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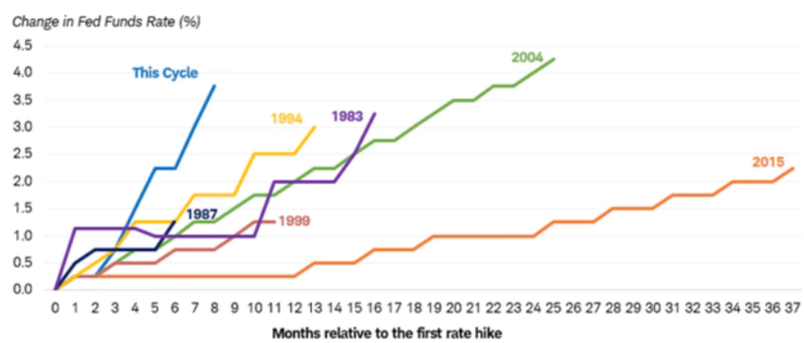
The Fed is changing gears, or so it appears. Indeed, after being very late in joining the battle against inflation, largely due to their disastrous premises that inflation was only "transitory", and that it was being caused primarily by the reopening of the global economy from the COVID-related shut-down, the Fed's rationale was that inflation would automatically recede once most global supply chains reopened, thus balancing supply and demand, and allowing prices to fall.

However, once they realized that inflation was anything but transitory, that it had many causes beyond the pandemic reopening, and that they were so late in responding to it that it was already getting out of control, the Federal Reserve drove monetary policy from being highly stimulative to modestly restrictive at an almost unprecedented speed. Indeed, we have not seen such an aggressively restrictive policy from the Fed in about forty years.

The Fed's intent was to make up for lost ground, and to drive interest rates high enough, and to restrict money supply sufficiently, where they cease being stimulative to the economy, and instead become a drag on economic growth and a depressant on inflation. From our perspective, it increasingly looks like policy is finally approaching the range necessary to achieve the Fed's aforementioned goals.

The pace of Fed rate hikes in this cycle, in comparison to previous cycles, has been rapid



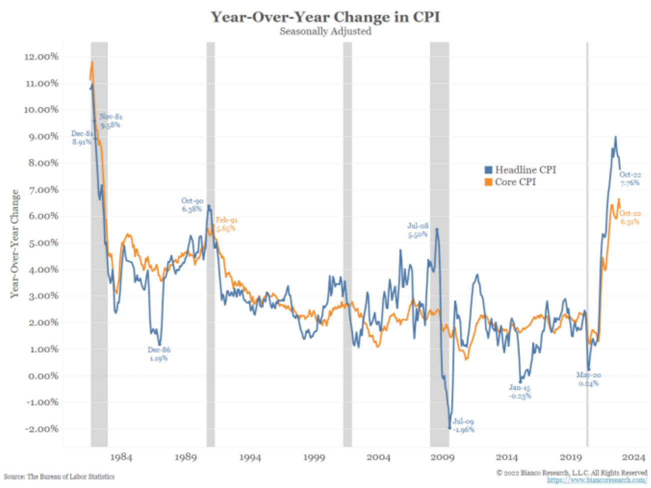
Source: Bloomberg. Federal Funds Target Rate - Upper Bound (FDTR Index), using monthly data as of 11/2/2022.

Note: Data is the short-term interest rate targeted by the Federal Reserve's Federal Open Market Committee (FOMC) as part of its monetary policy. **Past performance is no guarantee of future results.**

Indeed, there is increasing commentary from members of the Federal Reserve that suggests, while they are not yet at their ultimate destination, that they are now close enough to justify a downshift in the rate of monetary tightening. We view this as further affirmation of our premise that the Federal Reserve will likely pause rate hikes by mid-year 2023 at the latest.

We believe that the Fed is likely to reduce the size of rate hikes to fifty basis points (0.50%) as soon as their next meeting in December, with one or two smaller rate hikes likely in the first or second quarter of next year. That said, we also believe that any "pivot" to the Fed actually cutting rates is still at least a year away, and that rates are likely to stay relatively high (around 5% for short-term rates and most maturities of Treasuries) in the meantime.

