Caron's Corner Transcript - 10.10.2022

R.I.P. Cycle, Part 3: Markets, Meet Your (Policy) Maker

- Risk premia continues to rise as markets price the Fed policy seriously, namely 4.75% by January 2023, with upside rate risk if inflation, particularly wage inflation, doesn't make sufficient progress to target.

- R.I.P. (Recession, Inflation and Policy Risk) Cycle: The risk of Recession and Inflation are occurring simultaneously, but Policy can only respond to one, not both. If policy chooses to battle inflation, the casualty will be a higher risk of recession. At this juncture it will be hard for policy makers not to make a mistake by either over- or under-tightening, and a mistake can be deadly (R.I.P.)

- Good news is unfortunately bad news, in the sense that economic strength "ups the ante" for more aggressive rate hikes. Mathematically, Fed rate hikes push discounted future cashflow rates higher, lowering the present value of asset prices, the reason for the current down draft in risk assets.

- Higher rates and an increased risk of recession go hand in hand, adversely impacting credit risks and heightening default risks, which in turn widens credit spreads. As both the cost and risk for credit increase, the more likely something breaks in the economy, leading a "hard landing."

- The "pivot" in policy rates in mid-2023 represents the markets pricing a bad outcome that forces the Fed to stop hiking or even start cutting rates. This is the opposite of what Fed officials are saying, who instead claim they will keep policy rates high for as long as it takes to get inflation to target. And so begins the R.I.P. cycle.

- The labor market becomes a key factor as we try to understand at what "cost" is the Fed willing to pay in order to get inflation, namely wage inflation, to target. That cost is measured by the unemployment rate, which ticked lower to 3.5% on Friday (Oct 7), putting the Fed at odds with the labor market.

- Over the past three months, the economy has produced on average 372k jobs per month. At this this pace, remaining slack will be fully absorbed by year's end, at which point there will be virtually no one left to hire.

- This is why wage inflation is likely to be sticky, which puts more upward risk on policy rates and that in turn hurts capital. At this point, labor is winning and capital (i.e. asset prices) is losing, in an ever steepening uphill battle.

Jim Caron: On this week's audio cast I would like to discuss this R.I.P. Cycle - Recession, Inflation and Policy – that we have previously outlined. This is part three of this series and I'm going to call it "Markets, Meet Your (Policy) Maker," a take on "Meet Your Maker" that fits with R.I.P.

Market risk premia continues to rise as the market is taking the Fed and their policy very seriously. The Fed is moving to 4.75% based on expectations probably by January and there's upside risk to that policy rate, particularly if inflation and wage inflation don't make sufficient progress to getting back down to target levels. Again, the R.I.P. Cycle is recession, inflation and policy risk, a framework that we've discussed in the past where we look at recession and inflation risks that are occurring simultaneously, but that policy can only respond to one but not both. If policymakers choose to battle inflation then the casualty will be a higher risk for recession. It will be hard for policy makers not to make a mistake either by over tightening or under tightening and mistakes made in the cycle can be very deadly. Hence R.I.P.

Unfortunately good news becomes bad news in this cycle because economic strength really "ups the ante" for more aggressive rate hikes. Mathematically this pushes rates higher for discounting future cash flows and that lowers the present value of asset prices which is why asset prices have dropped lately. But higher rates and increased recession risk do go hand in hand. The faster the Fed is willing to hike rates the more likely it is that we're going to have a recession in the future. In last week's audio cast we discussed how this adversely impacts credit markets, because it increases recession risk, which in turn increases default risk, which results in widening credit spreads. This all makes it more likely for something break in the economy, a hard landing as it were.

A lot talk about the "pivot" in terms of Fed policy, where if you look at the Fed funds futures market the Fed is expected to hike interest rates, but at some point in the middle of 2023 the market is pricing that they're going to start to cut rates. This pivot in policy rates in mid-2023 really represents a market pricing of a bad outcome that forces the Fed to stop hiking and maybe even starting to cut rates. This is completely the opposite of what Fed officials have been saying, as they claim that they will keep policy rates high for as long as it takes to get inflation to target. Again, this risks recession and is the start of the R.I.P. Cycle.

