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MACRO FOCUS

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Inflation vs labor market drives Fed dilemma

- Reported inflation has been very volatile in recent years, but has been falling since June, along with commodity prices. This strongly suggests that inflation has peaked and is already well into in the process of returning to more normal readings.

- The other element of the Fed's "dual mandate" of low inflation and full employment is driving the current policy dilemma: measures of overall economic growth are slowing, but the labor market remains strong (though slowing at the margin). The Fed views labor market tightness as a driver of inflation, and thus wants to see fewer jobs and smaller raises before it takes its foot off the monetary policy brake.

- The Fed's rhetoric has continued to be "we will keep raising rates, and then keep them high, until both inflation and labor markets have clearly slowed". The bond market, however, does not fully believe this and is pricing in lower rates starting later this year. The yield curve remains heavily inverted as investors take a forward-looking view.

- While the Fed's tightening has been historically aggressive, the US economy is likely more resilient to rate hikes now than in the past (especially vs the 2005-2007 cycle) due to lower leverage and the lagged effects of the historic post-COVID stimulus. Thus any recession may be relatively mild, and corporate earnings may also see less severe declines than some expect.

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Inflation peaked in June, lagged shelter costs the main CPI driver now

Much of the focus for investors and policy makers in 2022 was the worry about excessive economic growth and inflation. The effects of returning to more normal activity after COVID and the historic fiscal stimulus accompanying it, along with the invasion of Ukraine by Russia, provoked a rare mix of supply and demand shocks on the US and global economy.

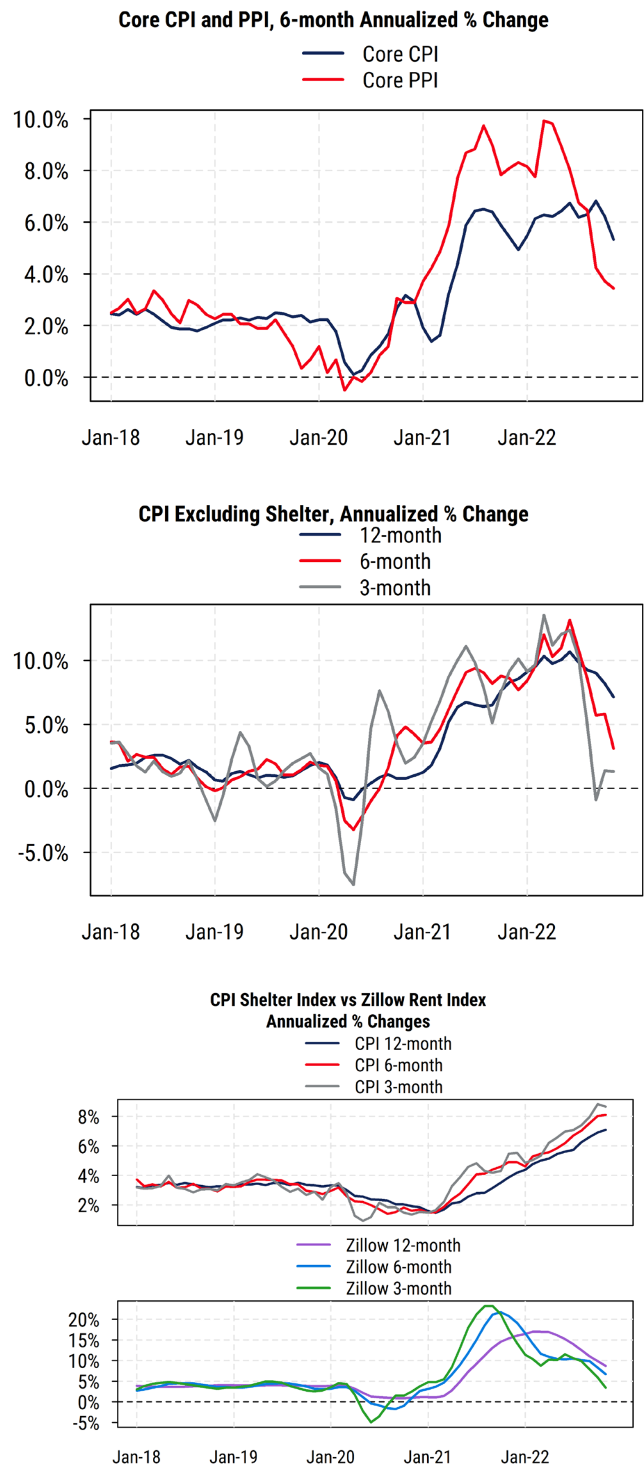
So after many years of low (often viewed as "too low") inflation, 2021 and the first half of 2022 saw an extreme rise in reported inflation, which drove the Fed to begin a historically aggressive campaign of raising rates and reducing the security holdings on their balance sheet.

