THE GLOBAL CIO OFFICE

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The Penny Finally Drops

- **Jerome Powell sends a very clear message – rates will be higher for longer**
- **Equity market sell-off could extend**
- **However, longer-dated bonds are well behaved; 10-year looks to hold the 3% level**
- **We remain underweight equities and, instead, continue to recommend holding high levels of cash**

The US financial markets and the Fed have finally realised what is needed to fight inflation—or so it appears. If Fed Chairman Jerome Powell is finally adjusting his speeches to fit the common wisdom about how a central bank should fight inflation, the markets must listen. And the markets are listening, too. Friday's market rout could be the harbinger of the challenges ahead.

What a difference a year makes! We recall Powell's comments at Jackson Hole in August 2021 when he sounded rather upbeat about the then-prevailing inflation scenario – *"To sum up, the baseline outlook is for continued progress toward maximum employment, with inflation returning to levels consistent with our goal of inflation averaging 2% over time."* Back then the Fed was steadfast in its view that inflation was transitory.

But that was a year ago. Cut to the present and the Fed chairman, paying heed to the current narrative that inflation has been too high for too long, adopted a hawkish tone at Jackson Hole on 26 August – *"We are taking forceful and rapid steps to moderate demand so that it comes into better alignment with supply, and to keep inflation expectations anchored. We will keep at it until we are confident the job is done."*

Powell was finally unequivocal in his acknowledgment about the fight the Fed has at hand with inflation. Gone was any pandering to the financial markets, particularly the equity market, about dampening volatility for fear of upsetting investors. Powell was forthright in acknowledging that inflation is a concern, and a fit-for-purpose central bank must take appropriate measures to bring inflation down–even if that means forcing the economy into recession.

The initial reaction to the speech was logical; equities retreated, and longer-dated US government bonds rallied. We expect the recent run-up in equity markets to continue to unravel. Initially, we expect the S&P500 to correct to around the 3800 level, which is a further 6% downside from Friday's close. A more substantial fall, if at all, may take time.

Chart 1: S&P500 projected to slip back to 3800

Source: Bloomberg

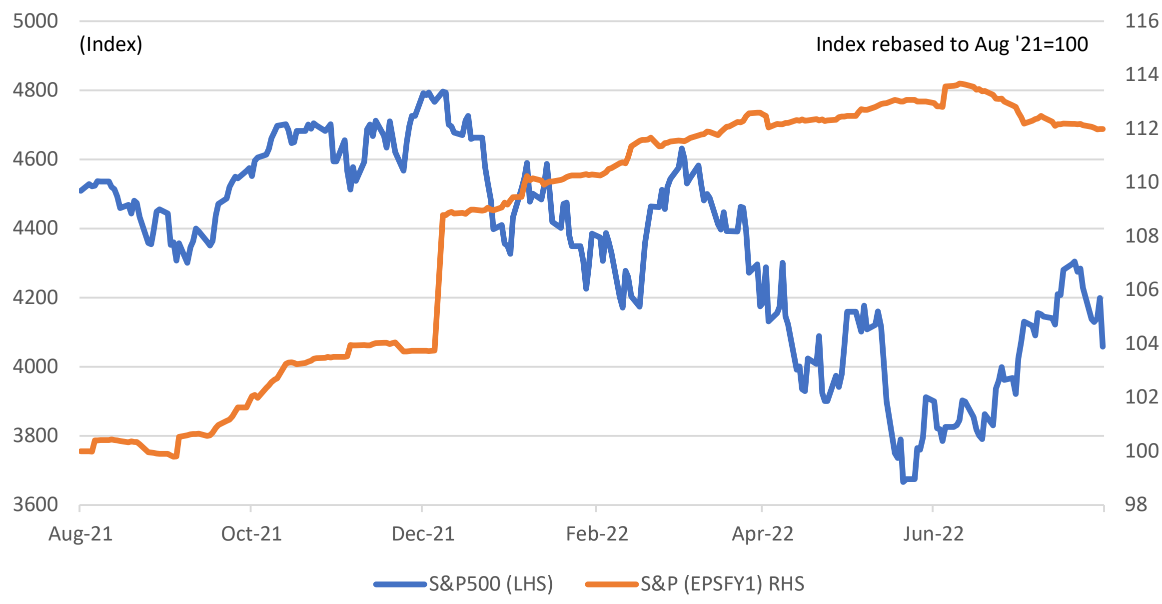
One of the reasons the equity market had a substantial fall in June was the spike in the US 10-year bond yield to 3.45% from 2.75% in two weeks (Chart 2). With such a spike in bond yields, tech stocks fell sharply. So far, through the current sell-off, the US 10-year yield has 2remained around the 3.0% level. That implies that the current discount rate for the market is 50bps lower than it was in June, which is good for stock valuations. However, yields are lower because the bond market is pricing a greater risk of recession. The scale of an equity market sell-off moving forward could depend more on the degree to which analysts bake the prospects of a recession into their forecasts.

