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The recent turbulence battering the financial markets reflects widespread confusion and uncertainty over monetary and fiscal policies, toxic geopolitical developments, global economic turmoil, high inflation, and upcoming elections. These shock waves show no signs of receding in the immediate future, pointing to continued market volatility and grim near-term prospects for the US and global economy. Against this backdrop, there has been no place to hide for investors, as virtually all asset classes have suffered significant losses this year, including stocks, bonds, gold, crypto, and commodities. The only key asset exception is the dollar, which has gained more than 15 percent against major currencies this year. While the dollar's strength does convey anti-inflation benefits for the US, it also damages corporate profitability and heightens the risk of a global meltdown, as it increases debt burdens for overseas borrowers and adds to their inflation pressures.

The astonishing saga that recently unfolded in the UK—the unfathomable, unfunded, proposed tax cut for the wealthy that has now been ditched—is the latest example of a string of poor decisions on both sides of the Pond that have roiled the global economy and financial markets. On the domestic front, the Biden administration poured trillions of extraneous dollars into a supply-constrained economy last year, which could not accommodate the surge in demand that understandably ensued. The inevitable inflation outbreak wreaking havoc on Americans' budgets and stoking the policy-driven rise in interest rates will soon break the back of the expansion. The two-quarter decline in GDP was mainly an output recession, not a broad-based one, as incomes and job growth continued to grow over the year's first half.

We suspect the third quarter will see a better headline GDP but with a softer underbelly as the economy's growth engine is running out of fuel. Revised data show that income growth was far less robust over the first half of the year than initially reported. The downward adjustment wiped out a big chunk of the excess savings that were supposed to power consumption over the year's balance. Hence, in August, the personal savings rate had shrunk to 3.5 percent, the lowest since August 2008 and down from 9.5 a year ago. In addition, plunging stock and bond prices wiped out a record \$6.1 trillion of household wealth in the second quarter alone, leaving less discretionary funds for upper-income individuals and shrunken retirement accounts in 401ks for blue-collar workers. Against this backdrop, the Fed is steadfastly committed to a rate-hiking campaign that we believe will crush inflation but deliver a recession next year.

The Great Debate

Just how severely the Fed needs to slam on the brakes is a matter of widespread disagreement. Some experts, most notably former Treasury Secretary Larry Summers, believe the Fed must increase unemployment to at least 6 percent to bring inflation under control. Against the current 3.7 percent rate, that would throw millions of workers out of jobs and undoubtedly constitute a severe downturn – not as bad as the 2008 financial crisis, but more drastic than most earlier ones. According to Summers and his like-thinking colleagues, once the inflation genie is out of the bottle – as it is now – only tough measures would put it back.

At the other extreme are those much more sanguine about the challenge. Although they readily admit that inflation has been far higher and more enduring than earlier thought, they also believe that many of the forces driving it are related to special shocks linked to the pandemic, supply disruptions, and the War in Ukraine. As the health situation continues to improve, spurring consumers to normalize spending habits, and supply bottlenecks ease, inflation will recede on its own. The endgame for the War in Ukraine is unpredictable, but the spike in oil prices it caused is reversing, reflecting weaker global growth that reduced the demand for crude. From this lens, the Fed does not have to turn the monetary screws as tightly as the inflation hawks think is necessary.

Both arguments can make a strong case. The inflation hawks can correctly point to the fact that we have not seen inflation of this magnitude since the 1980s, not only in terms of the rapid increase – a run-up from under 2 percent to 8.3 percent in less than two years – but also its breadth. Prices of food, clothing and other essentials that consumers buy daily have surged. Labor costs are also accelerating, evoking the dreaded wage-price cycle that is difficult to arrest. But the doves also have ammunition, noting that bottlenecks are thawing, bringing more supply to the market, and prices of many goods have already fallen. And while wage growth is up, there is some evidence that they are more reactive to price changes than their causes. Hence, as price gains slow, so too will wage growth.

The Fed Stands Firm

We fall between these two extremes but expect a mild recession to set in during the first half of 2023. The economy has not buckled yet; as noted, job growth remains strong, and consumers – the main growth driver – are keeping their wallets open. But history suggests that activity will eventually turn over. Historically, a recession has never been avoided when the unemployment rate rises by at least half percent, and even the Fed expects a rise of that magnitude over the next year. According to the Summary of Economic Projections released at the September 21 policy meeting, the jobless rate is expected to rise to 4.4 percent next year.

Importantly, it is hard to see the economy surviving the steep rate hikes planned by the Fed, with the benchmark Federal Funds expected to reach 4.6 percent early next year. That would be the most rapid tightening of monetary policy since the early 1980s. Indeed, Fed chair Powell is channeling Paul Volcker, the Fed chief who orchestrated the extreme inflation-fighting campaign forty years ago that sent the economy into two deep recessions in the 1980s. Powell has no intention of going that far, but he has asserted in no uncertain terms that policymakers will do whatever it takes to rein in inflation.