This monetary tightening, along with a drop-off in the earlier fiscal support, has had a significant impact already. Those policy forces have combined with the easing of energy prices after a surge in early 2022 following Russia's invasion of Ukraine and the sudden reduction of oil and gas exports from Russia. Along with energy, other commodity prices have also been declining since mid-2022 as demand has weakened, especially in China where COVID has caused another severe bout of disease and economic lockdowns that are only very recently starting to ease.

The net effect is that **reported inflation looks to have peaked around June/July of this year, and has fallen off rapidly since then**. While this is only partly visible in traditional year-on-year inflation measures, rolling six-month and three-month measures show that quite clearly in both the CPI and the leading PPI data (top chart).

This is especially true when excluding **shelter costs** (middle chart), whose calculation in the CPI is well known to be lagged by construction relative to market-based measures (bottom chart). Thus the evidence is piling up that inflation pressures have eased sharply since the Fed has been raising rates, and **by some measures inflation is already close to the Fed's target**.

Exhibit 1: Inflation is slowing rapidly, especially ex shelter



Source: Mill Street Research, Bloomberg, Factset

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Big gap between leading and coincident indicators raises risk of policy mistakes

The markets have naturally been focused on the Fed for much of the last year, and trying to gauge which economic data the central bank is most focused on. **Analyzing economic data has been unusually difficult in the post-COVID era, as it remains quite volatile and skewed by multiple extraordinary influences.**

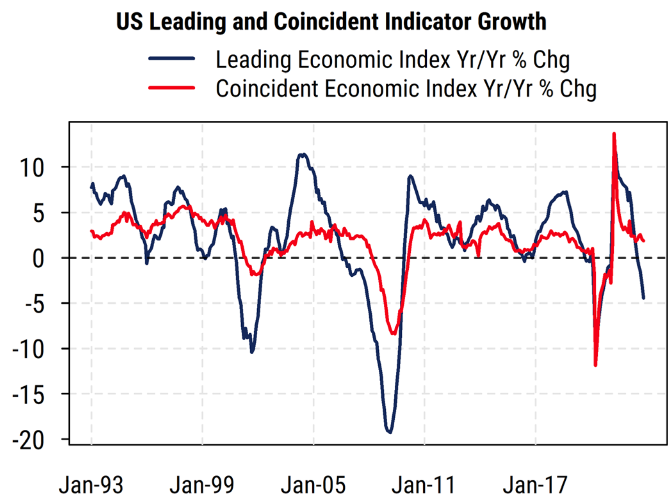
Since one of the basic assumptions for policy makers (and thus investors) is that "too much growth causes inflation", determining the economy's current, future, and potential growth rate is always important. But the data is making it harder than usual right now, which raises the risks of policy mistakes if officials focus on the wrong metrics.

