A Fed pause could be coming, but don't expect a pivot

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Highlights

- A sharp pivot by the U.S. Federal Reserve (Fed) towards more accommodative policy over the coming quarters is unlikely.
- While year-on-year inflation has probably peaked, underlying inflation is still running hot. Growth is slowing, but the economy remains stable, with investment and employment in good shape.
- It's crucial to differentiate between a pause in interest rate increases and outright rate cuts. The former is reasonable to expect in early 2023, while the latter is improbable unless job losses accelerate markedly.

In late July, the Federal Open Market Committee (FOMC) elected to raise the Fed's policy rates by 75 basis points (bps), an aggressive move broadly in line with market expectations. But markets interpreted the accompanying statement by Fed Chair Powell as "dovish," sending the S&P 500 Index surging by 5.3% in the three days following the decision. Powell's statement appeared to open the door to a slower pace of rate increases going forward and conveyed that the Fed's policy rate was already around neutral. But most of the statement was decidedly "hawkish," with Powell stating that "the labour market is extremely tight, and inflation is much too high."

Exactly a month later, at the Fed's Jackson Hole conference, Powell reiterated his hawkish message, this time leaving out the dovish bits that had peppered his July statement. In an unusually short speech, he emphasized the importance of raising rates to stamp out inflation, even at the cost of "some pain to households and businesses." Interestingly, his focus was not on signalling higher rates, but rather on emphasizing the need to keep rates above neutral for a long time. The shift in messaging underscored that the Fed is willing to tolerate a weaker economy to achieve its inflation goal, strengthening its credibility as an inflation-fighting central bank.

While the Fed could pause rate increases as soon as early 2023, it will need to hold rates above neutral for a while. Subtracting realized year-on-year inflation of 8.5%, the Fed's real interest rates are still around the most negative they have ever been. However, Figure 1 shows that forward-looking real interest rates are finally approaching "neutral" – the rate above which monetary policy starts to be restrictive – estimated at around 0.5% by the Fed. Year-on-year inflation has likely peaked, curtailing the need to spike policy rates higher as in the early 1980s. But inflation will probably stick above 2% for a while, requiring the Fed to keep interest rates in excess of neutral for an extended time as the economy slows. Figure 1 shows that even if monthly U.S. headline inflation was 0% in July owing to lower energy prices, underlying annualized inflation was still in the 4%-6% range. Slow-moving inflation drivers like rents and wages may run above target for several quarters.

In late July, markets were expecting the Fed to cut rates three times in 2023. Two of those three cuts were priced out in August. Figure 2 shows that markets now expect the Fed to implement six additional rate increases of 25 bps each over the next two quarters, bringing the target rate from about 2.5% to roughly 4%, and then to keep rates above neutral until at least 2024.

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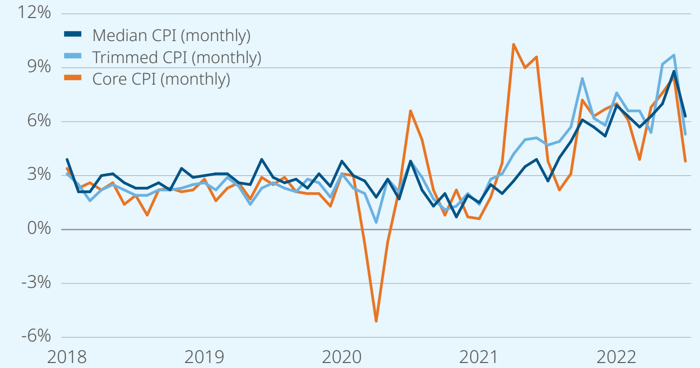
Figure 1. The Fed will have to keep interest rates above neutral for a while