Of course, when you drive at a slower speed (i.e., raise rates in smaller increments), it takes more time to reach the destination, and in this instance, it is very possible that the delay will ultimately also increase the "distance traveled", by forcing the "terminal rate" (the ultimate peak rate) higher than might have been the case without the deceleration.

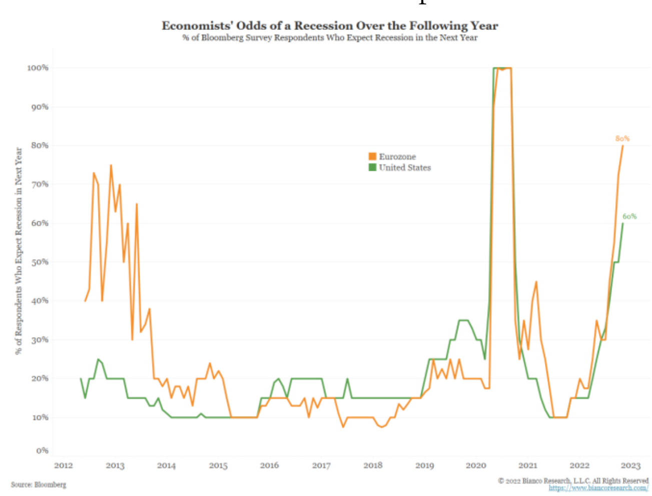


Importantly, what gives the Fed confidence that they can adopt a less aggressive stance is the growing array of evidence that inflation has at least peaked.

Indeed, while only one month's data, the recently released consumer inflation report for October had the smallest increase in inflation since January, before the Russian invasion of Ukraine caused a massive surge in energy and commodity prices. We maintain that there is reason to believe that inflation will not only continue to recede, but will do so at an accelerating pace.

That said, how far inflation will fall and how long it will take for inflation to return to the Fed's 2% target (if even achievable) are still open questions. Indeed, they are probably the single most important questions for investors in this environment.

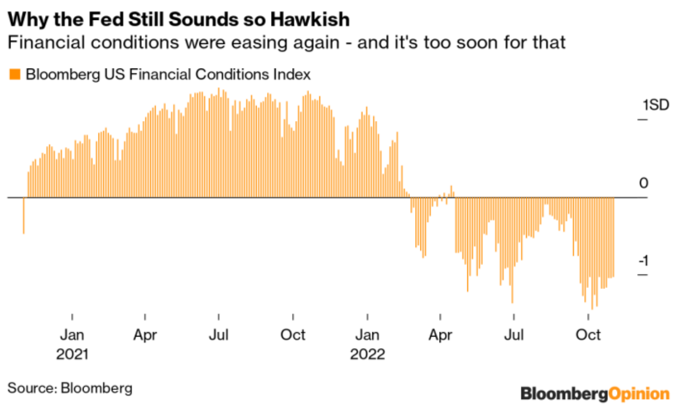
In a noteworthy change in forward guidance, the Fed announced on November 2nd that, "In determining the pace of future increases in the target range, the Committee will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, and economic and financial developments." [1]



This statement exemplifies one of the two giant dilemmas faced by the Fed, which is that the impact of their actions takes place with "long and variable lags" (to quote Milton Friedman), which can range from 6 to 18 months. [1] This means that, almost without exception, the Federal Reserve does not know that their policies have been overly aggressive until after the damage (whether it be inflation or recession) is already done.

The other major dilemma is a function of the fact that, after a year of historically severe price corrections in most financial asset classes, investors seem to be very inclined to push both stock and bond prices sharply higher any time that there is as much as a hint that inflation is peaking out and/or that the Fed's tightening cycle is approaching its end. As was just noted by Randy Frederick, managing director of trading and derivatives at Charles Schwab, "Markets are poised to respond to anything remotely positive. ... It's kind of like a coiled spring more than anything else." [2]

This creates a dilemma for the Fed, as every time that the markets rally, interest rates fall and financial liquidity improves which, in turn, potentially exacerbates inflation, the dramatic reduction of which is the Fed's primary objective. Talk about a "Catch-22", as it makes it very difficult for the Fed to taper the size of its rates hikes, without simultaneously easing financial liquidity and exacerbating inflation.