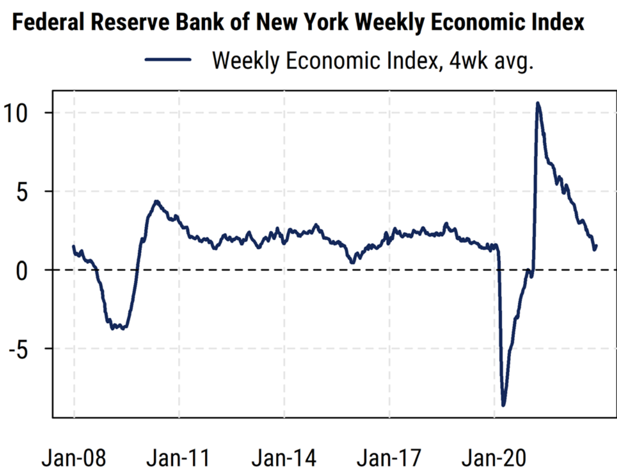
As we have noted before, **there is an unusually wide gap between leading economic indicators** (LEIs, based on the Conference Board's 10-indicator measure) **and coincident indicators** (CEI, a separate measure comprised of four inputs). The **LEIs have fallen sharply** since their peak in February 2022, and are now -4.5% below year-ago levels (through November).

The less volatile Coincident Indicators, by contrast, are still rising (at all-time highs) and up 1.9% from a year ago. We see a similar picture in the more timely Weekly Economic Index produced by the New York Fed (bottom chart). It uses daily and weekly economic data to estimate current year-on-year real growth, and it has slowed rapidly but remains positive at about 1.5% right now.

Thus the economy is clearly slowing, and the LEIs are consistent with a recession this year, but coincident measures that seem to hold more of the Fed's attention lately are holding up, **raising the risk that they overshoot in their tightening** and provoke more economic damage than is necessary to reduce inflation.

Exhibit 2: Leading indicators have plunged even while coincident indicators hold up, with the Fed focused on the latter





Source: Mill Street Research, Bloomberg, Factset

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Labor market is the Fed's main concern now, and a reason for optimism

Since the Fed's dual mandate was formally put in place in 1977, trying to maintain low, stable inflation and full employment at the same time has always been a challenging demand.

The inflation component was the key concern in 2022, with the highest reported inflation rates since the early 1980s. After many years of low inflation, the combined effects of COVID, stimulus, and Russia have meant demand has been above available supply in many areas.

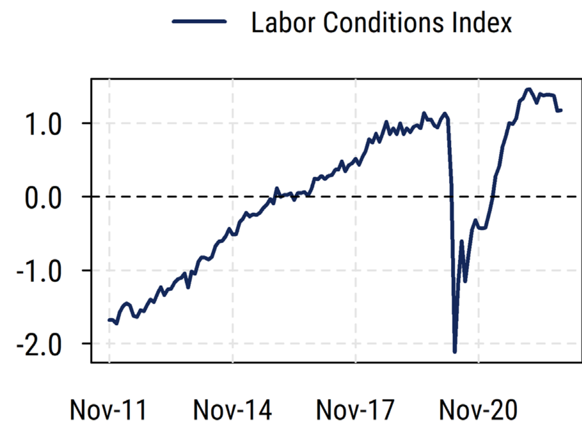
Most recently, however, demand and supply have become more balanced in goods-producing industries as supply chains have normalized and the effects of stimulus has worn off and been reversed. **In services by contrast, which are heavily driven by the need for labor, inflation pressures remain more elevated and thus a worry for the Fed.**

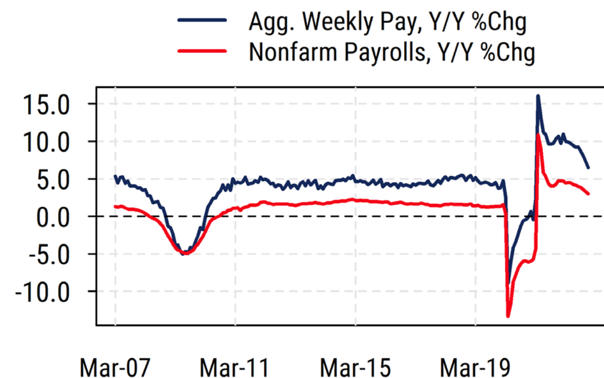
Labor markets in the US remain tight by most measures, as the reduction in labor supply caused by COVID itself and by the restrictions on immigration and internal movement have made it harder for businesses to find enough workers to meet demand. High demand for workers has thus led to both more people being employed, and higher wages.