Real interest rates at every horizon have converged above zero

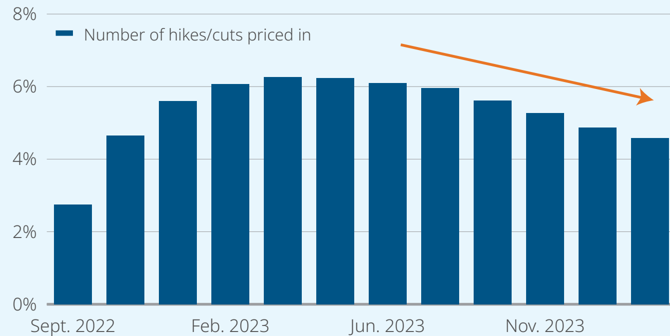
Underlying U.S. inflation was well above 2% in July



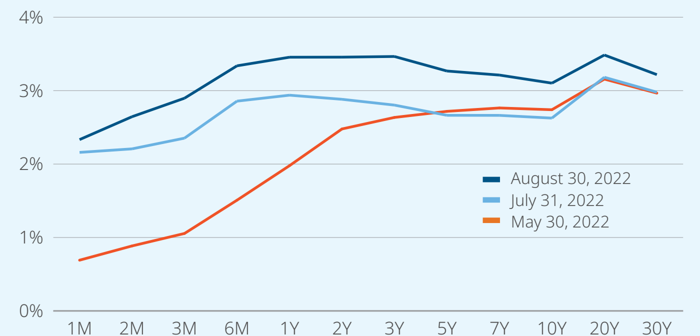
Notes: All data via Bloomberg as at August 30, 2022. The first chart subtracts expected inflation as implied by inflation swaps from the yields on 1-, 2-, 5- and 10-year Treasuries as proxy for the real rates at various horizons. The second chart shows the annualized month-on-month change in median CPI, trimmed CPI and core CPI (excluding food and energy). First two series from the Cleveland Fed, the latter from the Bureau of Labor Statistics.

Figure 2. No summer vacation for interest rate volatility

The 2023 "Fed pivot" has been mostly priced out



The Treasury yield curve flattened in August



Notes: All data via Bloomberg as at August 30, 2022. The first chart derives market expectations of Fed rates from Fed funds futures.

By laying his cards on the table at Jackson Hole, Powell provided clarity to investors and economic actors. Interest rate volatility was high over the summer, with market expectations alternating between the extremes of a Volcker shock and a Fed pivot. To orchestrate an orderly tightening of financial conditions that will curb inflation without crashing the economy, the Fed needs to bring rates slightly above neutral and keep them there for a while. Although the sticker shock of higher rates caused stocks to slide in the final days of August, risk assets could benefit in the medium term from this policy transparency. The newfound clarity in the Fed's intentions could cement its credibility, reducing volatile price swings going forward. Plus, frontloading rate increases should help prevent a further inflation spiral, precluding the need to raise rates even higher down the road. On the other hand, this outcome relies on the Fed's forecast of a resilient economy and labour market to come true. Figure 2 shows that much of the yield curve is now inverted, a historical signal for a recession (see our April commentary). However, investment and jobs have stayed remarkedly solid throughout 2022, and, absent any additional shocks, global supply should slowly recover.

A moderation of inflation while avoiding a deep recession is still possible. But to achieve this, the Fed needs to quickly bring their rates above neutral and hold them there until demand slows enough to converge to a constrained aggregate supply. With consensus forecasts of U.S. economic growth falling to about 1.7% this year and just 1.1% in 2023, the Fed has increasingly less room to sacrifice growth before tipping the economy into a recession. A soft landing for the economy remains feasible, but the runway is getting shorter.

