SMITH AFFILIATED CAPITAL

SECOND QUARTER 2022 INVESTMENT COMMENTARY

The Fed's Aggressive Moves to Stifle Inflation Heightens Recession Risks

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With barely three months in the books, it is hard to remember another year that opened with as much drama as 2022. The swirl of events included the surge and rapid descent of the Omicron variant, spiraling inflation, heart-throbbing geopolitical tensions with Russia, a hawkish pivot by the central bank, and tumultuous moves in the financial markets. Against this backdrop, the economy wobbled but remained standing -- albeit just barely. Barring a string of surprisingly strong data for March, the first quarter will likely show little if any growth.

While the latest jobs report confirmed that labor conditions remain red-hot, other indicators point to nascent weakness in consumer spending and manufacturing activity. We believe the economy has enough firepower to sustain growth through at least the latter part of this year, but the risks of a recession are rising. Of course, a wild card in the outlook is the war in Ukraine. The Russian invasion is primarily a human tragedy, but the global costs cannot be ignored – and they are piling up. It's unclear how long the war will go on; the longer it persists, the greater the toll on world economies. As it is, the conflict has put a crimp in economic activity and amplified inflationary pressures that were already stoked by pandemic-related supply shortages. That combination has led some to compare the looming economic environment with the stagflation of the 1970s, a decade that featured many years of sluggish growth, high unemployment, and sharply rising prices.

We do not see a return to that dispiriting experience, but the balance of risks between higher inflation and slower growth has become symmetrical. Both loom large over the rest of the year, and the task of restoring a tolerable balance between them will require skillful management of the policy levers by the Federal Reserve. The historical record is not promising, as the Fed has never successfully maneuvered the economy into a soft landing when the inflation rate exceeded 5 percent. That record, together with the uncertain fate of the forces stoking inflation and crimping growth, is disrupting the pricing mechanism in the financial markets. The inversion of the yield curve suggests that a policy mistake is in the offing, heightening recession prospects, and recent Fed comments signal that policy is poised to turn significantly more aggressive at upcoming FOMC meetings.

No More Mr. Nice Guy

The Fed is ready to take away the punch bowl. After two years of supplying an enormous amount of liquidity and keeping short-term rates at near zero, policymakers decided it was time to remove some juice from the economy to keep revelers in check. To this end, it hiked the federal funds rate by 25 basis points at its March 15-16 policy meeting and signaled at least six more increases over the balance of the year and three more in 2023, winding up 2.75 percent at the end of next year. Since that meeting, Fed officials have turned even more hawkish, highlighted by Chair Powell's NABE speech. He noted that the FOMC will do whatever it takes to curb inflation, including hiking rates by 50 basis points in upcoming meetings.

Simply put, the Fed has pivoted decisively away from promoting maximum employment to reining in inflation. Based on Powell's remarks, which have since been echoed by other Fed officials, a 50 basis point increase at the May meeting appears to be a done deal, and the odds of a similar hike in June are high. The markets are pricing in an even more aggressive tightening path, expecting at least 200 basis points more this year and an endgame of 3.50 percent by the middle of 2023. This would be an exceptionally swift and steep tightening relative to recent policy shifts, particularly when combined with the balance sheet reduction the Fed intends to start in the coming months. A more detailed plan for QE unraveling should be announced at the May FOMC meeting.

The hawkish pivot by the central bank is not surprising; indeed, many critics believe that it waited too long to make the move. Amid pandemic-related supply shortages, the combination of massive fiscal and monetary stimulus has not only prevented demand from collapsing, it has powered it above prepandemic levels. Hence, inflation has taken off – a time-honored response when too much money chases too few goods. The annual increase in the consumer price index surged to a 40-year high of 7.9 percent in February, a climb that has been steeper and longer-lasting than policymakers had expected. What's more, inflationary pressures will get worse before receding. The Russian invasion and Covid-related factory shutdowns in China are likely to add to supply-chain pressures and postpone the normalization process.