The top chart at right plots a composite index created by the Kansas City Federal Reserve, which puts a variety of labor indicators together and centers the index around zero, which would indicate long-term historical "normal" labor conditions. Readings above zero indicate stronger than average labor conditions, and recent readings have been extremely high, though they are starting to come down from their peaks. **If the US is entering a recession soon, it is starting from a position of unusual strength in the labor market, potentially mitigating the extent of the contraction.**

The lower chart plots the year-on-year growth of nonfarm payrolls (red line) and **total aggregate weekly pay** (blue line), which combines job growth, wage growth, and hours worked. **Aggregate pay growth remains above normal pre-COVID readings, and is the main source of the Fed's worry as an inflation driver. But it is rapidly slowing, and may reach acceptable levels for the Fed fairly soon.**

Exhibit 3: Labor market data remains strong, a worry for the Fed but a reason for economic optimism. There have been signs of slowing recently that may ease pressure on the Fed.





Source: Mill Street Research, Bloomberg, Factset

Fed projections continue to diverge from the market

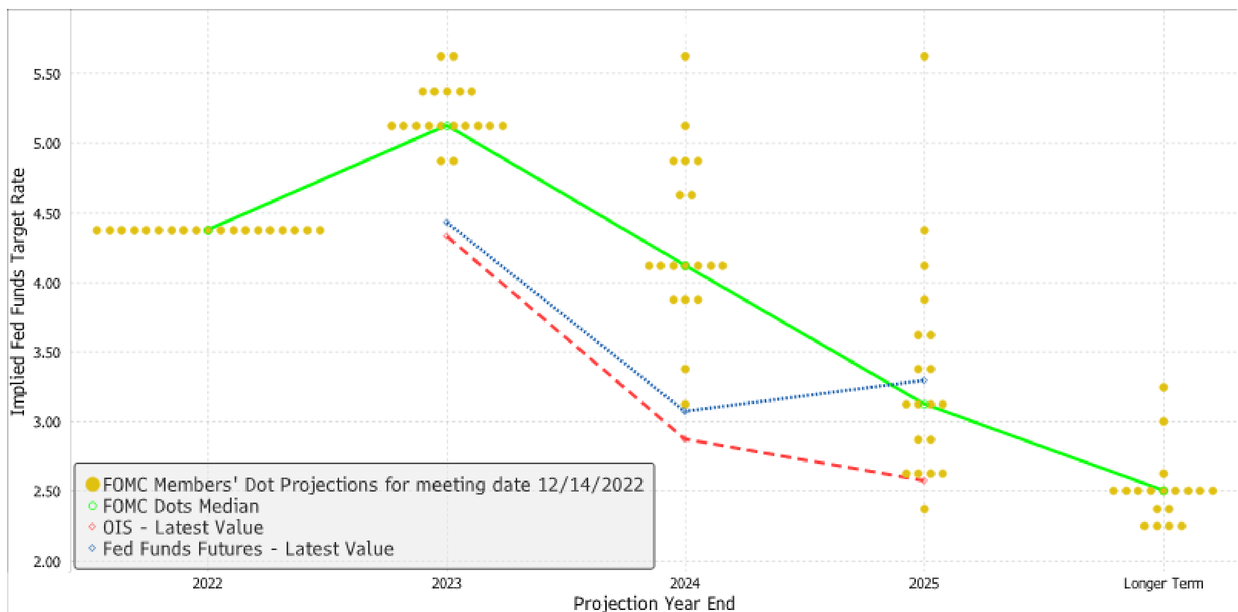
Fed officials have maintained a fairly hawkish public message, focusing on the tightness of the labor market and **the concern that inflation expectations will become "unanchored" and lead to persistent, embedded inflatio**n. Thus the latest public projections (the Summary of Economic Projections, or SEP, from mid-December) show the **median expectation for the fed funds rate as being above 5% at year-end 2023** before falling to a little more than 4% at year-end 2024, then falling further after that toward the expected long-term target rate of 2.5%.

