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The Bottom Line
Relevant Insights for the Savvy Investor

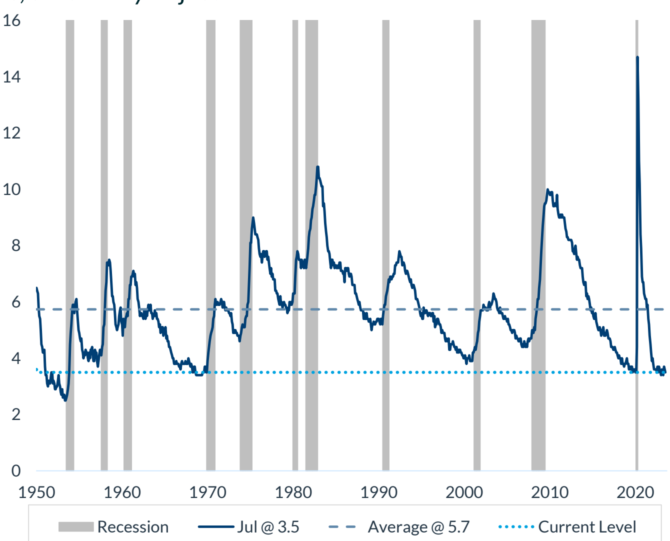
It Will Be a Long Time Before Inflation Is Under Control

In the past month or two, the economic outlook has shifted to the sunny side of the street, with some forecasters believing the economy may bypass the much anticipated recession and comfortably settle into a "soft landing," a gradual slowdown of economic growth that avoids a recession.

This belief has been supported by inflationary pressures that have moved down significantly from the 40-year high of last year (CPI is at 3.2% from the peak of 9.1% last year) and economic data that has remained relatively robust despite the Federal Reserve (Fed) raising the federal funds rate by 525 basis points (the unemployment rate is hovering around historic lows and consumer spending remains resilient to the higher interest rates) (charts 1 & 2).

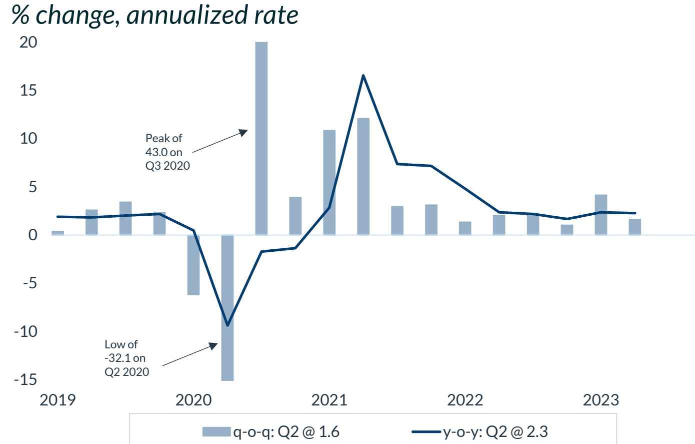
Much of the optimism is based on the belief that the inflation problem has been conquered. But in reality, the decline in inflation has been driven heavily by falling energy and commodity prices. When the Fed focuses on inflation, it looks at core inflation, which takes out the food and energy components because it is deemed a more reliable

CHART 1: Unemployment Rate
%, seasonally adjusted



Source: Bureau of Labor Statistics, as of July 2023.

CHART 2: GDP: Consumption
% change, annualized rate



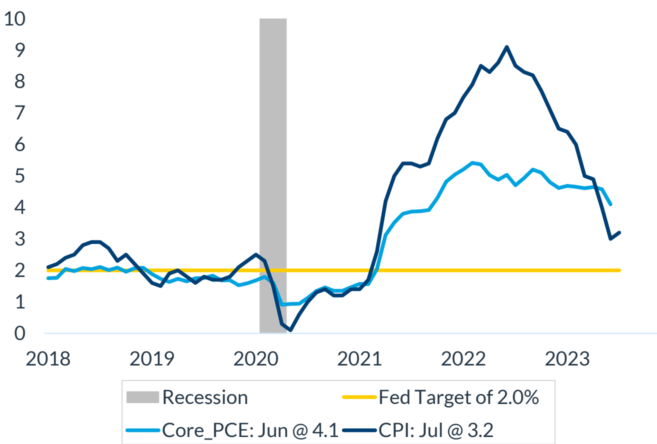
Source: Bureau of Economic Analysis, as of Q2 2023.
Information is subject to change and is not a guarantee of future results.

gauge of future inflation. Food and energy prices tend to be very volatile; they can move up as quickly as they can move down. Fortunately for the Fed, they have been falling over the past year. As for core inflation, it hasn't declined as much.

