would be important to calibrate the pace of further policy tightening with the aim of mitigating the risk of significant adverse effects on the economic outlook."[4] The reality is that there is no "off ramp" for the Fed right now given the current data.

Earnings calls have suggested inflation would remain at least somewhat persistent. One large bank reported that "Both consumeand business customers remain in a strong financial condition, and we continued to see historically low delinquencies and high payment rates across our portfolios"[5] That may bode well for the US being able to avoid recession, but raises concerns that the Fed hasn't yet cooled the economy enough. And a large airline shared that, "We don't think that just one busy summer of traveling is going to quench the desire and the needs of consumers …This demand surge is going … to continue for some time."[6]

The good news

The good news is that nothing has "broken" yet – and governments appear more sensitive to ensuring nothing "breaks." The big concern over the last week was the UK, as the "mini budget" from new UK Prime Minister Liz Truss and her government set off market fears and a gilt sell-off. While there was speculation that the Bank of England would have to continue its bond-buying intervention, it ended it on Friday (as previously announced). Instead, it was the Truss government that blinked. After his "fiscal event" provoked market chaos, Kwasi Kwarteng was replaced as UK Chancellor of the Exchequer by Jeremy Hunt, who is widely regarded as more experienced.

The new Chancellor is thought to have more authority than Truss and immediately signaled a further reversal on the corporate tax rate and has suggested tax increases and/or spending cuts may be needed. This marks a return to a more orthodox fiscal policy that I believe is likely to further soothe markets. I found his Oct. 17 comments to be very calming and believe they are just what markets needed to hear: "No government can control markets, but every government can give certainty about the sustainability of public finances."[7] The next big event for the UK will be the "Halloween" budget on Oct. 31, although I believe it is far less likely to cause apprehension in markets given that there is more confidence in the new Chancellor.

While a few questions have been answered (at least temporarily), many more remain. Among them: What will happen at — and after — the Chinese Communist Party's Congress that began Oct. 16? Will European countries manage this winter without major energy-related shutdowns? How will the Russia-Ukraine war unfold? And what will earnings season tell us? We will keep you updated as we all remain in this holding pattern…

With contributions from Paul Jackson and Brian Levitt

Notes

[1]Source: IMF World Economic Outlook, Oct. 11, 2022

[2]Source: NY Fed Survey of Consumers, Oct. 11, 2022

[3]Source: University of Michigan Survey of Consumers, Oct. 14, 2022

[4]Source: Federal Reserve, FOMC September meeting minutes, released Oct. 12, 2022

[5]Source: Reuters, "Wells Fargo profit falls on sales scandal costs, higher reserves," Oct. 14, 2022

[6]Source: Reuters, "Delta expects unquenched demand for travel to fuel profit," Oct. 13, 2022

[7]Source: Reuters, "UK finance minister Hunt reverses most of 'mini-budget'," Oct. 17, 2022

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.

Gross domestic product is a broad indicator of a region's economic activity, measuring the monetary value of all the finished goods and services produced in that region over a specified period of time.

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 New York Fed's Survey of Consumer Expectations is a nationally representative, Internet-based survey of a rotating panel of approximately 1,300 household heads.

The International Monetary Fund is a global organization of 190 member countries that supports economic policies that promote financial stability and monetary cooperation.

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

The Federal Open Market Committee (FOMC) is a 12-member committee of the Federal Reserve Board that meets regularly to set monetary policy, including the interest rates that are charged to banks.

UK gilts are bonds issued by the British government.