Investors, however, do not fully believe the Fed's projections, and **market prices for futures and swaps based on policy rates are notably below those shown in the SEP**. This suggests markets expect the Fed to change its tune somewhat and not raise rates as much as expected, and/or begin cutting them sooner than expected.

This also highlights that **the Fed is already quite "tight" in policy terms relative to its own long-term rate forecast of 2.5%**. Indeed, the fact that monetary policy (including ongoing "quantitative tightening" or balance sheet reduction) is already quite tight is likely a key reason why investors expect lower inflation and weaker growth, and thus lower rates, than the Fed does.

Both the Fed and the markets have been wrong in the past: in December 2021, the Fed projected no more than 100bps of rate hikes this year and inflation below 3%, while bonds have been anticipating a "pause" for months now. **In our view, the data is shifting more toward the bond market's side than the Fed's lately, but that may not prevent the Fed from overtightening due to worries about its public perception.**

Exhibit 4: Market expectations are notably below the "dot plot" for this year and next as investors anticipate more weakness than the Fed does. Current rates are already far above the Fed's own long-term rate target.



Source: Mill Street Research, Bloomberg

Markets looking ahead, seeing lower rates

Even more clear-cut evidence that investors do not believe the Fed will follow the path laid out in its "dot plot" is the **ongoing and historically extreme inversion of the Treasury yield curve.**

The widely-watched spread between the 10-year and two-year Treasury note yields is at its most negative readings in decades (blue line, top chart), with a similar picture when comparing 10-year to three-month bill yields (red line).

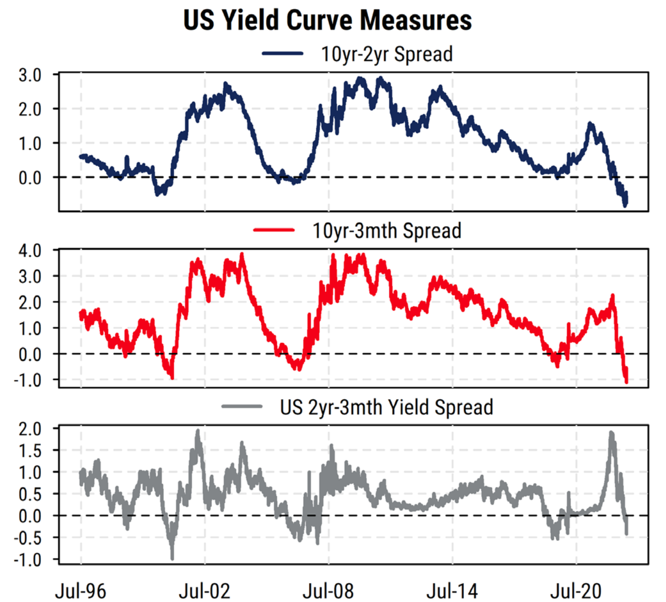
This tells us investors are willing to forgo higher current yields (the ~4.5% available on 1-2 year notes) in order to own lower yielding 10-year notes (~3.5%), and potentially pay the higher financing cost on longer-term bonds for leveraged players.

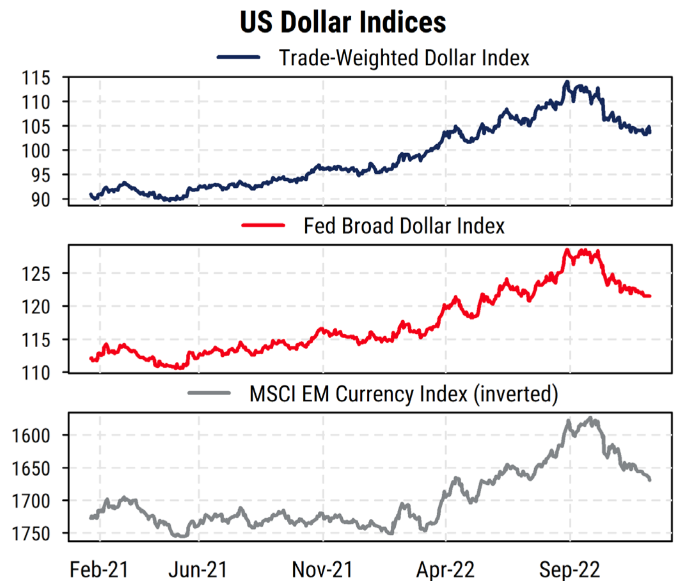
And even the spread between the two-year and three-month Treasury yields is in negative territory, **implying that a pause and potential rate cuts are expected reasonably soon**, in order to make the current two-year yield appealing.