Now we will complicate this even more by adding a wrinkle known as the labor market. Look, the labor market is just refusing to go along with the script, because the labor market remains relatively strong. When we think about the Fed's desire to bring inflation to target, we have to ask the question "at what cost?" What we are really looking at is wage inflation and the "cost" is measured in terms of the unemployment rate, which actually ticked lower on Friday (Oct 7) to about 3.5%. This puts the Fed at complete odds with the labor market and is the crux of the debate.

When we break it all down, it's simply about labor versus capital (i.e. asset prices). The Fed needs to bring down wage inflation in order to control total inflation based on their models, and as such, is going to increase interest rates. By increasing interest rates a lot they end up increasing recession risk. That is a negative outcome for asset prices and that's the labor versus capital debate that's going on. If this were a football game the score would be Labor – 3, Capital - 0. If you look at the unemployment rate it moved back down to cycle lows of 3.5% as of last Friday's data (Oct 7) and you can basically just "drop the mic" and just say labor has won, or just winning by a large margin.

But, there's more. The strong monthly run rate of jobs that we've seen is very impressive. If we look at private sector employment gains, they're averaging 393,000 with an unemployment rate averaging

about 3.6%. In 2018 to 2019, the average monthly job gain was about 163,000 - which is still a pretty good number - with an unemployment rate averaging about 3.8. Based on history, 2018 - 2019 was much more typical of monthly job gains when we're at full employment. Today we're running at 393,000 as opposed to 163,000. So the 263,000 job print that we got on Friday for September is lower than the three-month average run rate for jobs, indicating some slowing, but as I just stated, this run rate is actually pretty strong and very significant.

The other thing that we're going to look at is the vacancies unemployment ratio. It's still very high and likely to remain strong as services, hospitality and leisure, are all making a very strong comeback. Furthermore, despite corrections and supply chain issues the manufacturing jobs rate is actually not too shabby either. What we're seeing is a return of the pre-COVID pattern of nearly 50% of monthly job gains being the combination of health, social services, accommodations and food services. These hard hit COVID sectors are making a strong comeback and don't seem to be letting up anytime soon. Not to mention travel and tourism, which has also rebounded nicely. Monthly gains even in manufacturing are running about twice the pace that was set in the 2018 – 2019.

Back to the football score. The 3 for Labor is 1) the unemployment rate is low, 2) a strong monthly run rate and 3) the vacancy unemployment ratio is still very high. Those are the three points. And I still gotta score capital at 0, cause all you have to do is look at the YTD performance of the financial markets, one of the worst bond market performances in modern history, equities in decline and even cash net of inflation was underperforming. There's nowhere to hide.

Let’s look at this inflation component and understand how this continues to be a problem for the. When I think about inflation it's broadening into the service sector right now. Yes, it may be peaking, we may have seen the top inflation but it's starting to broaden into the service sector. This is worrisome because the Fed sees service sector inflation as stickier and harder to control and embeds itself into inflation expectations. The decline in the labor force as of last Friday led to a 0.1% drop in the participation rate to 62.3% from 62.4%. This caused the unemployment rate to reverse the 0.2% gain from last month back down to the cycle low of 3.5%. So over the past three months, the economy has produced really on average about 372,000 jobs per month and at this pace. Extrapolating, if we look at the jobs pace of 372,000 jobs per month, the remaining slack in the labor market will be fully absorbed by the end of the year and after that there would be virtually no one left to hire. And this is why wage inflation is likely to remain sticky, which puts more upward pressure on policy rates and that in turn for its capital. So there is no question that labor is winning over capital or asset prices.

It's an ever steepening uphill battle for capital to regain ground and there is real risk that there is upside to the Fed’s terminal forecast of policy rates, which we think will be 4.75%. But there's real risk that actually moves higher. This circles back to why I titled this audio cast “Markets, Meet Your (Policy) Maker” because policy is going to be the key the driver of asset prices. Having said that we still advocate for a balanced portfolio, trying to hedge against rising interest rates by owning short duration assets, maybe some floating rate, but all in high quality because of the risk of recession risk in the future.

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CRC 4982130 Exp. 10/31/2023