No “Stag” In The Near Term

We expect inflation to peak sometime in the second quarter but unwind more slowly than thought prior to the Russian invasion. As noted earlier, the conflict is a wildcard in the outlook, but we have made certain assumptions. Most important is that while the hostilities should end sometime before the end of this year, the most economically damaging sanctions on Russia/Belarus will remain in place indefinitely. That would still be the case even in the event of a ceasefire in the coming weeks or months. What’s more, private companies will continue to self-sanction to some extent for the foreseeable future.

Although the U.S. feels the impact of the geopolitical turmoil, it is holding up better than other Western nations, particularly in Europe, which is much more reliant on Russian oil and natural gas. The war in Ukraine intensifies supply-chain snarls and amplifies production constraints, injecting the stag into the inflationary equation. With these restraints on the supply side being drawn out, so too is the shortfall of goods relative to demand, keeping upward pressure on prices. Still, the U.S. economy is a long way from entering a stagflation environment.

For one, near-term growth prospects are positive, thanks to the solid underpinning of a robust job market. The 431 thousand increase in nonfarm payrolls in March was in line with expectations but followed upwardly revised even stronger increases in January and February that averaged 627 thousand a month. With the unemployment rate driven down to a post-pandemic low of 3.6 percent, wages rising at the fastest clip in decades, and 80 percent more job openings than available job-seekers, it is hard to see the economy “stagnating” much less taking a serious turn for the worse over the near term.

The Fed Strives to Get Ahead of the Curve

With the war in Ukraine still raging and keeping upward pressure on oil and a range of other commodity prices, inflation will worsen before it starts to recede. We see the headline CPI inflation rate peaking between 9-10 percent later this spring. In addition to the war’s effects, China’s shutdown in Shanghai, due to its zero-Covid policy, is adding to supply-chain snarls even as a possible dock workers strike on the West Coast injects another hurdle that would crimp the delivery of goods to warehouses.

While the Fed realizes that these near-term supply pressures will fade over time, their near-term impact has driven inflation to a much higher level than expected at the March 15-16 meeting and prompted it to move more quickly and aggressively than planned a few weeks ago. The fear is that holding back in anticipation of supply-chain easing heightens the risk that inflation expectations would become more thoroughly entrenched and more difficult to tame later on. Chair Powell has already acknowledged that policy fell behind the inflation curve and would be more effective now had the rate-hiking cycle started sooner.

Whether or not that’s true, policymakers now believe they have to get ahead of the curve before things get out of control. From our lens, that means the Fed will push up rates to restrictive territory, lifting the federal funds rate by 200 basis points this year, including some half-point increases in future meetings. While a 2-2 ¼ percent funds rate at the end of the year is not historically high, the tightening impact will be amplified as the Fed starts to unwind its bloated balance sheet, which would remove liquidity from the economy. Unlike the quantitative tightening from 2017 to 2019, the Fed may not put the reduction on autopilot throughout the process, allowing securities to roll off as they mature. With market-based inflation expectations surging – the 5-year breakeven rate hit an all-time high of 3.59 percent in late March – some outright asset sales might be needed to restore investor confidence in the Fed’s inflation-fighting credibility.

The Market’s Recession Signal

Much attention has been given to the yield inversion in the 2-year/10-year sector of the curve that took hold at the end of the first quarter. In fact, March was the worst month for Treasuries since April 2004, and Q1 was the worst quarter for Treasuries on record. That is based on the 3.1 percent decline for the month in the Bloomberg US Treasury Total Return Index and the record 5.6 percent plunge in the index for the quarter. Ordinarily, rising yields across the board would be associated with a booming economy and rising inflation, but the inversion puts a kink in that perception.

