ECONOMIC OUTLOOK

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unique investment insight

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Rising Rates Bring Market Pain
Will The Federal Reserve Go Too Far?

Two years after the pandemic-induced global recession in 2020, the world is again facing many challenges. Fears of a global recession are rising as growth slows and inflation reaches multi-decade highs. Multiple waves of pandemic and the war in Ukraine unleashed a series of supply shocks hitting goods, labor, and commodities. Ongoing high inflation is due to factors including a strong rebound in demand, $5 trillion in U.S. government support, accommodative central banks, supply-chain disruptions related to China's zero Covid policy, and volatile commodity markets in areas such as oil, gas, and food - all exacerbated by war and climate events. Soaring prices, particularly in food and energy, are eroding real incomes and creating a cost-of-living crisis. To combat inflation, the Federal Reserve and central banks around the globe are aggressively hiking interest rates to curb demand even as growth in the world's three largest economies - the United States, Europe, and China - is sputtering.

In the U.S., the economic outlook has deteriorated considerably with high inflation, a slowdown in trade, and monetary tightening by the Fed. During 2022, the Fed became increasingly concerned about stubbornly high inflation as demand for labor, goods, and services exceeded supply. The buoyant labor market has recovered all the 22 million jobs lost since the start of the pandemic and is adding 350,000 jobs per month. A tight labor market has led to rising wages and given a lift to consumers, but wage and input inflation keeps the Fed on track to keep raising rates to slow demand. The Fed is worried that inflation might become imbedded as workers demand higher wages and businesses raise prices, feeding a cycle that can be difficult to control. In September, the Fed hiked rates 0.75% for an unprecedented third-straight meeting to a target range of 3.0% to 3.25%, up from 0% at the start of the year. In a speech in Jackson Hole in August, Fed Chair Powell acknowledged that the economy was slowing and that higher rates may lead to a hard landing: "While higher interest rates, slower growth, and softer labor market conditions will bring down inflation, they will also bring some pain to households and businesses. These are the unfortunate costs of reducing inflation."

The reversal in Fed policy over the past year, starting from 0% interest rates and a view that elevated inflation was "largely reflecting transitory factors" to raising interest rates to the point of pain, was a surprise to investors and the markets. An additional worry for investors is the Fed no longer seems willing to step in with support for the markets when they correct. As the Fed continues to push rates ever higher, economists are concerned that central banks will over-shoot their targets and tighten monetary conditions too much, leading to a deeper downturn than is necessary to bring down inflation. Prices of many goods and commodities have already fallen from their peaks (e.g., oil -30%, lumber -70%). Inflation has declined only slightly so far, but changes in interest rates can take a year or more to have a significant impact on the economy and inflation.

U.S. Economy

There are already signs that U.S. growth is slowing. GDP grew 5.7% in 2021 before declining -1.6% in the first quarter of 2022 and -0.6% in the second quarter. Growth estimates for 2022 are falling rapidly. The Atlanta Fed forecast for the third quarter dropped from over 2% in late August to 0.3% in September. Fed fund rates have increased from 0% at the beginning of the year to 3.0% to 3.25% in September with an additional 1.0% to 1.25% likely by year-end. Employment remains robust although consumer confidence is low. Auto sales have recovered from their pandemic lows, but have recently leveled off. Higher prices for housing are cooling the market. The U.S. trade picture reflected a broad slowdown in demand in August with imports down 1.5% while exports fell 0.3%. The U.S. economy may continue to grow for another quarter, but the odds of a recession in 2023 are increasing. With the economic forecast softening, the Federal Reserve lowered its GDP growth forecast for 2022 from 1.7% in June to 0.2% in September after starting the year with a forecast of 4.0%.