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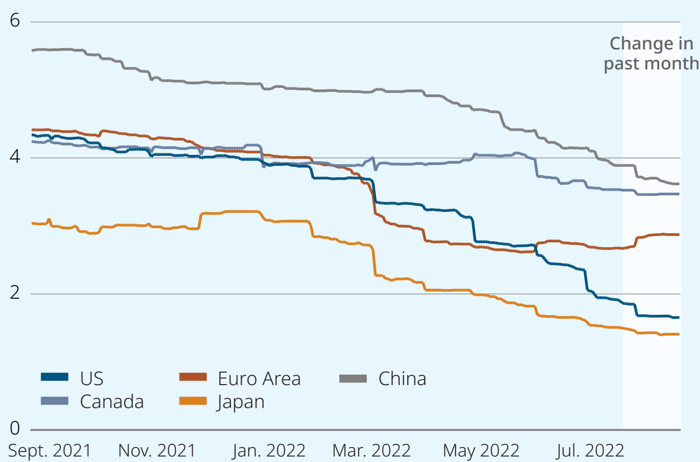
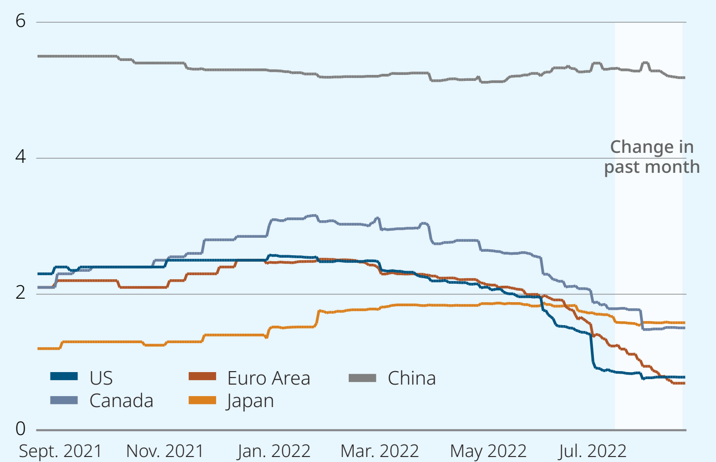
Global macro update

- As we foreshadowed in last month's Emerging theme, **U.S. gross domestic income** (GDI) saw positive growth in the second quarter (+1.4%), in contrast to negative second-quarter growth in gross domestic product (GDP). As a reminder, in theory GDI should track GDP perfectly, since they both seek to measure overall economic production. In practice, they have diverged in the past few quarters: GDP has been hinting at a recession, while GDI is revealing an environment of positive, albeit mediocre, growth. Alternative macroeconomic measures, like employment and industrial production, suggest that GDI could be painting a more accurate picture of the "true" state of the U.S. economy. Case in point, GDP growth in the second quarter has already been revised upwards (-0.9% to -0.6%), one month after its preliminary release.
- U.S. inflation for July came in below expectations (0% vs. 0.2% expected, month-on-month), as gasoline prices dropped by 7.7%. The pace of core inflation also moderated but remained above target at 0.3% month-on-month (3.6% annualized). Professional forecasters now expect 3.5% annual inflation for 2023 in the U.S., which is slightly above the Fed's own forecast from the July Summary of Economic Projections.

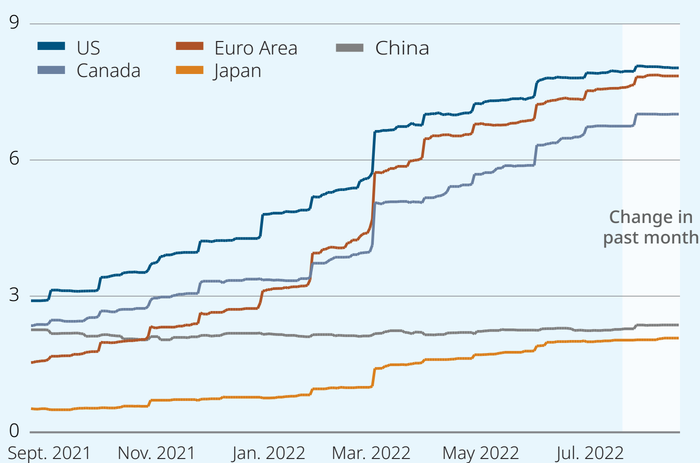
2022 real GDP growth forecast (%, consensus)