A vast body of literature and empirical evidence demonstrates that the slope of the yield curve is a reliable predictor of future economic activity and recessions. Therefore, it is not surprising that the inversion raises concern about what might be in store for the economy going forward as the Fed signals a much more hawkish policy stance. An inversion of the 2-year/10-year sector of the Treasury curve has preceded each of the past ten recessions. The only false-positive reading was in 1965-1966.

Since last April, the coupon curve has been flattening, with the closely watched 2-year/10-year spread narrowing from 158 basis points to a positive 6 basis points on April 1. The initial flattening was triggered by a partial unwind of the more than 90 basis point rise in the 10-year yield during the first quarter. The flattening since has been the result of surging front-end yields amid a steadily more hawkish Federal Reserve fueled by higher than expected inflation.

However, Fed research suggests that the 10-year/2-year spread may not be the best curve barometer for recession signals. Chair Powell recently alluded to Fed research that suggests looking at the very short-term portion of the curve through just the next 18 months. The predictive power of the near-term spread is limited though as a forecasting tool. As Powell noted, if the near-term spread is inverted, "that means the Fed's going to cut, which means the economy is weak."

Other research published by the Federal Reserve suggests that the 3-month/10year spread provides a more reliable indication of changes in the business cycle. The good news for the economy is that this spread remains significantly positive. But the main reason is that the 3-month T-bill rate is very closely tied to actual changes in the fed funds rate and does not reflect expectations for sharply faster Fed tightening that is tracked by the 2-year note. As a result, we do not believe you can ignore the 2-year/10-year spread signals. Our recession model using the 2-year/10-year spread does show rising odds of a recession in the next 12 months.

That said, history shows that an inversion would not provide clear guidance on the timing of a recession. Historically, the time between the spread inverting and the onset of recession has been long and variable. For the five recessions prior to the brief Covid-induced recession in 2020, the lead time between the inversion and the onset of the recession averaged approximately 20.5 months. Further, the lead time range is quite broad, spanning from 9.5 months ahead of the 1981-1982 recession to 35 months ahead of the 2001 recession.

Worry More About 2023

From our lens, the dismal performance of the bond market in the first quarter may be overdone. While we expect rates to trend higher over the course of the year, underpinned by a tighter Fed policy, there are a few reasons to look for a near-term consolidation around recent levels and a modest temporary unwinding of flattening trades. For one, markets are already pricing in around 210 basis points of additional Federal Reserve rate hikes this year, implying at least two 50 basis point rate hikes are already priced in. Unless some event calls for an even more aggressive tightening, additional near-term increases in front-end yields seem unlikely.

For another, Treasury prices may also benefit from supportive seasonal factors over the next few months, exerting downward pressure on 10-year Treasury yields. Historically, the first quarter has been challenging for fixed-income investors, as Treasury issuance tends to be higher in the first few months of the year, particularly in the short-term sector. Conversely, the Treasury tends to be in surplus in April, flush with income tax receipts. On the demand side, the sharp rise in yields during the first quarter enhances the value of bonds relative to stocks, and hence, some funds may well be drawn from the equity market. The TINA allure of stocks is much less relevant at current rates. Higher yields and heightened global uncertainty surrounding the war in Ukraine are also attracting foreign funds, as manifested by the rise in the dollar in recent months.

Finally, expectations could change as slowdown risks proliferate. While the robust jobs market should keep consumers in a spending mood, they get less bang for the buck due to higher prices. Indeed, real personal consumption fell in February. Notably, income gains are not keeping up with inflation, as real disposable income fell in February for the seventh consecutive month – the longest stretch of declining purchasing power in nearly 50 years. Surveys indicate that lower and middle-income households are already cutting back purchases because of affordability issues.

We suspect that the $2.7 trillion of excess savings from fiscal transfers and foregone spending accumulated during the pandemic provides households with a formidable cushion to sustain expenditures for a while. We caution, however, that most of the savings are concentrated among upper-income households who have a low propensity to spend from accumulated wealth. Lower-income segments of the population are already depleting their savings, as indicated by the sharp decline in the personal savings rate in recent months. They will need to rely more heavily on income growth going forward. The passing of the income baton from the Federal government to the private sector is well underway, but real income growth, as noted above, is lagging. With borrowing costs on autos, credit cards, and mortgages rising sharply, consumers are facing mounting headwinds that are expected to restrain spending later this year.

