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ECONOMIC & MARKET UPDATE

The Operation Was a Success, But the Patient . . .

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Stock markets around the world are closing out a third quarter that has been better than the second. A roughly flat quarter is more desirable than the marked decline that preceded it. It doesn't seem that way, though. Primarily this is because the strong rally off June's lows raised – then subsequently dashed – our hopes with a fall back to those levels.

The heightened market volatility is primarily due to the actions and rhetoric of the U.S. Federal Reserve. A misinterpretation of Chair Jerome Powell's comments from the July meeting led investors to believe the Fed might pause interest rate hikes and may have even been able to reduce rates by early 2023. The Chair and other Fed speakers spent the last month disabusing the markets of those notions. That culminated this week with both a 75-basis point rate hike and a significant increase in the Fed's projections for the level at which rate hikes will end.

Could the Fed Catalyze a Recession?

The Federal Reserve is singularly focused on bringing inflation down and is prepared to take the economy into a recession if necessary. Official speeches, including the Chairman's Jackson Hole address last month, emphasized the point. The Fed is likely to succeed in its goal. In fact, inflation shows many signs of having peaked: pump prices for gasoline have fallen markedly, many other commodity prices are back to levels from the beginning of the year, prices paid and inflation expectations surveys are down, freight costs have declined. Yet the Fed seems impatient that the published inflation statistics are not declining fast enough and does not think it is able to let the effects of its actions this year play out. The Fed Funds Rate is 300 basis points higher than it was six months ago. Quantitative tightening, the process by which the Fed shrinks its balance sheet, is just starting. And the U.S. Dollar has soared this year. These are all indications of tighter financial conditions. Yet, the Fed is clearly indicating its intention to keep raising rates.

Markets want the Fed to be Patient

The stock market is suggesting the Fed is making a mistake. So is the bond market. The inversion in the yield curve, a condition in which shorter-dated treasuries yield more than longer-dated ones, is a clear indication of that. But the Fed is undeterred. In part, it is undeterred because the U.S. economy is so strong that it fears inflation will become entrenched: the labor market remains healthy, the banking system is stable, and economic indicators such as Friday's PMI surveys continue to indicate an economy that is staying out of recession. Pockets of the economy are weakening, though. Most noteworthy is the housing market, which has seen demand dry up as mortgage rates have doubled this year.

The Fed needs to see a "convincing" decline in inflation to change course. Until it does, financial markets will be challenged to find firm footing. What if those signs of easing inflation come well after the fact, though? That may indeed be what is happening. Housing prices as measured by Owner's Equivalent Rent (OER) are known to be lagging in their moves. Home prices fell in sales statistics this week. But the Consumer Price Index, which the Fed is watching, is 31% affected by OER which continues to move higher. If the Fed continues to raise rates instead of

letting this important inflation component come down in response to the rate hikes already in the economy, then a wholly unnecessary recession may occur.

Breaking Inflation Doesn't have to Break the Economy

Market commentators are starting to speak more to this risk. Bond manager Jeffrey Gundlach, economist Jeremy Siegel, and money manager Scott Minerd have all suggested this past week that the Fed is overdoing it. The Fed may be regretting its late move to tighten policy after believing for too long that inflation was transitory. While it was obviously correct to acknowledge the persistency of this early inflationary cycle, the rate increases need to be implemented in proper measure. The amount of monetary tightening this year is extraordinary. It does not appear the Fed is willing to let the effects of these rate increases be felt before tightening even further. But as the storm clouds gather, the Fed may have to rethink the point at which it stops. A pause is not the same thing as the so-called Fed Put, in which the Fed cuts rates to buoy the stock market. That would be unwise, as it could allow inflation to reignite. But if inflation is indeed coming down, the Fed would be wise to let it do so without further rate hikes. A successful operation that kills the patient is, in fact, not a successful operation.

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