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Heightened Recession Risks Overtaking Inflation Fears

In this Issue:

- **The Fed's Hasty Decision to Go Bolder**
- **Inflation May Have Already Peaked**
- **Financial Markets Repricing the Outlook**
- **How Far Will It Go?**

Last year the primary debate among economists was whether the inflation upsurge that suddenly gripped the nation was transitory or lasting. Most, including policymakers at the Federal Reserve, blamed transient forces related to the pandemic, which they believed would fade as health conditions improved. That view, of course, has since been debunked, and the Fed openly admits it waited too long to start the anti-inflation campaign that is now in full swing. At its last policy meeting on June 16, the Fed hiked short-term rates by three-quarters of a percentage point, the steepest one-off increase at a meeting since 1994, and signaled that several more increases were on the way in coming months.

More recently, the debate has shifted. Now the question is whether the Fed can tame inflation without causing a recession, i.e., steer the economy onto a "soft landing." Most economists believe a recession is inevitable, if not already here, as the Fed has a poor record of wringing out excesses in the system without overshooting the mark. For their part, Fed officials believe it can be done, although the effort has become far more challenging. The Fed hopes it can replicate the 1994-95 experience when rate hikes it implemented cooled activity and kept inflation under control without choking off growth. But its goal then was to prevent inflation from breaking out of the low 2-3 percent range it had been locked in over the previous decade. It's much more difficult to bring inflation down from 40-year highs underpinned by a sizeable excess of demand over supply. The challenge is to determine how much demand destruction is needed to wring out that excess and how much tightening is required to do the job.

A good deal of luck from external inflation-inducing forces will be needed as well as skillful policy management to bring about the elusive "soft landing." Given the still robust labor market, healthy balance sheets, and excess savings in the hands of households, there is a good chance that the economy can weather the rate hikes contemplated in the coming months. But ominous signs of weakening activity are increasing, even as lingering supply restraints indicate that more demand destruction would be needed to bring it back in line with output than otherwise. The Fed is front-loading and turning more aggressive in its rate-hiking stance in an effort to compensate for the late start to the tightening cycle. If it stays on this course, the odds of a recession later this year or in 2023 will increase exponentially.

The Fed's Hasty Decision to Go Bolder

The Fed's last-minute decision to raise the federal funds rate by 75 basis points rather than the 50 basis points taken at the previous meeting in May reflected two key reports released in the days before the meeting. The first tipping point was the CPI report for June, which clocked in at 8.6 percent year over year, up from 8.3 percent in May. It was widely thought that inflation had peaked at 8.5 percent in March and would continue to moderate as it had in April; instead, it accelerated.

The second disturbing report, perhaps even more so, was the University of Michigan reading on consumer inflation expectations over the next five years. After holding at 3 percent or less for the past 25 years, the June survey revealed a leap to 3.3 percent, the highest since 1994. Nothing is more alarming to Fed officials than seeing inflation expectations become unanchored: that would mean inflation is more entrenched, setting in motion a self-fulfilling prophecy that could only be countered by harsh growth-destroying policies. Indeed, the combination of these two reports and the Fed's subsequent hawkish pivot spurred the fixed income markets into a frenzy, sending the 10-year Treasury yield up to 3.50 percent in mid-June – the highest in more than a decade – and equally sizeable jumps in shorter-term rates. Meanwhile, the Fed's aggressive rate-hiking campaign sent shivers through the stock market, sending it tumbling into bear territory, which by the end of June had punctuated the worst first-half performance since 1970.

While inflation is still grabbing headlines and causing seismic shifts on Main Street, the Fed may soon have second thoughts about how much pressure it needs to apply to combat it. For one, the catalyst spurring its more aggressive move at the June meeting – and the amped-up warnings of steeper rate hikes in coming months – turned out to be less menacing than thought. Upon revision, the University of Michigan's reading on longer-term inflation expectations was reduced to 3.1 percent. This is not as alarming and barely above the range in effect before the initial report. For another, the Fed's preferred inflation gauge – the core personal consumption deflator – is moving in the opposite direction of the headline CPI. According to the May data released on July 1, the core PCE increased 4.7 in May from a year ago, down from the 4.9 percent increase in April.

Inflation May Have Already Peaked

The reduced heat reflected in these inflation indicators echoes a similar pattern in an array of other measures. Commodity prices – paced by lumber, copper, steel, and a long list of raw materials– have tumbled dramatically over the past month; the Bloomberg Commodity Index is off 15 percent since the first week of June. Even natural gas and oil prices have retreated from their nearby peaks. Crude quotes fell below $100 for the first time since May on July 5 and are still well below the $125 peak hit in early March.

It won't be long before disinflationary forces resonate on the retail level. The chip shortage that has throttled auto output and sent car prices surging is easing, thanks to a dramatic fall in demand for personal computers as well as the slowdown in global growth. The war-related energy crisis has weakened Europe far more severely than the US, and China's growth engine has downshifted dramatically owing to frequent Covid-related lockdowns. Meanwhile, big retailers, like Walmart, Target, and even Amazon, had overbooked goods months ago, only to be stuck with excess inventory that consumers no longer want or need. Heavy discounting will be required to move the unfolding involuntary buildup of merchandise.