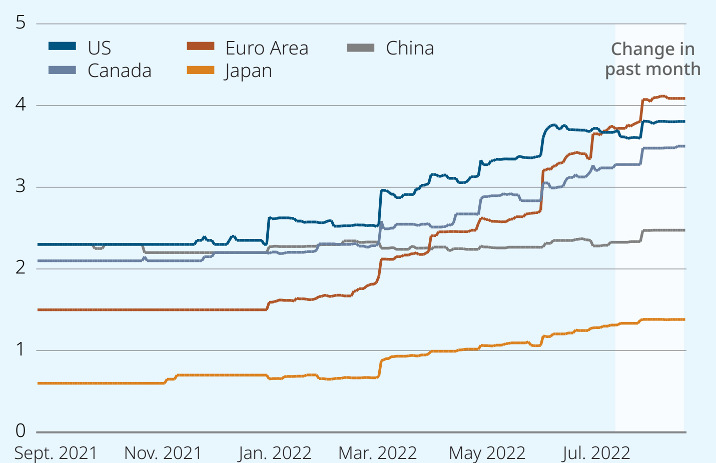
2023 real GDP growth forecast (%, consensus)



2022 inflation forecast (%, consensus)



2023 inflation forecast (%, consensus)



Notes: Average growth and inflation forecasts from Consensus Economics as at August 31, 2022.

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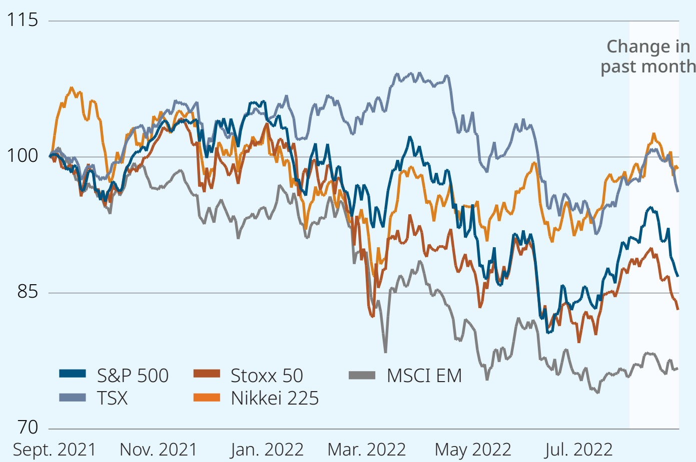
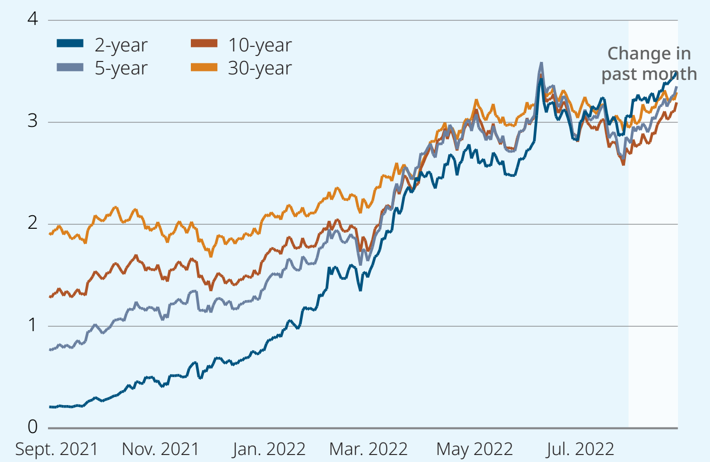
Capital markets update