The jury is still out as to how deeply households will be drawing down their savings to finance purchases over the remainder of the year. No doubt, as health conditions continue to improve, wealthier individuals will have more options to spend on services, and they will do so. But uncertainty regarding Fed policy and its impact on economic conditions is likely to make households wary about the future and encourage them to hold more significant precautionary savings balances. While we do not expect a recession this year, the risks of a downturn in 2023 are growing as the Fed continues to move aggressively to slow perceived demand-pull inflation primarily driven by supply-side forces. As long as they stay on that course, the odds of a hard landing next year become more than a trivial prospect.

RATES AND TOTAL RETURNS QUARTERLY AND ANNUAL COMPARISONS

U.S. Treasury Market (Barclays TSY Bellwethers)	Yields (%)			Total Return (%)	
	3/31/2021	12/31/2021	3/31/2022	Last Quarter	Last Year
6-Mo. Bill	0.03	0.18	1.02	-0.10	-0.06
2-Yr. Note	0.16	0.73	2.33	-2.54	-3.05
5-Yr. Note	0.93	1.26	2.45	-5.16	-5.50
10-Yr. Note	1.74	1.50	2.33	-6.86	-3.44
30-Yr. Note	2.40	1.89	2.44	-11.41	0.41

Municipal Bonds	Yields (%)			Total Return (%)	
	3/31/2021	12/31/2021	3/31/2022	Last Quarter	Last Year
Barclays GO Bond Index	1.00	0.97	2.43	-6.07	-4.61
Barclays State GO Bond Index	0.89	0.86	2.32	-5.43	-4.14
Barclays Local GO Bond Index	1.12	1.07	2.53	-6.68	-5.05
Barclays Revenue Bond Index	1.32	1.22	2.72	-6.54	-4.52

Equities	Levels			US $ Terms (%)	
	3/31/2021	12/31/2021	3/31/2022	Last Quarter	Last Year
S&P 500	3972.89	4766.11	4530.41	-4.60	15.63
DJIA	32981.55	36338.3	34678.35	-4.10	7.11
NIKKEI (Tokyo)	29178.8	28791.71	27821.43	-2.58	-2.96

Commodities	US $			Percent Change (%)	
	3/31/2021	12/31/2021	3/31/2022	Last Quarter	Last Year
COMEX Gold Active Monthly	1713.8	1829	1949.2	6.57	13.74
CRB Future Com. Pr. Index*	184.96	232.37	295.1832	27.03	59.59
West Texas Intermediate Crude ($ per bbl.)	59.16	76.99	100.28	30.25	69.51

Currencies	Levels			Percent Change (%)	
	3/31/2021	12/31/2021	3/31/2022	Last Quarter	Last Year
Yen	110.72	115.08	121.7	-5.75%	-9.92%
Sterling	1.3783	1.353	1.3138	-2.90%	-4.68%
Euro	1.173	1.137	1.1067	-2.66%	-5.65%

Global Bond Markets**	Levels			US Dollar Terms (%)	
	3/31/2021	12/31/2021	3/31/2022	Last Quarter	Last Year
German 10-Yr.Bond	-0.41	-0.30	0.46	-5.77	-6.70
Japanese 10-Yr.+ Bond	0.04	0.00	0.17	-1.24	-0.70
UK 10-Yr.+ Bond	0.77	0.90	1.53	-4.60	-4.63
Emerging Market (USD)	4.05	4.33	5.63	-9.23	-7.51

Source: Bloomberg Financial Data
*Thomson Reuters/Jefferies CRB Commodity Excess Return Index
** Global Bonds Represented by Bloomberg Barclays Indices