The market's rate expectations are visible the downdraft in the US dollar as well. After a powerful surge through October 2022, all major measures of the dollar (bottom chart) have turned decisively lower in the last two months. This reflects both the odds that the Fed is nearly done raising rates, and that other central banks have narrowed the gap in policy rates somewhat. Even Japan, where rates are still hovering near zero, has shown signs of allowing for somewhat higher rates, bringing a sharp rally in the yen.

So while it is potentially painful for bond investors to manage during inverted yield curves, and currency volatility remains elevated, **markets are aligning more clearly behind the view that US policy rates are approaching a peak and may start to fall within the next 12-18 months.**

Exhibit 5: Inverted yield curves and a falling dollar indicate markets expecting an end to the Fed's rate hikes soon.





Source: Mill Street Research, Bloomberg, Factset

Financial conditions are tighter, but tight enough for the Fed?

The Fed has commented on its interest in keeping financial conditions tight in order to reduce inflation. Thus **rallies in stocks and bonds tend to be followed by hawkish commentary meant to "jawbone" the market lower.**

Financial conditions have clearly tightened in the last year, which can be seen in the Chicago Fed's Financial Conditions Index (top chart). However, conditions are not nearly as tight as in the 1970s and 1980s (or crisis periods like 2008-09), and so with inflation at its highest since the early 1980s, **investors are left wondering "how tight is tight enough?"**

The performance of US stocks and bonds in the last 12 months has certainly been a drag on financial conditions and thus the "wealth effect" on consumer spending. And these indices exclude losses in non-index securities (e.g. most SPACs) or crypto-related assets.

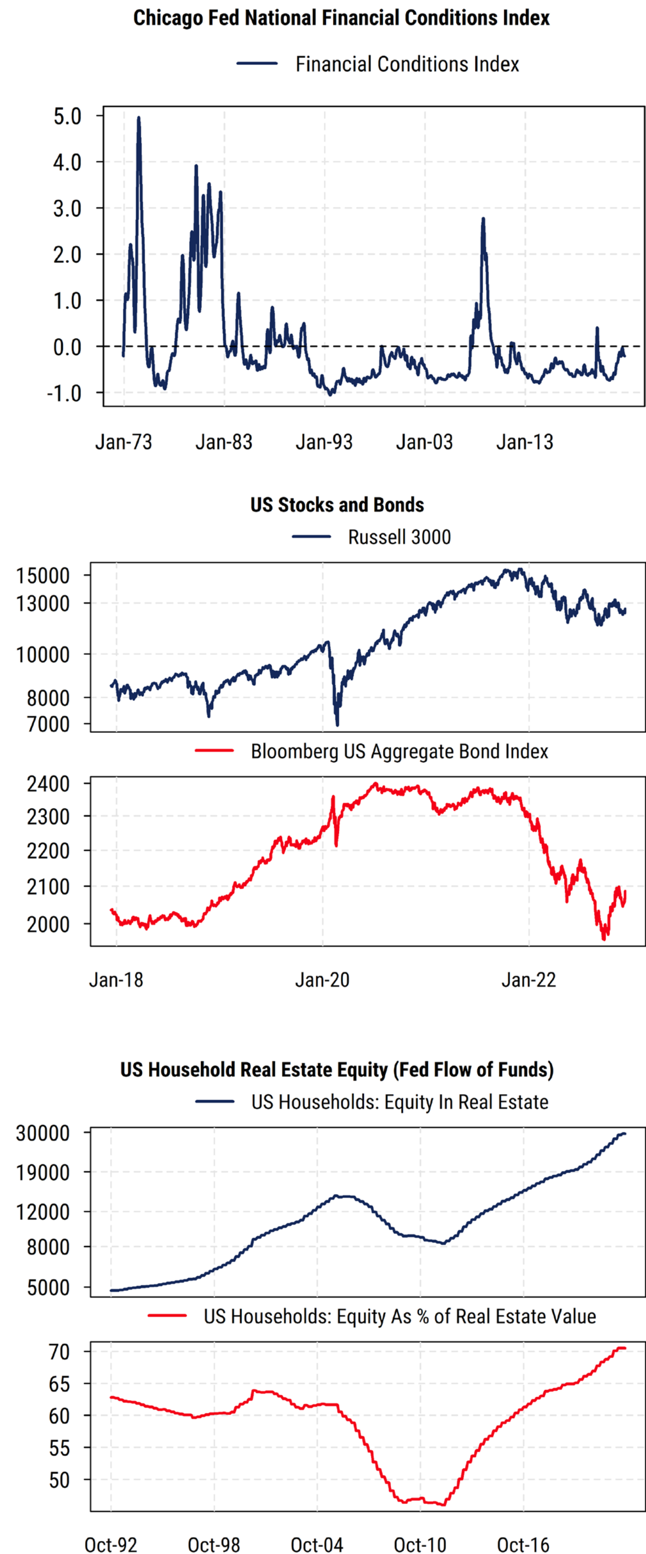
Housing (so far) remains a source of household balance sheet strength