- **U.S. Treasury yields** rose in August after retreating in July. After markets interpreted the FOMC's July statement as dovish, various Fed officials embarked upon an unusually coordinated blitz of public appearances to remind investors, workers and businesses that tackling inflation remained their chief concern. As a result, yields shifted up across the curve, with a flattening bias. Following Jackson Hole, two-year yields are now above their previous peak from June, but 10-year yields have not retested their highs.
- **Oil prices** had a V-shaped price action in August, as a 12% intra-month drawdown was erased in the second half of the month. Oil prices have exhibited a negative correlation to equities in 2022, especially over the past few months, with oil rising when equity markets fell, and vice versa. At -0.6, the year-to-date correlation in the price changes of oil and U.S. stocks is the most negative annualized correlation since 2002. A negative correlation is uncommon, as 14 of the past 15 years saw positive oil-equities correlations. This is likely a result of inflation being the main driver of financial markets this year, rather than growth.

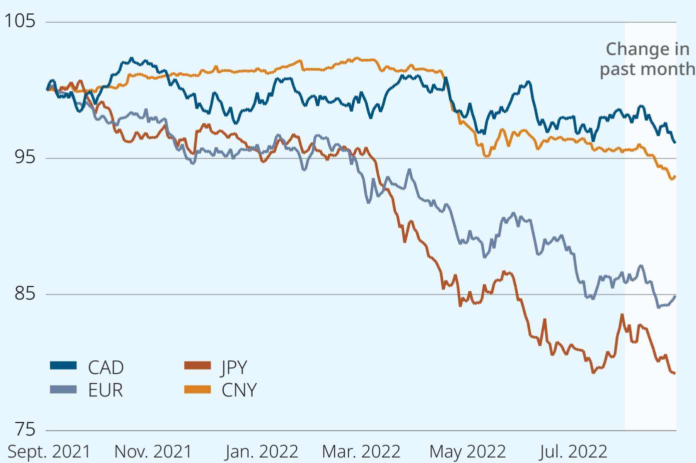
Equity indices (one year ago=100)



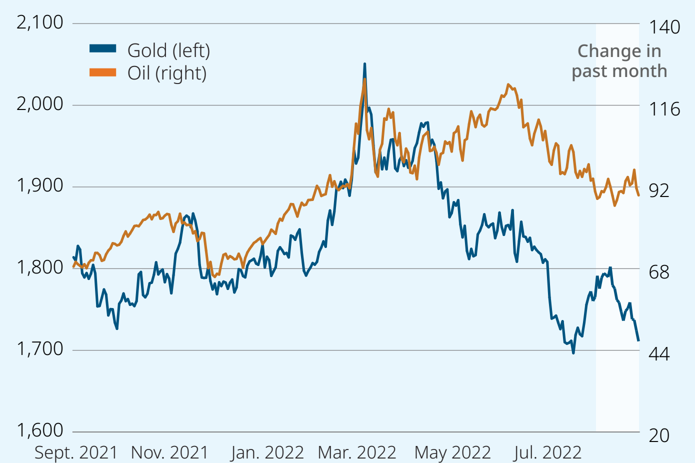
US Treasury yields (%)



Currencies (relative to USD, one year ago=100)



Commodity prices (in USD)



Notes: Financial data from Bloomberg as at August 31, 2022. Total-return equity indices are in local currencies, except MSCI EM, which is denominated in USD.

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What we'll be watching in September

September 15: China retail sales

- This year's slowdown in the Chinese economy has been mainly driven by weak consumer demand. Industrial production, exports and investment have been solid, while consumption has been historically weak. Retail sales have been flat in nominal terms year-to-date, compared to 8%-9% average annual growth in the pre-pandemic era. For China to start driving global demand growth once again, the Chinese government must find a way to rebalance the economy towards consumers.

September 19: Canada housing starts for July

- Canada housing starts have been mostly unfazed by higher interest rates, averaging 267,000 starts since the Bank of Canada kicked off its cycle of rate increases in March. Since 1980, only the summer of 2021 saw higher average starts. The number of new construction permits has also remained solid.

