PERFORMA

JUNE 2022 MARKET UPDATE

MARKET PERSPECTIVE

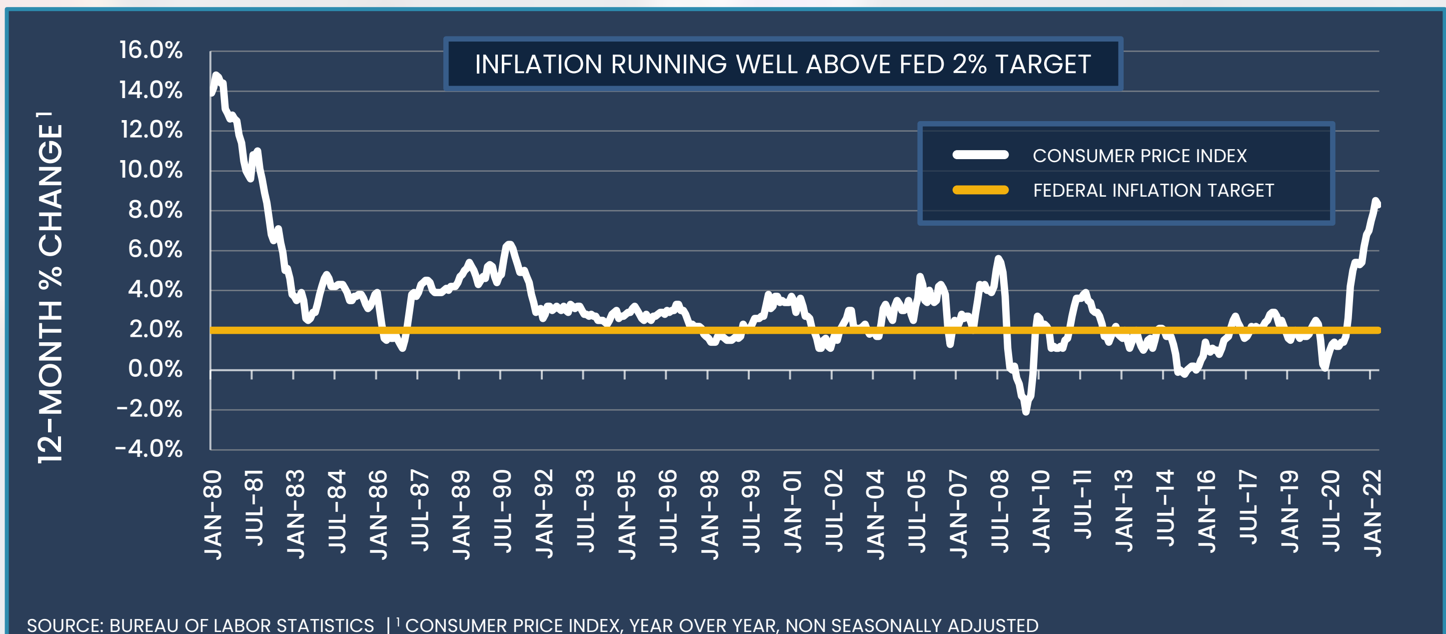
INSIGHTS & REVIEW FROM PERFORMA'S INVESTMENT TEAM

"CLEAR AND CONVINCING" POSES CLEAR AND PRESENT DANGER FOR FED

Aesop was thought to have lived around 620 B.C. – although, nobody really knows how many fables can be attributed to his name or if he even truly existed. Nonetheless, one of Aesop's renowned fables comes to mind when considering the Federal Reserve's monumental task of manufacturing a soft economic landing amid the highest rates of inflation we have seen in decades.

As the fable goes: an old man grows tired of collecting firewood for winter and he wishes for his own death. When Death arrives, the old man immediately changes his mind and asks Death to help lift the load upon his back so he can finish the work. The lesson we have all heard a million times is to "*be careful what you wish for.*"

Unfortunately, the Federal Reserve is learning this lesson the hard way. After years of low-to-no inflation and a revamp of its policy framework (a 2% average inflation target), the Fed was practically begging for higher inflation rates. Well, the Fed's wish was granted and inflation is running at 40-year highs (see graph below). As such, the Fed has made it unambiguously clear that its primary policy objective is to tame runaway inflation.



SOURCE: BUREAU OF LABOR STATISTICS | [1] CONSUMER PRICE INDEX, YEAR OVER YEAR, NON SEASONALLY ADJUSTED

Yes, the Fed wished it and was slow to remove policy accommodation, but today's inflation problem isn't all its own doing by any stretch of the imagination. The U.S. economy has faced a series of supply-side shocks that are out of the Fed's control. COVID-19 slashed production and tossed global supply chains into disarray at a moment when massive government transfers boosted demand; all of which worked to exacerbate the imbalance between supply and demand. Today, the war in Ukraine has produced a commodity price shock and China's zero-tolerance COVID policies have only added to an already worrisome and highly uncertain inflationary environment.

Since their hawkish pivot late last year, the Fed has moved aggressively to remove accommodation and slow demand. They have increased the federal funds rate by 75 basis points (bps) year-to-date, with two more 50 bps hikes expected in June and July and a terminal rate of roughly 3% (according to current market pricing). In response, mortgage rates have spiked and housing data has cooled, an early indication that their policies are having the desired effects on interest rate-sensitive sectors of the economy. Additionally, the process of unwinding pandemic-era bond purchases has begun, working to reduce the size of the Fed's balance sheet, drain liquidity and tighten overall financial conditions.

The expeditious shift in policy has sent waves of volatility through the financial system, resulting in meaningfully higher interest rates and steep declines in equity markets. The presence of inflation is the glaring difference between this tightening cycle and what we saw toward the end of the last expansion. Last cycle, the Fed had scope to respond to financial market volatility because inflation was low. Pausing or reversing policy tightening helped stabilize markets and added to labor market gains but did not result in troubling levels of inflation. This time around, the Fed does not have that luxury.

So far, the Fed has demonstrated resolve in its promise to restore price stability and, to a large degree, the market believes that the Fed will be successful in bringing inflation back toward its 2% target. We caution that we are very early in this policy transition period. Balance sheet runoff has only just begun and rate hikes will take time to filter through the economy. Chair Powell wants to see *"clear and convincing"* evidence that inflation is returning to target before he will be comfortable that the Fed is doing its job on inflation. Thus, if inflation proves stickier than currently expected, the Fed would be forced to hike more aggressively if they are genuine in their commitment to bring inflation back towards target.

While the outlook for inflation remains highly uncertain, one thing is clear: the last time the Fed tried to hike interest rates and reduce the size of its balance sheet, vulnerabilities in the financial system were revealed. This time around, the Fed is moving more aggressively and there is still the problem of COVID, a war in Europe, painfully high inflation, ongoing supply chain issues and a commodity price shock that has food and energy prices soaring. Threading this needle will take the steadiest of hands and most likely some luck. We have no doubt that Powell and company will try their best but wonder if the economic die has already been cast.

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ABOUT PERFORMA

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