Furthermore, the Fed's preferred inflation gauge is not CPI but the inflation measurement that is released with the personal spending report because it accurately reflects the spending habits of consumers. That hasn't retreated nearly as much as CPI, falling to 4.1%

CHART 3: Inflation: CPI & Core-PCE

% change, y-o-y, seasonally adjusted



Source: Bureau of Economic Analysis, Bureau Labor Statistics, as of July 2023.

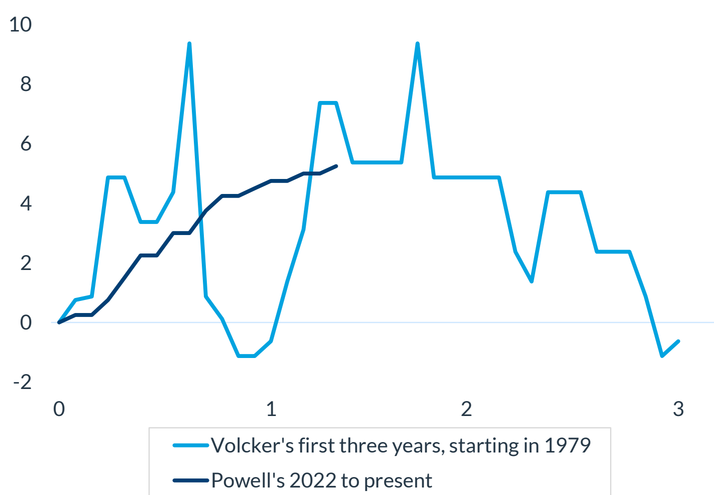
from a recent high of 5.4% (chart 3). The Fed still has a long battle ahead against inflation. In June, Fed Chair Jerome Powell stated that he anticipates that core inflation will not return to the Fed's target rate of 2.0% until 2025.

The magnitude of the Fed's tightening of monetary policy in this cycle has been greater than has been seen since Paul Volcker took control of the Fed in 1979. With Volcker's shock-and-awe approach, he famously raised the federal funds rate to 20%. The first-time rates were increased that high; the following month, they dropped 850 bps to 11.5%, and the second time at 20%; the next month, they were reduced by 450 bps to 15.5% (chart 4). The Powell Fed has taken a different approach to combating inflation. It has methodically alerted the markets of planned interest rate increases in 11 hikes. The first few increases were small, increasing to several hikes of 75 bps each and gradually tapering the size of the hikes (chart 4).

The Powell approach must be different; the world is different. The financial system is far more leveraged than 40 years ago, and the uncertainty of the shock-and-awe approach would play havoc on the capital markets, increasing market volatility and the risk of a severe recession. With Powell, his approach will require the Fed to keep the funds rate higher for longer to ensure inflation gets to the target rate of 2.0%, it is sustainable and expectations for future inflation remain muted. The Powell Fed does not want to do what the Volcker Fed was forced to do, which was to cut interest rates and have inflation rebound, which forced Volcker to raise interest rates a second time to 20%.

CHART 4: Federal Funds Rate

%, change in rates in two different tightening cycles, years



Source: Federal Reserve, as of July 2023.

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Market Trends

After a steady advance over the past four months, US equity markets are dealing with their first real challenge since the emergence of bank turmoil last March. Enthusiasm around moderating inflation and prospects for a soft landing is now increasingly being countered by concerns over global growth and rising interest rates. We continue to expect a less supportive environment for equities in coming months as the Fed maintains its hawkish tilt, recessionary pressures build and earnings estimates are revised lower.

LABOR

Job growth continues to slow but remains robust, averaging around 200,000 hires each month. It is around the same growth rate the economy averaged in the five years before the pandemic.[1]

THE FED

The Fed is divided over the need for more interest rate hikes, but they are resolute about one thing: inflation, while moderating, is still too high.[2]

HOUSING

Mortgage rates rose above 7.0%, the highest level in more than 20 years, which is expected to put a cap on home sales, which were starting to rebound from last year's jump in rates.[3]

BANKING

Banks have reported tighter credit standards and weaker loan demand from businesses and consumers, which has been slowing loan growth.[4]

INFLATION

Price pressures have settled down to the 3.0% range, but the Fed remains concerned with service and shelter (housing) costs, which are stickier than other prices and not declining fast enough for their liking.[5]

TREASURY

Fitch Ratings downgraded the US government's credit rating to AA+ from AAA, reflecting an "erosion of governance" in the US relative to top-tier economies.[6]

Sources

1. Bureau of Labor Statistics, July 2023
2. The Federal Reserve, August 2023
3. Freddie Mac, US Census Bureau, National Association of Realtors, August 2023
4. The Federal Reserve, July 2023
5. The Federal Reserve, Bureau of Labor Statistics, August 2023
6. Fitch Ratings, August 2023

Index Definitions

The consumer price index (CPI) measures the monthly change in prices paid by US consumers.

The S&P 500 Index is a market-capitalization-weighted index of 500 leading publicly traded companies in the US.

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