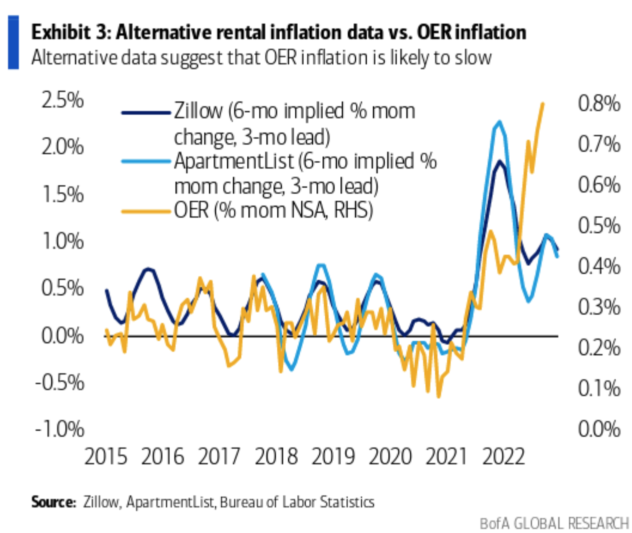


In such an environment, the Fed is likely to respond to any rally in financial assets with very hawkish commentary, as they endeavor to keep financial liquidity tight, and to minimize any increase in consumer spending or consumer confidence that might result from higher portfolio values.

Indeed, we believe that the Fed will use this practice of "jawboning" the markets to provide cover for their slowing of rate hikes, and to tighten financial conditions without actually needing to raise rates. This less disruptive alternative to rate hikes is likely to be particularly important, at a time when we are already seeing a probable peak in inflation, a slight loosening in tight labor market conditions, and growing signs of a significant slowdown in the housing market.

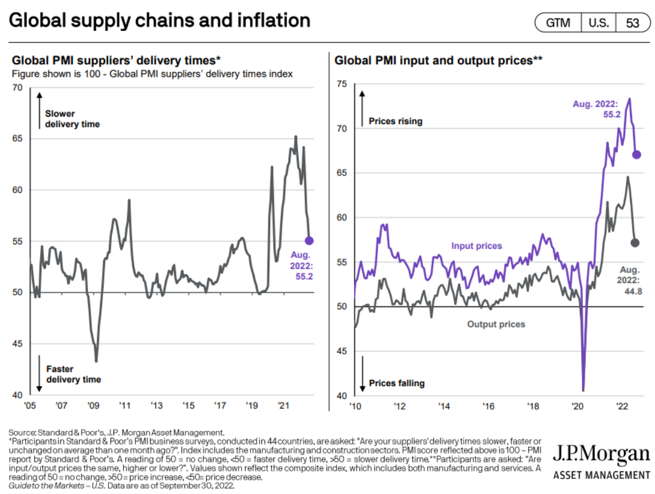
Importantly, we believe that this last factor will be a major driver of lower inflation, as the "shelter" component represents 32.8% of the Consumer Price Index and 42.0% of the Core (ex-food and energy) Consumer Price Index. The government measures housing inflation via rents rather than home prices, and they only survey each part of the country twice per year, and average-in the most recent data over the following six months. This inefficient approach means that the measure of shelter inflation is very slow to pick up price changes, particularly at major inflection points.

You can see this reflected clearly in the rental inflation chart, where the gold line illustrates OER (Owners' Equivalent Rent), which is how shelter inflation is reflected in the government's inflation data, while the two blue lines illustrate what is happening to rents in real time.