Although not explicitly saying so, that includes accepting a recession. To be sure, Fed officials still believe there's a good chance they can bring down inflation without sending the economy into a tailspin. But history is not on their side, and there's a genuine chance that policy tightening will go too far, which would cause more damage to the economy than hoped. Keep in mind that other forces besides monetary policy also weigh on activity. Fiscal aid that propped up the economy so importantly in 2021 has ended, and that stimulus has morphed into a serious growth drag, as the Federal deficit is shrinking rapidly. It's also important to remember that the US does not exist in a vacuum but responds to global and domestic forces. Critically, the nation's main trading partners are in worse shape than we are. Europe, heavily dependent on Russian oil and natural gas, is sagging under surging energy prices. Additionally, China – the major global growth driver following the Great Recession – is reeling under its zero-Covid policy that is shutting down vast swaths of factory output. Finally, the inflation fight is not just a US challenge; about 90 central banks have raised interest rates this year, heightening the global recession risk.

Housing Slump

While the overall US economy is still growing, the Fed's actions have sent at least one key sector, housing, into a recession. Existing home sales have declined for seven consecutive months – the longest stretch since the housing collapse in 2007 and are currently 20 percent below last year's level. The reason is apparent: housing affordability has crashed thanks to sky-high mortgage rates and record home prices. For the first time since 2008, the 30-year mortgage rate exceeds 6 percent, more than twice the level of a year ago.

The collapse in sales is, unsurprisingly, feeding into homebuilder sentiment, which stands at an eight-year low and is affecting construction plans. Single-family building permits – a forward-looking gauge of construction spending – fell to the lowest level since the pandemic in August. The only bright spot in the housing sector is the ongoing strength in apartment building, where permits and starts increased again in August. But that strength has a dark side, as the strong demand for rental units comes from households priced out of the single-family market.

To be sure, residential construction outlays comprise a small fraction of the overall economy, accounting for less than 5 percent of GDP. But housing punches above its weight. When people buy a home, they also buy a bunch of stuff that goes inside, including furnishings, appliances, and fixtures, and incur moving expenses. Not surprisingly, the slump in home sales is taking a steep toll on sellers of home-related goods and services. Sales fell 5.7 percent at appliance stores and 1.6 percent at furniture stores from a year ago in August, the only two retail categories where sales are trailing year-ago levels.

Economic Toll Will Grow

The steep run up in interest rates has already taken a toll on economic activity. The slump in housing activity is the first shoe to drop, but the effects will broaden and deepen. As famously noted by Milton Friedman, monetary policy affects the economy with long and variable lags. It's important to remember that the pivot away from the long-standing zero-interest rate policy only started a few short months ago, and the last jumbo-sized 75 basis point increase in the federal funds rate – the third in as many policy meetings – was implemented in September. The impact of the first two hikes is having first-round effects now, and the cumulative toll will not be evident until sometime next year.

What's more, the Fed firmly believes it still has more work to bring inflation closer to its 2 percent target. As noted, the SEP median forecast for the funds rate next year is 4.6 percent, which implies another 150 basis points of increase from current levels. The upgraded rate forecast followed the latest consumer price report, which revealed a surprising acceleration in the core CPI in August. This cemented perceptions in the financial markets that the Fed will stick to its guns and do whatever it takes to break the back of inflation before it becomes entrenched in public expectations.

Hence, even as markets are pricing in a more restrictive Fed policy than a few months ago, they are also pricing in greater odds of a recession. The 2-year/10-year curve inversion is steeper (as of October 3) than before the last four recessions, exceeded only in the period just before the downturns in the early 1980s. Meanwhile, the risk of a financial accident looms as the Fed tightens the screws. Some major bank balance sheets are viewed with a jaundiced eye by traders, who have driven their market value below book value, which is never a good sign for survival. No one expects a Lehman-type shock at this juncture, but vulnerabilities usually get exposed when the tide runs out. The Fed is still draining liquidity from the system.

Erroneous Optimism the Fed Will Pivot

In the first few days of October, the stock and bond markets enjoyed astonishing rallies as stock prices staged a dramatic rebound and bond yields fell precipitously. It remains to be seen if the stock bounce is merely another bear-market rally that will vanish in time or something more enduring. Likewise, for the bond market. In both instances, investors turned optimistic that the Fed will not follow through with its aggressive rate-hiking campaign as it confronts increasing signs of an economic slowdown and the possibility of a financial accident – the UK episode brought the Bank of England into play due to fears of a pension fund meltdown, as well as slowing inflation.

Simply put, the odds of achieving the elusive "soft landing" that investors and most economists had scoffed at just a few weeks ago suddenly seemed more achievable in the eyes of market participants. We are doubtful that the Fed will achieve that goal, although a softish recession is still the most likely outcome. Importantly, barring a financial shock – such as a bank failure or other systemic threat – the Fed will likely stay the course to bring demand and supply in both the product and labor markets into better balance.