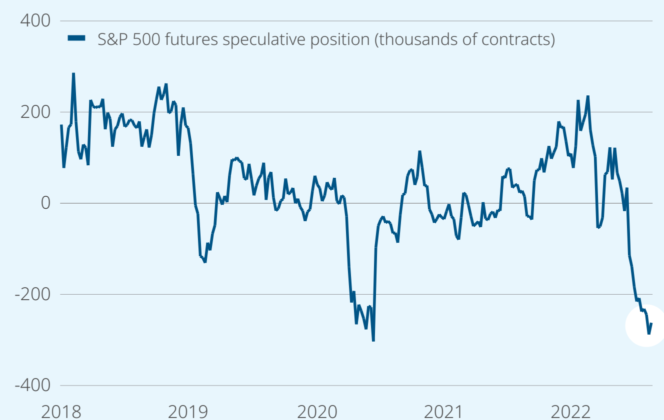
September 21: FOMC rate decision

- After Fed Chair Powell's hawkish speech at Jackson Hole, markets are pricing a 75% chance of a third consecutive rate increase of 75 bps at the September FOMC meeting. If the August CPI print comes out soft, i.e., headline deflation and a further easing in core inflation, we could see the Fed settle for a 50 bps increase, but 75 bps is much more likely, in our view.
- Starting in September, the Fed will double the pace of quantitative tightening (QT), shrinking its balance sheet by US$95 billion per month. Fed Chair Powell has made it clear that the balance sheet contraction is not his preferred monetary policy tool, so we don't expect any additional tweaks to the QT schedule at the September FOMC.

Emerging theme

- Speculative positioning for U.S. equity futures is at a bearish extreme, according to Commitment of Traders data from the Commodity Futures Trading Commission (CFTC). Asset managers and hedge funds are net-short 260,000 S&P 500 futures contracts, around US$53 billion in notional terms.
- Extreme positioning tends to be a contrarian signal, albeit a weak one. In the current context, a large aggregate short position could raise the likelihood of a rebound in equity markets. Why is that? Many participants use a significant amount of leverage when trading futures. Because of both regulatory and risk-based constraints to leverage, some hedge funds and asset managers could have a hard time adding to their shorts with positioning already at an extreme, which may limit downside risk to the markets. Plus, if markets start moving against speculators' positioning, effective leverage should expand, potentially forcing speculators to unwind their short positions.
- However, extreme positioning in the futures market is far from a perfect signal, with futures being only one of many instruments hedge funds and asset managers use to speculate. Plus, leverage limits are not absolute; positioning could always become more extreme! But it can be a piece of the puzzle for tactical asset allocation, along with fundamental valuation and economic factors.

Equities positioning at bearish extreme



Notes: Bloomberg as of August 29, 2022. Denominated in thousands of E-Mini S&P 500 futures contracts.