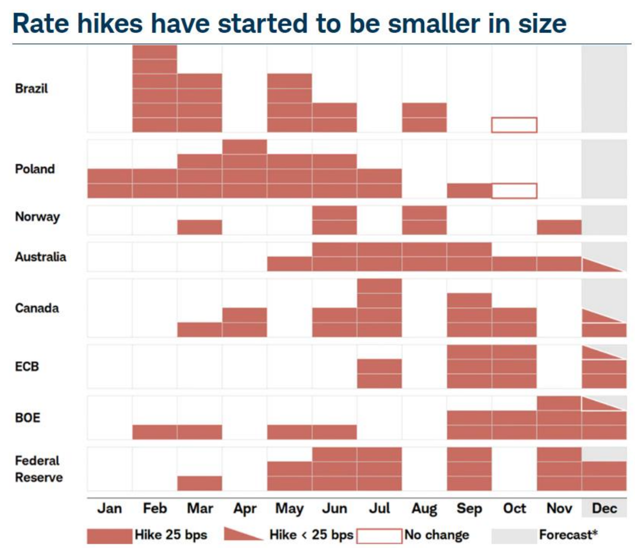
Given that this housing component represents an overwhelming plurality of the government's inflation weightings, this catch-up factor alone should help to push inflation lower through the next year or two, and then when you throw in the historic pace and scope of the Fed's rate hikes, and the fact that they are draining financial liquidity by a targeted $95 billion per month through quantitative tightening, there is, at least in our opinion, every reason to believe that the Fed will ultimately be successful in its battle against inflation.

As for their original premise that the surge in inflation was primarily pandemic-related, and that the price pressures would automatically reverse once the supply chains reopened, they are being proven at least partially correct, with both prices and delivery times falling as supply chains reopen, and that is despite cities representing 50% of the Chinese economy currently being under mobility and/or social distancing restrictions, as part of China's "zero-covid" policies. [3]



All of these factors combine to help explain why Federal Reserve Vice-Chair Lael Brainard just announced that "It will probably be appropriate soon to move to a slower pace of increases." [4]

Perhaps of equal importance is the fact that this trend towards less aggressive monetary policy is looking increasingly global in scope, with Norway, Australia, and Canada each recently making smaller than expected rate hikes, while England, the European Union and the U.S. have each hinted at a slowing pace and/or a smaller size of future rate hikes. [5]



Blank columns reflect months without scheduled central bank rate setting meetings.

*Forecasts contained herein are for illustrative purposes only, may be based upon proprietary research and are developed through analysis of historical public data.

Source: Charles Schwab, Bloomberg, as of 11/4/2022.

From our perspective, this move to smaller and/or less frequent rate hikes is the logical intermediate stop on the way to a pause in rate increases, which will ultimately be followed by rate cuts, likely in a year or so.

A pause (shifting into neutral) will not put an end the strong headwinds currently being faced by both the economy and the markets, but it will keep them from becoming increasingly stronger with each passing Fed meeting, as has been the case since March of this year. Importantly, it is the next changing of gears, the change from pausing to easing (rate cuts), when history suggests that the probability of a powerful and broad-based bull market should increase dramatically.

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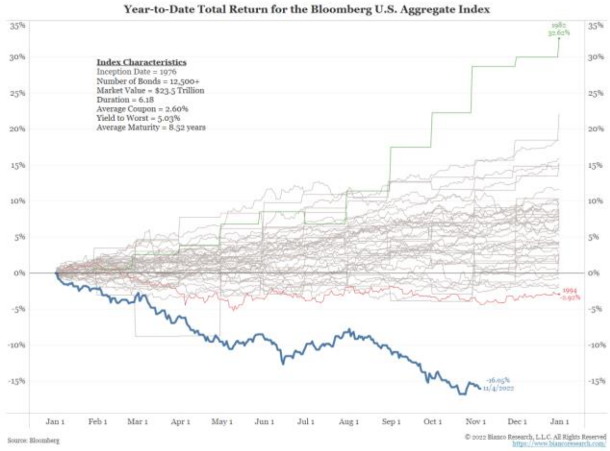
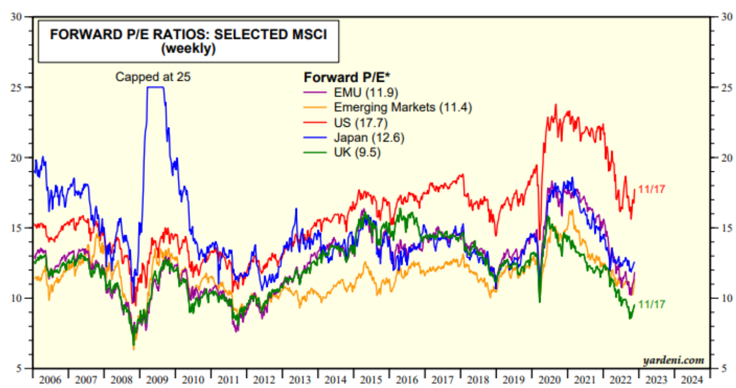
FOMC Meeting Date	Rate Change (bps)	Federal Funds Rate
Nov 2, 2022	+75	3.75% to 4.00%
Sept 21, 2022	+75	3.00% to 3.25%
July 27, 2022	+75	2.25% to 2.5%
June 16, 2022	+75	1.5% to 1.75%
May 5, 2022	+50	0.75% to 1.00%
March 17, 2022	+25	0.25% to 0.50%

