Caron's Corner Transcript - 10.17.2022

Are We There Yet? No! But Not All the News Is Bad

- The market is collectively trying to assess when the Fed will stop hiking rates i.e. Are We There Yet?

- The timing of when the Fed may stop hiking is not only tethered to inflation falling, but to their prescriptive precondition to end the tightening cycle. But the recent CPI inflation report complicates things, where historically the Fed doesn't stop tightening until policy rates exceed the inflation rate.

- The problem is that inflation pressures are broadening into the service sector, particularly problematic for the Fed because service sector inflation is more structural than cyclical inflation - e.g. goods - and ultimately harder to control.

- With inflation still rising, this muddies the view of where the terminal rate might end, adding a risk that the Fed may once again need to adjust higher than 4.75%, their forecast as of mid-September.

- So when does the cycle end? It was thought the peak would be 4.75% in early Q1 of 2023, but this might go higher and be pushed out further, a risk that will weigh on asset valuations, as it is incorporated into earnings and discounted future cashflows.

- Despite the risk, the investment implication is that although we may not have bottomed, we are getting close and finding well-valued assets to hold through the likely upcoming volatility.

- The silver lining is that a strong jobs market keeps the economy from falling into a deep protracted recession i.e. Not All the News Is Bad.

Jim Caron: Are we there yet? This is a question I get a lot, one that refers to the level at which the Fed will stop hiking interest rates, effectively to their terminal policy rate, what we believe to be 4.75%. That number is closely linked to the bottom of risk markets. So when people are asking, "are we there yet?" that's really what they're asking.

Well, I would say, no, we're probably <u>not</u> there yet. At least there's a risk that we're not there yet. The risks are tilted that way. But not all the news is bad. So let me go through this. The market is collectively trying to assess when the Fed will stop hiking rates, and sees that as a signal for asset returns to reverse course strongly. But the timing of when the Fed may stop hiking is not only to have inflation falling but also the prescriptive precondition for the Fed to end their tightening cycle. But if it were only that simple. Unfortunately the recent CPI inflation report complicates this.

If we go back historically, we recognize that the Fed doesn't stop tightening policy until rates <u>exceed</u> the inflation rate. But since inflation is still going up as of last week's numbers, this really muddies the view of where the terminal rate might be. This “ups the ante” on the risk the Fed may need to once again adjust their forecast for a terminal policy rate higher than 4.75%. Remember in June the number was 3.8%. Then in September 4.75%. Back in March, the number was 2.5%. So this 4.75% level for the terminal policy rate was just forecasted in mid-September, not really all that long ago.

What the market is trying to do is discount the risk of higher rates and what we need to solve for now is how much might the Fed need to hike rates beyond 4.75%, and when might the cycle actually end? It was thought that the peak was 4.75% by early first quarter of 2023. But you know, there is risk that the peak is higher and pushed out further. This is going to weigh on asset valuations as this a higher interest rate risk needs to be incorporated into earnings and discounted future cash flows, and ultimately lowers valuations.

Let's break this down into pieces. First, look at inflation risk, and then try to determine the policy rate risk. With respect to inflation risk, keep in mind that the market was expecting the Fed to move to 4.75% peak policy rate. As such, we should think of this as a hurdle rate that separates “risk on” from the “risk off.” So if we look at the inflation data trail - spoiler alert - **service sector inflation** is the culprit and very problematic for the Fed.

Let's start with PPI, which had headline at 8.5% and core at 5.6%. The core data was the result of the services sector, trade and transportation, all despite the fact that there was a slowing in goods prices. So again, its service sector inflation, something I’m going to repeat over and over. Service sector inflation. Trade and transportation and warehousing was very strong, up about 0.6% and 0.4% last month, respectively. This pointed to continued price pressures in the service sector, particularly in the travel and accommodation sector, hotels, lodging and the like. If we look at core PPI for goods inflation, that was actually flat, its lowest month over month reading since June of 2020. Goods sector inflation is actually softer or least flat. But the service sector inflation is coming in a whole lot higher and that's the key point here.