Chart 2: US 10-year government bond yield holds around the 3% level

Source: Bloomberg

The consensus forecast for the level of S&P500 corporate profits for 2022 is down just one percentage point from where the forecast stood at the start of June, but it is trending down (Chart 3).

Chart 3: S&P500 Corporate profits forecasts trending down



Source: Bloomberg

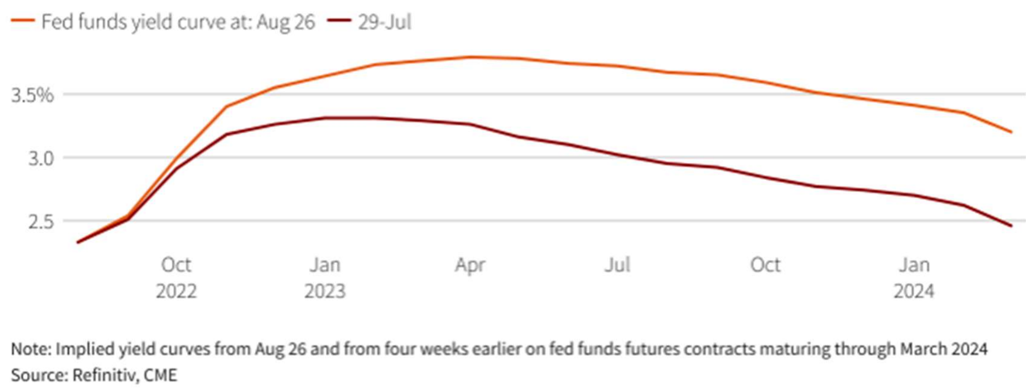
The sharp sell-off in the equity markets in June was also triggered by tepid economic data, which surprised markedly to the downside versus expectations. The jury is currently out on whether there is a pronounced weakening in the US economy. While some of the recent economic data has been poor, other data points have not disappointed. The Citigroup US Economic Surprise Index is still negative and has recently retreated further. However, there are no apparent signs of a broad weakening of the economy.

Chart 4: Citigroup US Economic Surprise Index slips back

Source: Bloomberg

There has, however, been a marked change in the market's pricing of future interest rate changes. The message is loud and clear that the rate would be higher for longer. Chart 5 shows that the market still expects the Fed Funds Rate to peak in the first quarter of 2023, but the critical change this time is that the rate will remain elevated for longer. Indeed, this was the key message of Chairman Powell's speech. What that means for the economy is that there is no quick, sharp tightening of monetary policy that is likely to be reversed swiftly. Instead, the Fed's message is that a prolonged period of tight monetary policy could bring inflation—and inflation expectations—down to the 2% level. In the meantime, there will have to be pain in the economy.

Chart 5: Market pricing of the future Fed Funds Rate has shifted up and is expected to persist at a higher level



The dollar may finally be peaking. With higher for longer expected, one would naturally conclude that to be good news for the dollar. However, it is already trading at its highs, and the message from Powell's speech is that the higher for longer is to exact pain on the US economy. The dollar fell sharply when the US economy suffered, as it did during the early days of the global financial crisis. Only when the Fed rode to the rescue and other parts of the world suffered more significant issues did the dollar recover. The factor that keeps anyone from forecasting the greenback's demise is that the other major economies are facing substantial challenges. Europe's energy crisis, for instance, will keep inflation bubbling and lead to a marked setback in the economy. Japan continues to underwhelm, and the Bank of Japan shows no sign of defending the yen.

A strategy for a higher-for-longer Fed Funds Rate

- Underweight equities
- Long cash
- Hold bond positions even in credit
- Absolute return strategies should do well, given the more predictable volatility in the markets.
- Tactical opportunity in Chinese equities. Accumulate energy stocks into any weakness.

Gary Dugan
Johan Jooste (Consultant)
Bill O'Neill (Consultant)