August 7, 2023

Weekly Commentary

Last week...

JOLTS data indicates some cooling in the labor market. Job openings remain elevated, but quits are back to pre-pandemic levels. The bond rating agency Fitch cut the United States' sovereign rating to AA+ from AAA. The timing of the downgrade is baffling, but the US has long-term fiscal challenges that should be addressed.

Pricing in a Soft Landing

Fig. 1: Market-implied change in the Fed Funds rate for the July '23 and January '24 period

Source: Bloomberg, Mill Creek.

Fed Chair Jerome Powell took a victory lap of sorts at the July Federal Open Market Committee (FOMC) meeting. While leaving open the possibility of further rate hikes, it was clear from his comments that he believes the Fed has tightened monetary policy sufficiently to restore price stability (2% inflation) over the medium term. Powell mentioned that the Fed staff is no longer forecasting a recession in the US, and he even opined on the possibility of rate cuts next year:

"…the federal funds rate is at a restrictive level now. So, if we see inflation coming down credibly, sustainably, then we don't need to be at a restrictive level anymore. We can move back to a neutral level and then below a neutral level at a certain point."

Powell is describing the type of economic outcome that economists have referred to as a “soft landing.” This week, we look at the likelihood of a *soft landing*, *hard landing*, or *no landing* as potential outcomes over the next 12 months.

A ***soft landing*** outcome is one where the labor market remains strong, but inflation declines enough to allow the Fed to lower its target Fed Funds rate back to a less-restrictive level in 2024. Real economic growth may or may not fall temporarily into a technical recession in this scenario, but households continue to experience rising incomes, low unemployment, and a lack of the typical debt/credit cycle seen in past recessions. Asset prices are mostly supported in a soft landing, but interest rate-sensitive sectors might continue to see headwinds. The yield curve would likely de-invert by short rates slowly declining as longer-term rates remain fairly stable.

A ***hard landing*** outcome is what the Federal Reserve had been forecasting since early 2021. In this scenario, tighter monetary policy leads to substantially slower economic growth, 2-3 million job losses, and lower inflation. The Fed would lower policy rates, but only after economic pain has done its work to slow both the economy and inflation. A hard landing would likely include a negative credit cycle for households and businesses, along with lower asset prices.

A ***no landing*** outcome is one where economic growth remains too strong and underlying inflationary pressures persist, prompting the Fed to step back in with at least two more rate hikes. The Fed estimates sustainable long-run economic growth at 1.8%. The US economy has averaged 2.6% growth for the last four quarters, so if growth doesn’t slow to around 2%, the Fed will feel pressured to hike sometime in the fall. A no-landing outcome simply pushes the “soft or hard landing” debate into the future. The yield curve remains inverted, short-term interest rates move higher, interest rate-sensitive sectors continue to struggle, and we face a higher probability that “long and variable lags” eventually push us into a hard landing.

Like the Fed, market participants have also shifted their expectations from a hard landing to a soft landing. Initially, in April of this year, market participants anticipated a quick series of rate cuts totaling 100bps between now and the end of the year (Fig. 1). Now, they expect no cuts at all. The market-implied path for the Fed Funds rate is for the Fed to remain at 5.25-5.5% through April 2024 and then to slowly cut back to 4-4.25% by the end of 2024.

Our assessment, on the margin, suggests that both Fed forecasts and current market expectations underestimate the likelihood of strong growth, which may force additional hikes in late 2023 or early 2024. The Fed forecasts a sharp growth slowdown in the second half of 2023 that lasts through 2024. It’s hard to find that slowdown in the data. Aggregate wages and salary growth have picked up, home prices are rising, and initial and continuing jobless claims are falling. The Atlanta Fed’s GDP tracker for the third quarter came in at 3.5%.

For the time being, disinflationary trends, particularly from housing, will provide cover for the Fed to take a wait-and-see approach until the data confirms or rejects Powell’s optimism. Until then, The Powell Trade remains alive and well.

This week's contributor: Michael Crook, CAIA

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