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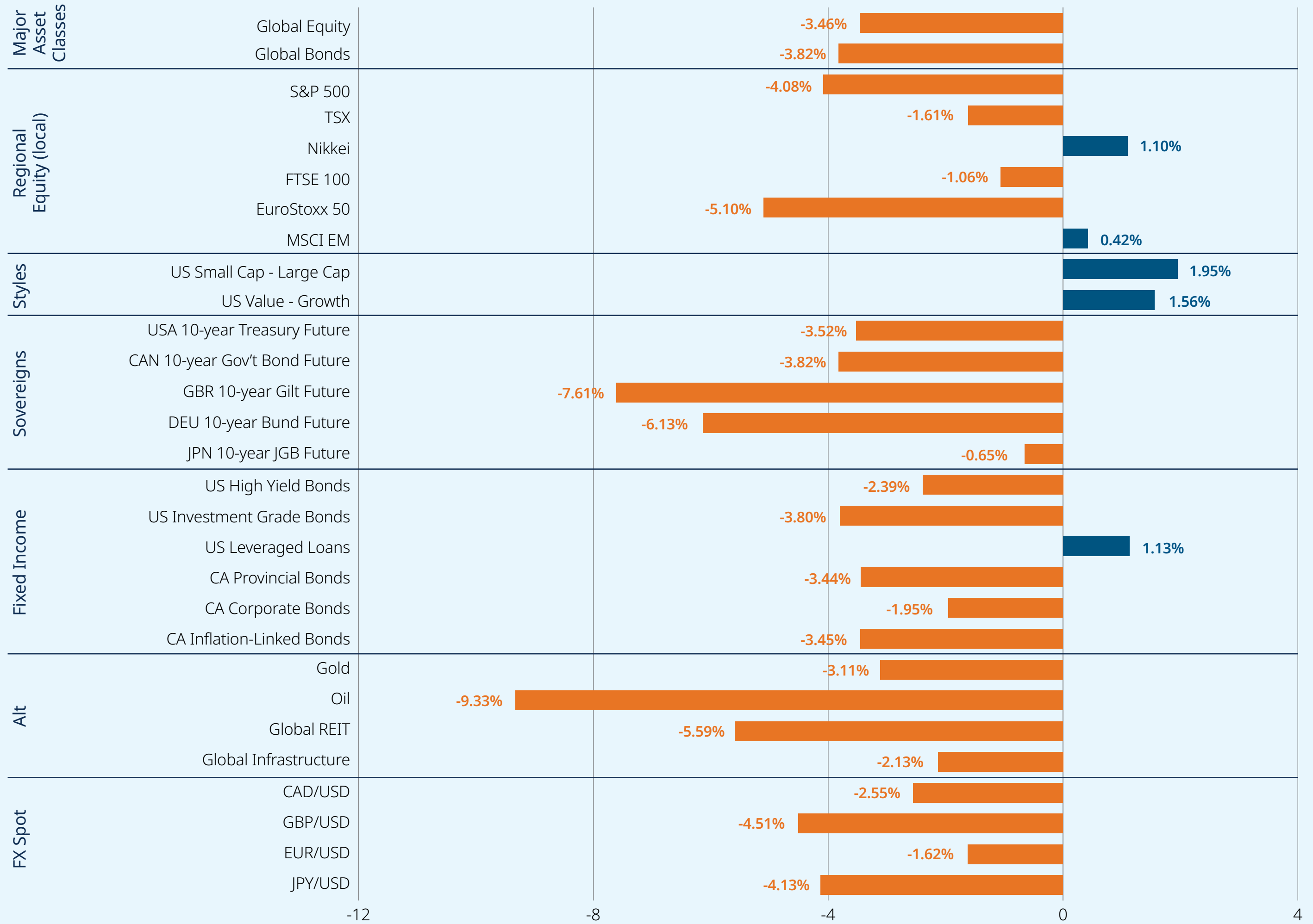
Capital market returns in August



Notes: Market data from Bloomberg as at August 31, 2022. Index returns are for the period: 2022-08-01 to 2022-08-31. In order, the indices are: MSCI World (lcl), BBG Barclays Multiverse, S&P 500 (USD), S&P/TSX 60 (CAD), Nikkei 225 (JPY), FTSE 100 (GBP), EuroStoxx 50 (EUR), MSCI EM (lcl), Russell 2000 - Russell 1000, Russell 1000 Value - Russell 1000 Growth, USA 10-year Treasury Future, CAN 10-year Gov't Bond Future, GBR 10-year Gilt Future, DEU 10-year Bund Future, JPN 10-year JGB Future, BAML HY Master II, iBoxx US Liquid IG, Leveraged Loans BBG (USD), Provincial Bonds (FTSE/TMX Universe), BAML Canada Corp, BAML Canada IL, BBG Gold, BBG WTI, REIT (MSCI Local), Infrastructure (MSCI Local), BBG CADUSD, BBG GBPUSD, BBG EURUSD, BBG JPYUSD.

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