Caron's Corner Transcript - 10.31.2022

2023: A Year of Long and Variable Lags

- It is timely to connect the November Fed meeting with an outlook for 2023, as that meeting may mark the end of aggressive 75 basis point (bps) hikes, where the pace may slow to 50 bps in December and 25 bps thereafter.

- A terminal Fed funds rate of 4.75 - 5.25% may be reached in 1Q 2023, dependent on inflation data. Nevertheless, the end is near.

- This is important because interest rates hikes have been the key driver of asset prices in 2022, and changes in policy likely will have a strong influence on asset prices in 2023.

- But it is important to understand that rate hikes will influence the path of earnings, default risks and credit spreads, and ultimately the type of recession we get whether deep (earnings) or wide (spreads).

- Why? Because as the Fed has said, rate hikes work with long and variable lags making 2023 "The Year of Long and Variable Lags."

Jim Caron: I want to speak with you about 2023, essentially a look at "the year ahead" which these days comes earlier and earlier. So let me be the first and I'm going to call 2023 "A Year of Long and Variable Lags." Now clearly what I'm picking up on is what Powell discussed as the "long and variable lags" of monetary policy. In 2022 he hiked rates a lot and in 2023 we're going to see what kind of an impact that has on the markets.

I think it's timely to connect the November Fed meeting on Wednesday with the year ahead outlook for 2023. The reason is that meeting may mark the end of the aggressive 75 basis point (bps) hikes. The pace may slow to 50 basis points in December, maybe 50 or 25 in February and then 25 in March depending on how one is thinking about this. The Fed policy rate may end within a range between 4.75% and 5.25% and the market's pricing in that policy rate hikes end at 5% sometime in the first or second quarter of next year. But nevertheless, the end is near.

It's important to discuss this because monetary policy decisions to hike interest rates has been a key driver of asset prices this year, and any change in policy will likely have a strong influence on asset prices in 2023. That's the whole concept of long and variable lags. But of course the fallout from these rate hikes are likely to impact both the economy and markets, so it will influence certainly the path of earnings default risks and credit spreads. And the question that we're going to be asking ourselves is, what type of recession do we get? How deep will it be? And that's going to refer to earnings. And how wide? Meaning spreads, how wide my spreads actually get. This is because it's stated by the Fed rate hikes work with long and variable legs.

Let's now talk about policy driven demand destruction because that's essentially what's taking place whenever the Fed hikes interest rates. What they're doing is they're trying to reduce demand in the economy in order to bring down prices or inflation. Fed policy tightened to address a sharp rise in prices due to both supply shortages from the pandemic and excess demand driven by pandemic-related fiscal stimulus. Both packed a powerful one-two punch in terms of driving inflation higher. The Fed believe that inflation driven from supply shortages would fall away as we pass the pandemic and supply chains reopened. There's certainly evidence that that occurred, at least to a degree as consumer goods prices did fall in 2022.

But Fed policy tightening is ineffective in terms of controlling supply driven inflation aka "cost push inflation." However, the unprecedented fiscal stimulus stoked consumer demand or what we call "demand pull inflation." Well, that type of inflation Fed policy is very effective at addressing because essentially the Fed can reduce demand and when you reduce demand, you also lower GDP growth. The Fed believes that most of the inflow is due to excess demand today, making aggressive rate hikes more appropriate in terms of their thinking, as tight labor markets and wage inflation only served to exacerbate the problem because consumers could afford higher prices passed on by manufacturers. But remember that **service sector inflation** is where all the inflation is today and remains high and problematic for the Fed because essentially it ends up increasing inflation expectations.

But how much tightening is too much since rate hikes work with long and variable lags? Well, has the Fed tightened too much already? This is the debate we're having right now. So let's focus a bit more on demand and some GDP data that came out last week. I think there is evidence that demand is already starting to slow reasonably – and I'd say pretty significantly at this point - evidence of demand destruction based on Fed hikes. This is evident beneath the surface of the Q3 GDP release particularly in the housing markets and mortgage-related sectors.

If we look at third quarter GDP it rose by 2.6%, a little better than consensus. But the details underneath that number aren't as strong as originally suggested. Looking at private final domestic demand, this is a measure within GDP that strips out the more externally exposed areas of the economy, including exports, inventories and government spending. All of these have slowed for four straight quarters, and are roughly flat at this point. Final domestic demand has already moved towards a flat level, and there is evidence that the past policy actions are affecting the domestic economy more broadly. This suggests that we're just at the beginning as we're starting to make our way to 2023 and we could see these demand numbers even fall further.