Even the headline-grabbing surge in home prices – which is driving up shelter costs in the CPI – may be reaching an inflection point. Like big retailers sitting on excess inventory, homes are taking longer to sell. Bidding wars are fading as an increasing swath of the population has been priced out of the housing market, thanks to a combination of nose-bleed prices and the surge in mortgage rates. Moreover, a record number of unfinished homes is in the pipeline, poised to hit the market in the coming months as construction is completed. As home price increases slow – or even decline in many regions – affordability restraints should ease and bring back buyers, relieving some of the pressures in the rental market. For sure, this process will take time to play out, and rental costs are among the stickiest components of the CPI that should keep inflation elevated for months to come. But the outsized share of household budgets devoted to housing should reinforce the drag on demand and accelerate the growth slowdown the Fed is striving to bring about.

Finally, the dreaded wage-price cycle – the corollary to heightened inflation expectations – is far from gaining traction. True, wage increases have accelerated, spurred by labor shortages, and enabled by the strengthened pricing power of employers. But both ends of the ledger are cooling. Job openings slipped in May for the second consecutive month, the first back-to-back retreat since the onset of the pandemic, layoffs are edging up, and fewer workers are quitting. Meanwhile, the strength in business pricing power is not likely to be sustained in the face of overstocked goods and weakening demand.

Financial Markets Repricing the Outlook

Importantly, recession fears have overtaken inflation expectations in the financial markets. Since the Fed's June 15-16 meeting, the markets have dramatically repriced expectations of inflation, monetary policy and economic growth. Markets are still pricing in around 85 percent odds of a 75-basis point rate hike for the FOMC meeting later this month, but that's down from 90 percent odds two weeks ago. And the implied fed funds rate for December has fallen to around 3.35 percent from 3.65 percent two weeks ago and as high as 3.79 percent on June 15. Moreover, the outlook beyond this year has shifted, as traders now believe the Fed will start cutting rates before the middle of 2023.

Highlighting the abrupt reduction in market-based inflation expectations, the 10-year breakeven has fallen to around 2.30 percent from a 3.04 percent peak in late April, and the 5-year breakeven is currently around 2.50 percent down from a 3.73 percent peak in late March. Meanwhile, rising recession risks and falling inflation expectations pushed the nominal 3-year, 5-year, and 10-year yields back below 3.00 percent even as the yield curve has flattened. Indeed, the 2-year/10-year sector of the curve is again flirting with inversion, and we expect that recession risks and the Fed's outlook for higher rates and slower growth will keep the curve biased toward flattening over the medium-term.

Meanwhile, the stock market is mired in bear market territory as pessimism over earnings prospects deepens, and more attractive options in the fixed income market cause TINA to fall by the waysides. Unlike the tail-end of the 2018 tightening cycle, the Fed is not overly concerned about the stock market swoon; indeed, it may even appreciate the helping hand that the wealth destruction from stock losses provides in curbing demand. Likewise, the surge in market interest rates, which has been much steeper than the rate hikes imposed by the Fed, is doing some of the Fed's dirty work as the more it curbs activity, the less the Fed needs to raise interest rates.

That said, the aggressive and front-loaded policy tightening is far from over. The Fed has a dual mandate of achieving full employment and low and stable inflation of around 2%. Given that the employment mandate has been met – the unemployment rate stands at a historically low 3.6 percent – but inflation continues to overshoot its 2% target massively, the Fed is hyper-focused on reducing inflation. While Chairman Powell is aware that tightening policy too quickly and by too much could tip the economy into recession, he has asserted that "the worst mistake we could make would be to fail" to restore inflation to its 2% target, "which is not an option."

How Far Will It Go?

At his Congressional testimony on June 21 and more recent public appearances, Chair Powell reiterated that sentiment even more forcibly, admitting that the interest-rate hikes could send the economy into a recession. Still, it's an outcome he is willing to risk to rein in inflation. That's surely not what the administration wants to hear, but neither does it want its poll numbers to continue to sink because of inflation. In survey after survey, households steadfastly proclaim that inflation is their top worry. Indeed, a remarkable proportion of respondents believe that the economy is already in a recession, despite the still sturdy growth in jobs, rising wages, and low unemployment.

While recession fears amid a robust job market seem counterintuitive, it makes sense to workers who see their wages eroded by inflation. In inflation-adjusted dollars, average hourly earnings are no higher now than two years ago. True, lower-paid workers have received faster wage increases than higher-paid workers over the past year, although they too have not kept up with inflation. Importantly, as the Fed's rate-hiking campaign continues and its growth-dampening influence grows, the lower-paid workers will be the first to be laid off.

There is still a reasonable chance that the Fed can pull off the elusive soft landing, but the odds of a recession within the next year have risen exponentially. The rate hikes being considered by the end of this year alone – landing the Fed's prime lending rate above 3% — would be steeper than the increases seen during the entire 10-year expansion following the financial crisis. The rise in borrowing costs is already taking a toll on the economy. The housing market, as noted, has turned considerably weaker, with sales and new construction activity on a steep decline alongside deteriorating builder sentiment. Real consumer spending fell in May for the first time this year; factory activity is slumping, with the ISM manufacturing index falling to the lowest level in two years in June, a downtrend confirmed by virtually all regional Federal Reserve bank surveys.