However, the other major component of household balance sheets is housing (real estate). The Fed's quarterly Flow of Funds report gives data on the aggregate value of homeowners' equity in their homes, along with the proportion that equity represents of the total value of the homes (i.e., the value not offset by mortgage debt).

The latest data (bottom chart) only goes through Q3 2022, but shows that **homeowners equity has continued to rise steadily** for two reasons: the value of US housing has risen (though it may now be reversing somewhat), and mortgage debt has not kept up. Indeed, **the equity percentage of homeowners' real estate value is at multi-decade highs** (highest since early 1980s) at 70.5%, a dramatic difference from 10-15 years ago.

US households thus should, in aggregate, have more "cushion" in the form of housing wealth to withstand the Fed's rate hikes and financial market losses now than in the past.

Exhibit 6: US financial conditions have tightened, but not like the 70s/80s. Homeowners' equity is a larger potential cushion now than in the past.



Source: Mill Street Research, Bloomberg, Factset

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Inflation expectations at or below Fed target, well "anchored"

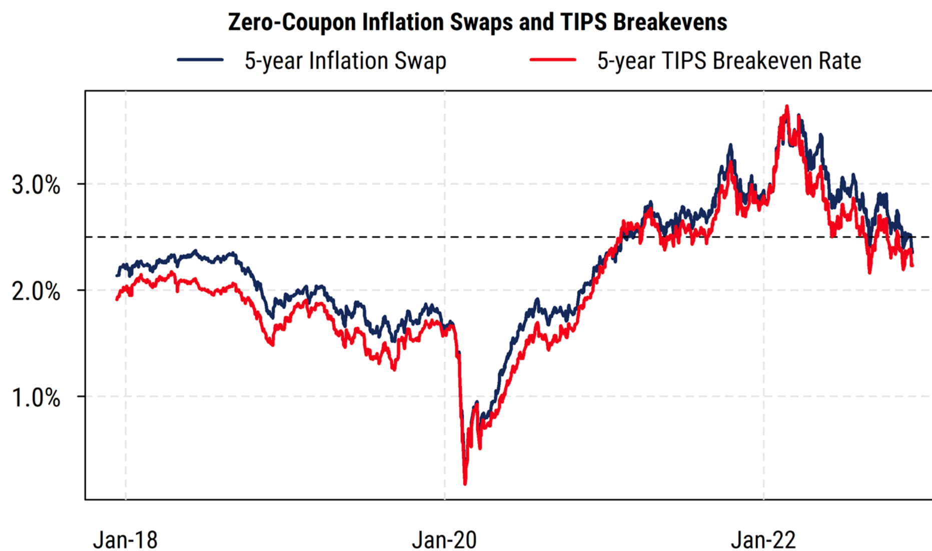
While stock, bond, and currency movements can tell us a lot about what markets seem to believe, **the market for inflation swaps and inflation-protected bonds (TIPS) are smaller but much more direct ways of tracking inflation expectations**.