In the meantime, we believe that there are a number of market opportunities that have the potential to serve investors rather well during this transitional period. Interestingly, two of these asset classes are areas where we have been very cautious (if not outright bearish) over recent years.



The first of these is the higher-quality segment of the domestic bond markets, including both Treasuries and investment-grade corporate debt. This asset class has experienced its worst decline in modern history, which has driven debt yields above equity yields for the first time in years, and created what we believe to be opportunities for capital gains as inflation and rates meander lower over time.

In regard to domestic equities, we believe that this environment should favor short-duration stocks over their longer-duration brethren. Put another way, we view this as an environment where investors are likely to reward the stocks of companies with attributes like attractive valuations, high free cash flow, high dividends, share repurchases and strong balance sheets (short-duration stocks) over stocks that attract investors based upon their growth potential, innovation, and what they have the potential to grow into over the longer term (long-duration stocks).



* Price divided by 12-month forward consensus expected operating earnings per share.
Source: I/B/E/S data by Refinitiv.

Another asset class that is starting to look interesting is foreign equities, and it is noteworthy that foreign equity markets tend to have a much greater percentage of short-duration stocks, while the U.S., with its heavy weighting towards technology and other innovation-driven growth companies, has a higher percentage of long-duration stocks. This fact, when combined with much lower valuations overseas, a falling dollar, and 15 consecutive years of U.S. equity market outperformance, suggest that investors should perhaps take another look at the foreign equity markets.

While we do expect a recession next year, the good news is that the economy in general, and employment and retail sales in particular, are currently so strong that the anticipated recession is likely to be rather mild. Of course, that also gives the Fed plenty of room to continue tightening until it is confident that they have wrung inflation out of the economy.

That said, we continue to believe that the stock and bond market declines are getting very long in the tooth, and that the ultimate lows may already be in place. And it seems that we are not alone, as you will see in this quote from the just-released J.P. Morgan Long-Term Capital Market Assumption Report, which states that the long-term asset return forecasts for "portfolios of all kinds are better today than they have been in a decade". [6]

Disclosures

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Past performance is no guarantee of future results. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance quoted.

Definitions

The Consumer Price Index (CPI), which is produced by the Bureau of Labor Statistics, is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services. Indexes are available for the U.S. and various geographic areas. Average price data for select utility, automotive fuel, and food items are also available.

Core CPI refers to inflation based on the consumer price index (CPI), covering the inflation of all the goods and services except the volatile food & fuel prices, excise duties, income tax, and other financial investments.

The Bloomberg U.S. Financial Conditions Index is a Z-score tracking the overall level of financial stress in the U.S. money, bond, and equity markets to help assess the availability and cost of credit.

The Bloomberg Barclays US Aggregate Bond Index measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate pass-throughs), ABS and CMBS (agency and non-agency).

The Purchasing Managers' Index (PMI) is an index of the prevailing direction of economic trends in the manufacturing and service sectors. The purpose of the PMI is to provide information about current and future business conditions to company decision makers, analysts, and investors.

Citations

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