These weakening signs point to slowing growth in the coming months but do not necessarily portend a recession this year. For one, the job market is still holding up, and businesses are bidding for scarce workers, driving up wages. For another, household and business balance sheets are in good shape. Only a small fraction of the savings accumulated during the pandemic has been spent, and homeowners have built up a formidable cushion of housing equity, thanks to booming property values. These positive influences give the Fed the flexibility to keep applying the brakes until demand is brought back into alignment with supply.

A key risk, however, is that supply remains depressed by external forces, including the war in Ukraine and Covid-related lockdowns, which would require a greater amount of demand destruction to restore a balance than otherwise. The worst-case scenario facing the Fed is that it weakens demand and growth, even as supply restraints keep inflation elevated. That is a recipe for the dreaded "stagflation" reminiscent of the 1970s. Stagflation would present policymakers with a much more complex set of challenges than they are dealing with now. At this juncture, we give a low probability of that scenario unfolding as the structural imbalances that prevailed then are not in evidence. Inflation expectations are still well anchored, labor unions are not as powerful, and COLA clauses are far less prominent in labor contracts. And unlike the 1970s, the main drivers of inflation now are related to supply constraints rather than excess demand.

A more likely alternative outcome to a soft landing for the US economy is a return to low inflation combined with weak or negative growth. The Atlanta Federal Reserve Bank's GDPnow tracking indicator estimates that GDP contracted by 2.1 percent in the second quarter, which would be the second consecutive quarterly decline that satisfies the unofficial yardstick of a recession. However, the NBER uses a range of indicators, not just GDP, to identify recessions, and those measures suggest the economy is still above water. We agree with that assessment and expect growth to downshift over the summer months but still advance while inflation remains too elevated for the Fed's comfort. While another 75 basis point hike in the Fed funds rate at the July 27-28 meeting should not push the economy over the edge – a 2.25 percent funds rate is still historically low and negative in real terms – there is a good chance the Fed will throttle back its rate-hiking campaign in October and the following months. Mainly if, as we expect, the headline inflation data show tangible signs of slowing.

Rates and Total Returns Quarterly And Annual Comparisons

U.S. Treasury Market (Barclays TSY Bellwethers)	Yields (%)			Total Return (%)	
	6/30/2021	3/31/2022	6/30/2022	Last Quarter	Last Year
6-Mo. Bill	0.05	1.02	2.49	0.06	-0.01
2-Yr. Note	0.25	2.33	2.97	-0.53	-3.47
5-Yr. Note	0.88	2.45	3.04	-2.10	-8.12
10-Yr. Note	1.45	2.33	3.01	-5.20	-11.18
30-Yr. Note	2.07	2.44	3.16	-13.73	-19.67

Municipal Bonds	Yields (%)			Total Return (%)	
	6/30/2021	3/31/2022	6/30/2022	Last Quarter	Last Year
Barclays GO Bond Index	0.87	2.43	2.94	-2.51	-8.01
Barclays State GO Bond Index	0.75	2.32	2.75	-1.65	-6.68
Barclays Local GO Bond Index	0.98	2.53	3.12	-3.31	-9.25
Barclays Revenue Bond Index	1.11	2.72	3.40	-3.37	-9.24

Equities	Levels			US $ Terms (%)	
	6/30/2021	3/31/2022	6/30/2022	Last Quarter	Last Year
S&P 500	4297.5	4530.41	3785.38	-16.11	-10.64
DJIA	34502.51	34678.35	30775.43	-10.78	-9.05
NIKKEI (Tokyo)	28791.53	27821.43	26393.04	-14.90	-23.47

Commodities	US $			Percent Change (%)	
	6/30/2021	3/31/2022	6/30/2022	Last Quarter	Last Year
COMEX Gold Active Monthly	1771.6	1949.2	1807.3	-7.28	2.02
CRB Future Com. Pr. Index*	213.853	295.1832	291.1476	-1.37	36.14
West Texas Intermediate Crude ($ per bbl.)	73.47	100.28	110.65	10.34	50.61

Currencies	Levels			Percent Change (%)	
	6/30/2021	3/31/2022	6/30/2022	Last Quarter	Last Year
Yen	111.11	121.7	135.72	-11.52%	-22.15%
Sterling	1.383	1.3138	1.2178	-7.31%	-11.95%
Euro	1.186	1.1067	1.0484	-5.27%	-11.60%

Global Bond Markets**	Levels			US Dollar Terms (%)	
	6/30/2021	3/31/2022	6/30/2022	Last Quarter	Last Year
German 10-Yr.Bond	-0.37	0.46	1.50	-5.97	-11.95
Japanese 10-Yr.+ Bond	0.00	0.17	0.24	-0.42	-1.53
UK 10-Yr.+ Bond	0.66	1.53	2.15	-4.07	-9.48
Emerging Market (USD)	3.85	5.63	7.18	-8.72	-18.02

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