MARKET INSIGHTS

from Ziegler Capital Management

Press On, Pause, or Pivot?

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In an effort to contain the highest inflation since the 1980s, the Federal Reserve has raised the Federal Funds Rate by 375 basis points so far this year, in the largest and fastest policy shift since that inflationary era. As we finish 2022, the markets are evaluating the potential for a recession in 2023 and subsequent earnings deceleration. How aggressive will the Fed be in raising rates and how many more adjustments will be necessary?

Historically, it takes 9 to 12 months for Fed rate hikes to impact the economy. Once the Federal Funds rate reaches 4.75% - 5.00%, it would seem prudent for the Fed to pause and monitor the impact of its large rate increases. Reaching that level sooner could reduce the need for further rate hikes next year.

Since the Jackson Hole meeting in August, Chairman Jerome Powell has underscored the central bank's aggressive policy actions with stern language, illustrating the Fed's commitment to bring inflation in line with their 2% target. Other voting Federal Open Market Committee (FOMC) members affirmed this stance in public comments over the last few months. Federal Reserve Bank of St. Louis President James Bullard, considered one of the more hawkish members of the FOMC, continues to focus his comments on the likely need to raise rates to higher levels and for longer than financial markets currently expect. On November 28th, he said the financial markets are underestimating the chances the FOMC will need to be more aggressive next year in raising interest rates. His comments would suggest the "pause" in rate hikes that many economists and strategists are forecasting in 2023 may be delayed. On the same day, Federal Reserve Bank of New York President John Williams said, "I do see a point, probably in 2024, that we'll start bringing down nominal interest rates." Williams' comments point to a "pivot" in Fed policy to lowering rates, but that would be occurring later than current market expectations.

On November 30, Chairman Powell gave a speech on Inflation and the Labor Market, focusing on PCE as the Fed's preferred inflation signal and discussed the strength of the labor market. In the speech he signaled the FOMC would rase rates by 50 basis points on the December 14 meeting. Later that week, Nonfarm payrolls were reported for November, surprising on the upside as they expanded by 230,000. Additionally, average hourly earnings rose 0.6%, almost double expectations. These numbers illustrate that the U.S. economy is not in a recession and could extend the number of rate increases by the Fed.

KEY TAKEAWAYS

- The transition from a stimulus-based economy to one focused on fundamentals may require navigating another period of pain.
- Longer term, we believe the Fed's inflation fighting actions will result in strategic market opportunities for our clients.
- The Fed currently appears to be singularly focused on addressing inflation.

ABOUT ZCM MARKET INSIGHTS

A series that provides a glimpse of our internal thought process through current topics affecting our clients and colleagues.

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Given the global financial markets' intense focus on the Fed's actions, three key questions arise.

1) WHY ARE SUCH SIGNIFICANT MOVES NECESSARY?

Federal Fund Rate increases are necessary to return the U.S. economy to price level stability. The pandemic and consequent actions by fiscal and monetary authorities triggered extraordinary circumstances that altered consumer behavior and industrial processes. As the economy recovered from the pandemic, inflation spiked to levels not seen for four decades. Although the Fed was slow to react, upon realizing the potential damage from unchecked price increases and rising inflation expectations, they made it clear that they intended to reengage monetary policy in this fight. Going forward, the economy will likely be forced to transition from operating with stimulus to running on fundamentals, and financial markets will adapt accordingly. Historically, when the economy returns to price level stability, equity and bond markets react favorably as a key decision-making risk is removed from consideration for consumers, entrepreneurs, and businesses.

2) WILL THEY CAUSE A RECESSION?

After the Fed's September 75 basis point rate hike and ensuing FOMC Member commentary, investor pessimism rose both in relation to the economic outlook and financial market performance. Sentiment shifted dramatically in November, after the Fed's November 2, 75 basis point move when October's Consumer Price Index (CPI) came in modestly below expectations. All eyes remain on the Fed. Will they stop too soon, reigniting inflation concerns? Or will they go too far, causing a recession? Is there even such a thing as the "Goldie Locks" just right outcome? The answers to these questions are unknown, but the Fed comments above illustrate that they are likely to err on the side of higher rates and Chairman Powell indicated that a "soft landing" remains possible. It is easier for the Fed to take back words than reverse official policy action.

3) ARE THESE POLICY MOVES ALREADY REFLECTED IN EQUITY AND BOND PRICES?

Are market valuations already reflecting a recession? Bond yields are dramatically higher in 2022, and the yield curve is meaningfully inverted, which could be signaling an upcoming recession. Historically, after the 10-year Treasury yield drops below the 1-year Treasury yield, an official recession begins, on average, 12 months later and ranging from 5 to 24 months later. This part of the curve inverted on July 12, 2022. As for stocks, historically they bottom during an official recessionary period, and have not priced in a significant decline in earnings from a recession.

To summarize, the Fed currently appears to be singularly focused on addressing inflation. For now, this posture is enabled by a robust labor market which allows them to set aside one component of their dual mandate of "maximum employment and stable prices."

As Chairman Powell has signaled the Fed's likely move at the December FOMC meeting, the market will now focus on how many more rate increases will be necessary. We see a "pivot" to rate cuts as unlikely, and instead expect a "pause" in the rate hikes sometime in the first half of 2023.

It's a good time for a review of strategic asset allocations

The transition from a stimulus-based economy to one focused on fundamentals may require navigating another period of pain, but longer term, we believe the Fed's inflation fighting actions will result in strategic market opportunities for our clients. 2022 has been a year of higher volatility and negative returns for both stocks and bonds, but within each asset class there has been much dispersion, illustrating how active management can enhance returns.

We will continue to monitor the Fed, the economy, and markets. As we look to 2023, we will evaluate economic data and market valuations to determine our outlook. Stay tuned!

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