One of the frequent concerns voiced by Fed officials has been the **worry that inflation expectations among consumer, businesses, and investors will become structurally higher and "unanchored"**. This would mean that shorter-term cyclical fluctuations in inflation expectations would not return to "normal" low levels but would stay high or even accelerate in an uncontrolled manner, as occurred in the US in the 1970s (and a lesser degree right after WWII) and in other countries at various times.

Based on inflation swaps and TIPS breakeven rates, there seems to be little danger of "unanchored" inflation expectations now. After a sharp rise to around 3.5% in early 2022, the five-year expected CPI inflation rate has fallen back to slightly below the 2.5% rate that is the Fed's ostensible target (a 2% target on the Fed's preferred PCE price index typically equates to about 2.5% on CPI due to the differences in calculations).

If the Fed is worried about its reputation for fighting inflation, those worries seem misplaced right now, at least in the eyes of investors putting real money behind their inflation views. Indeed, **the markets seem to be rapidly shifting from worrying about inflation to worrying about a recession, and hoping the Fed can keep up with the rapidly shifting macro backdrop.**

Exhibit 7: Inflation swaps and TIPS breakeven rates show five-year inflation expectations now at or below the Fed's presumed CPI target of about 2.5% -- no "unanchored" inflation expectations among bond investors right now.



Source: Mill Street Research, Bloomberg, Factset

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Conclusions:

- **US inflation likely peaked around June**, and has been receding rapidly in most measures, with shelter costs in the CPI being the big divergence right now due to its construction. Structural inflation drivers in the developed world and China remain low, while supply and demand shocks (COVID, Russia, historic stimulus) have provoked a 2-3 year reversal of the previous trends.

- **Markets clearly see this and are pricing in 3% or less inflation within a year or so**, and similar readings over the longer-term. The Fed, while no doubt aware of these trends, has kept its focus on trailing 12-month reported inflation and the labor market, driving a **continued hawkish theme in public comments**.

- The Fed has made clear that it is **more focused on the risk of persistent inflation than on the risk of recession**, particularly given that it was late in starting its monetary tightening process and feels the need to reinforce its inflation-fighting credentials.

- **The Fed's future rate projections diverge sharply from those of the market,** and already indicate that policy is quite tight relative to its own longer-term rate assumptions (4.5% or higher current rates vs 2.5% expected long-term fed funds rate). It looks more likely now that the Fed will raise rates again at its February 1st meeting, then potentially pause, with the March meeting likely being the last hike if it occurs.

- Financial conditions clearly tightened sharply in 2022, but **the Fed is trying to prevent any "premature" loosening** (rallies in stocks or bonds), but having somewhat less impact now than earlier in 2022.

- The US housing market is under heavy pressure from higher rates and slowing activity, but **households have high absolute and relative levels of home equity now**, potentially cushioning the impact for the time being.

- **The strength in the US labor market that the Fed is concerned about is itself a reason to expect that any recession that develops this year will be mild by historical standards**. Moderate nominal growth and cost cutting could help corporate earnings and profit margins hold up better than in previous cycles.

- Many investors and economists are expecting recession and significant earnings declines this year, so **the end of the Fed's tightening cycle and "less bad" economic and earnings data could allow stocks to post gains this year**. Our Global Equity Risk Model enters the year at moderately bullish readings, and our Implied Growth Model continues to favor stocks over bonds on a longer-term relative valuation basis.

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