Let's now look at CPI, where both headline and core are strong, coming in at 8.2% in 6.6%, respectively, the highest core inflation in 40 years. Again, the upside surprise came from the service sector while the goods sector saw basically moderation and cooling. If we think about the good and the bad of the CPI number, the good is that we are starting to see commodity and supply chain pressures starting to ease. Core goods inflation was 0% in September which is the weakest reading since March. Many categories within core goods contracted including apparel, used cars, medical and education goods, but service inflation continues to shoot higher. Core services actually rose by 0.8% month over month, which is a new cycle high, and it really indicates broad based strength.

This goes back into owners equivalent rents and other service sectors, again, a new cycle high. Even if we look at the University of Michigan sentiment scores, inflation expectations are higher. The one-year-ahead inflation expectation index rose to from 4.7% to 5.1%. Expectations did dip over the summer, but it looks like that decline really had more to do with gas prices. Now that gas prices have stopped declining so quickly, this is actually a pretty troubling sign for the Fed in the sense that longer term expectations are more subdued. As we look at the University of Michigan sentiment for inflation it rose only to about 2.9%, up from 2.7%. What we have to remember is that when this measure reached 3.3% in June, that's what sparked the Fed to actually hike rates much more quickly, those 75 basis points. We should keep that in mind.

This is an important indicator for the Fed, but nonetheless, keeps the Fed on track for more rate hikes. The bottom line is that inflation appears to be broadening rather than peaking, although it may be topping. But the service sector inflation is still problematic for the Fed because it's hard to control with rate hikes and it's much more of a structural problem than cyclical inflation, which really reflects goods. Service sector inflation becomes firmly embedded into inflation expectations and keeps inflation sticky at higher levels. So unless we see a precipitous decline in inflation over the next three months, then there's real risk that the Fed may have to increase their terminal policy rate above that 4.75% level and push out the rate hiking cycle out to a later date. This is the policy risk.

Let's talk about that policy risk now. The question we get is how high do rates need to go? This is a very, very difficult question to answer, an answer rooted in the econometric models that the Fed uses. Let me explain. The first thing we need to understand that the Fed uses the Phillips curve as a guiding principle, a measure of the relationship between the unemployment rate and inflation. What the Fed is basically seeing is that the primary source of inflation is coming from wage inflation, really tight labor markets. The second thing that we have to understand is that the Fed has an estimate of NAIRU – the Non-Accelerating Inflation Rate of Unemployment. NAIRU is the unemployment rate that balances full employment and price stability, which essentially defines their mandate and is based on the September FOMC meeting, where what they forecasted was the unemployment rate would reach 4.4% consistent with inflation moving towards target of about 2.3%. That's an important number for us to look at.

The third point though is that we need to observe how their projected policy path is actually impacting employment and inflation, the feedback loop back to the Phillips curve. And so far, we're not seeing very much progress in the Fed meeting its goals. The unemployment rate a couple of weeks ago fell to 3.5%, and as we saw last week, inflation keeps rising. This calls into question if the Fed has to actually do more to achieve their goal based on the econometric process it uses. Its not unreasonable to suggest that the Fed may need to increase their policy rates beyond the 4.75% level and that they may actually even have to get up towards 5.0% or 5.5% to achieve their goal.

Now this is NOT a forecast. All I'm doing is extrapolating from current conditions, which is always risky and dangerous because we can't forecast the future. But the point here is that if we extrapolate, it would suggest that the Fed may have to actually increase their terminal target forecasted in September above 4.75%. That's really what weighing on the markets because that's going to impact valuations.

However, consistent with our analysis, we think the structural factors keeping the jobs market tight are the same factors that may keep the U.S. economy from slipping into a deep recession. It's a bit ironic, where it's difficult to see a deep recession with the jobs market so strong. Look, the strength in the jobs market is keeping inflation elevated, and that is bad. But the fact that the jobs market is strong also alleviates some of the risk of the economy slipping into a deep recession. Which is good.

The investment implication is that although we may not have bottomed, we're likely getting close and finding well-valued assets to hold through this likely to be volatile period coming up. But are we at the bottom yet? And do we know for sure what the terminal Fed funds rate is at this point? No. But Not All the News Is Bad.

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