This runs the risk of overcorrecting in our view. The Fed only controls the demand side of the equation, while supply constraints that played a key role in driving up prices are only slowly improving. In some product markets, the improvement has been significant. For example, a lot of cargo space has freed up thanks to a dramatic weakening of global demand for goods, resulting in a pronounced decline in shipping and other freight prices. Likewise, for many commodities, highlighted by the plunge in lumber prices, reflecting the ongoing slump in construction. But supply shortages remain acute in other vital sectors, such as autos, keeping upward pressure on vehicle prices.

What's more, labor shortages continue to be a significant issue for large and small companies, prompting wage increases that worry the Fed. The latest JOLTs report did reveal a marked slowing in job openings in August, suggesting some improvement on this front and spurring the market rallies built on hopes the Fed would soon pivot away from its tightening strategy. But the ratio of job openings to unemployment remains highly elevated. More importantly, Fed officials continued to affirm its commitment to future rate hikes even after the JOLTS report was released. This suggests that the Fed is willing to accept more job losses than the markets perceive it would, raising the odds of a recession next year.

Markets Will Diverge

We suspect the unusual synchronization of bond and stock prices this year will soon be broken. The demand destruction the Fed brings about, together with easing supply constraints, will usher in lower inflation and hasten the peak in bond yields, even as the Fed delays cutting the funds rate until 2024. Adding to favorable fundamentals, the demand for Treasuries should increase amid growing credit risks linked to a global backdrop fraught with potential shocks. A decade of zero interest rates encouraged unprecedented risk-taking by investors and a massive build-up of leverage to pump up profits and investment returns. These risk assets, including hidden derivatives held by the shadow banking system, are vulnerable to the very downturn that central banks are bringing about. The blowback to the US markets from potential debt defaults overseas, particularly among emerging market nations, should not be discounted.

Meanwhile, the looming recession and slowing inflation, reflecting weakening corporate pricing power, bodes negatively for the stock market, as that combination will exacerbate the profit squeeze that is already underway. The extent of the squeeze will influence the severity of the recession. That said, the peak to trough in GDP should be relatively mild. Employers will be reluctant to lay off workers as abruptly as in past downturns, reflecting ongoing labor shortages amid stubbornly low participation rates, reduced immigration, and demographic trends. To the extent that the job market holds up, a significant cushion against a big drop off in consumer spending should be in place. Even a mild recession, however, will be painful for many households, firms and investors.

RATES AND TOTAL RETURNS QUARTERLY AND ANNUAL COMPARISONS

U.S. Treasury Market	Yield (%)			Total Return (%)	
	9/30/2021	6/30/2022	9/30/2022	3rd Qtr	1Yr
6 Mo Bill	0.05	1.02	3.93	0.34	0.31
2 Year Note	0.29	2.33	4.23	-1.59	-5.10
5 Year Note	0.98	2.45	4.05	-3.91	-11.59
10 Year Note	1.52	2.33	3.79	-5.83	-16.29
30 Year Note	2.08	2.44	3.77	-10.36	-28.27

Municipal Bonds	Yield (%)			Total Return (%)	
	9/30/2021	6/30/2022	9/30/2022	3rd Qtr	1Yr
Barclays General Obligation Index	0.99	2.94	3.80	-3.30	-10.82
Barclays New York Bond Index	1.19	3.32	4.13	-3.69	-11.96
Barclays California Bond Index	1.05	3.09	3.87	-3.10	-11.20
Barclays Revenue Index	1.23	3.40	4.20	-3.62	-12.27

Equities	Levels			Total Return (%)	
	9/30/2021	6/30/2022	9/30/2022	3rd Qtr	1Yr
S&P 500	4307.54	3785.38	3585.62	-4.89	-15.50
DJIA	33843.92	30775.43	28725.51	-6.17	-13.40
Nikkei (Tokyo) US \$ Terms	29452.66	26393.04	25937.21	-7.14	-30.79

Commodities	US \$			Percent Change (%)	
	9/30/2021	6/30/2022	9/30/2022	3rd Qtr	1Yr
Gold Comex Spot (\$ per oz)	1756.95	1807.27	1660.61	-8.12	-5.48
CRB Future Com. Pr. Index*	228.92	291.1476	268.2911	-7.85	17.20
W. Tx Int. Crude (\$ per bbl.)	75.03	105.76	79.49	-24.84	5.94

Currencies	Levels			Percent Change (%)	
	9/30/2021	6/30/2022	9/30/2022	3rd Qtr	1Yr
Yen	111.29	135.72	144.74	-6.65	30.06
Sterling	1.35	1.2178	1.117	8.28	-17.10
Euro	1.16	1.0484	0.9802	6.51	-15.35

Global Bond Markets**	Levels			US \$ Terms (%)	
	9/30/2021	6/30/2022	9/30/2022	3rd Qtr	1Yr
German 10 year	-0.20	1.33	2.11	-11.68	-29.34
Japanese 10 Year	0.07	0.23	0.24	-6.31	-24.22
UK 10 Year	1.02	2.23	4.08	-21.13	-34.58
Barclays US Emerging Market	4.20	7.17	8.16	-4.06	-20.92

Source: Bloomberg Financial Data

*Thomson Reuters/Jefferies CRB Commodity Excess Return Index

** Global Bonds Represented by Bloomberg Barclays Indices

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