As we go through this, what we have to remember is that GDP is an accounting identity, its consumption, investment and government spending exports minus imports. All I'm really doing is parsing through all of the various parts of GDP. Let's now discuss exports, which did contribute about 2.8% points to Q3 GDP. But while inventories just took out about 0.7%, this compares to a 1.3% growth rate in Q1 and 0.2% in Q2. So although final demand did improve slightly in Q3 what we have to remember is the final demand trend is still pretty soft. Final demand is coming in around flat.

Now breaking down real demand, if we look at CAPEX was strong and consumption was okay. But the housing sector is a very important part of the overall GDP, and was extremely weak falling -26%. Government spending did help a bit, up about 2.4%. But remember, housing is a big part of the economy: owners equivalent, rent inflation, all of these various things factor in. What we're seeing is that many banks have already started to raise provisioning in terms of their loans and tightening lending standards in the face of tightening financial conditions. Mortgage markets are deteriorating rapidly because if we look at affordability for mortgages, they're at a 35-year low and auto loans are also weakening. These are reasonably decent size sectors of the economy from a credit perspective that we're seeing are already starting to slow.

But, we have to remember credit fundamentals are still good. It's just that credit costs more, which is enough to slow demand, and this is all by design. And this is true for corporate credit as well. So the Fed is trying to engineer a slowdown in demand in order to bring down prices. And guess what? It's working. They've been hiking rates, and it's working, and we're going to see a deeper fallout in 2023. Again, the reason I'm highlighting this Q3 GDP is because we're seeing signs that it's starting to work, and the Fed is going to take notice of this. The bottom line is that despite a rise in top-line GDP growth, the overall print and top line growth in corporations demand is actually cooling. Q4 will likely provide similar results to Q3, but momentum is likely to slow in 2023 as the slips from lower energy prices and lower imports paid, and policy drags both on the fiscal side and on the monetary policy side, starts to lose traction in the economy.

The risk is that corporations can't pass on higher prices, which squeezes margins, lowers earnings and unfortunately ushers in a cycle of layoffs and recession that maybe hits the markets by the middle of 2023. The question we have to ask ourselves as market participants is whether this demand destruction is fully priced already, and will the Fed take notice? Well, I think the Fed is aware of the signs of lower demand due to tightening financial conditions. I think they certainly can read the data as well as anybody else can, probably better. It may prompt them to start a process of slowing the pace of rate hikes in anticipation of reaching their terminal policy rate at some point in the first quarter of 2023. Now again that may be between 4.75 and 5.25%. The market is pricing it right at about 5%.

Now while the market may see the end of the rate hiking cycle as a reprieve from rising rates, it will ultimately have to contend with the long and variable lags from monetary policy and whether or not this is fully priced in in general. I don't think it is, but this doesn't mean that we can't get a risk rally in the near term. Markets are going to try to be efficient, but they're also somewhat technical at times, and this can sometimes surprise us. But our base case is that the economy does enter into a mild recession in 2023 and that's only because we believe the labor market remains stronger than usual. It's very hard to have a deep recession when the labor market remains strong. Now, earnings may fall and credit spreads may widen, but how much of that is already in the price is the key question.

For earnings, many people have various forecasts on that and I'm not going to go through that, but you know, clearly those people are looking at not just earnings reductions, but also revisions of earnings reductions which can have an impact on equities. If we look at investment grade credit spreads, based on the Bloomberg indices, I would argue that credit spreads at about 200 basis points, but we're not there. We're between 150 and 160 basis points. But 200 basis points is really seen as a full blown recession level. I'm not sure if we're going to fully get there, but maybe between 150 and 200 basis points might be where we end up going. A lot of that is already in the price.

I would say the fact that interest rates could come down could be supportive of bond markets. But the Fed may see start to see diminishing returns from continued rate hikes and they then decide to hold steady and keep their terminal rate well above their forecast's neutral policy rate of 2.5%. So let's say the Fed goes to 5% policy rates, they say neutral is 2.5% but the Fed is happy to stay at 5% policy rates for an extended period of time until inflation falls. That might be the prescription for bringing down inflation. I don't think the Fed has to continue to hike rates all through 2023 until inflation gets to target. I think they can sit sufficiently above neutral. Whatever that level is, the market's getting 5% and I'll agree with that. The new policy path may start with communications of this around at the November FOMC meeting on Wednesday, which I will recap later that day.

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