Consumer and Manufacturing

Consumer sentiment was essentially unchanged in September month/month and down 18% year/year according to survey data from the University of Michigan. Inflation expectations also waned further in September mostly due to declining gas prices. Inflation expectations were below 2.9%-3.1% for the first time since July 2021. The Conference Board consumer confidence index improved in September supported by jobs, wages, and declining gas prices. Businesses are expanding, but growth is slowing. The outlooks of purchasing managers have turned negative with most manufacturing sectors contracting, compared to earlier this year when they were still expanding. In a sign of the weaker consumer demand for goods, Trans-Pacific shipping rates were down 75% in September from a year ago. As an example of inventory bloat, Nike said it was sitting on 65% more inventory than a year ago and would resort to mark-downs.

Employment

Employment in the U.S. is near full strength. Nonfarm payrolls rose by a healthy 263,000 in September and 315,000 in August. Weekly jobless claims recently touched fifty-year lows, but have started to rise recently. The unemployment rate is 3.5%, just above the rate in February 2020 and down from 14% in April 2020. The Fed forecasts unemployment rising to 4.4% in 2023 as they raise rates and the economy slows. Average hourly wages grew 5.2% in August – this compares to 2-3% typical growth in prior years. Not included in the unemployment statistics are workers who are unable to pursue employment. Estimates of U.S. workers out of the workforce due to long Covid are between two to four million with tens of thousands of new infections daily. Also, since the beginning of the pandemic, more than 350,000 working age adults have died from Covid.

Real Estate

The housing sector is feeling the negative economic consequences of higher interest rates, as a housing downturn is underway according to the National Association of Home Builders (NAHB). In September, the average interest rate on the most popular U.S. home loan climbed close to 7%, the highest level since the financial crisis in 2008. Rising mortgage rates are increasingly weighing on the interest-rate-sensitive housing market as the Fed pushes on with aggressively lifting borrowing costs to cool demand and curb high inflation. Home prices remain high. In July, prices rose 15.8% yr/yr, but fell 0.44% from the prior month, the first monthly decrease since March 2012. Mortgage applications fell 29% from year-ago levels and the National Association of Realtors reported existing home sales were down 27% from the beginning of the year.

World Economy

Europe

For the first half of the year, demand for services and relaxation of Covid restrictions led to a robust expansion. Over the summer, economic activity in Europe declined sharply. The region is facing pressure from the war related energy crisis, high inflation, and rising interest rates. According to the WTO, trade is slowing sharply and total exports and imports are likely to grow just 1% in 2023. Eurozone inflation hit 10% in September with household energy prices rising 40.8% from a year ago. A potential shut-down of Russian gas during this winter could lead to energy shortages and push many countries into recession. Soaring energy and food prices are hurting households, with consumer confidence hitting a record low in July. In the U.K., the pound tumbled to its lowest level since 1985 after new Prime Minister Truss announced a plan to cut taxes, raising fears that the U.K. would need to borrow massively to finance the cuts and intensifying inflation concerns. After the negative market reaction, the government reversed the plans to lower taxes. According to the OECD, growth in the EU is projected at 3.1% this year before falling back to 0.3% in 2023.

China and Emerging Markets

After rising 8.1% in 2021, GDP growth in China is projected to slow to about 3.2% this year due to new waves of Covid and rising trade tensions. In the second quarter, GDP growth fell to a two-year low of 0.4% as strict lockdowns were re-introduced to control the virus. With inflation below target, the central bank has maintained monetary support and, unlike the rest of the world, is actually lowering rates. The government is boosting infrastructure investment while cutting taxes to support businesses. Chinese manufacturing is also contracting; the most recent PMI reading in the world’s second-largest economy was 49.5 (a reading below 50 indicates contraction). Other factors weigh on the economic recovery including declining real estate prices. An astonishing 70% of individual wealth in China is invested in real estate. The Organization for Economic Cooperation (OECD) estimates Chinese growth at 3.2% in 2022, rising to 4.7% in 2023.

In a bright spot, India’s economy remains on track to grow 7% or more this year, more than double the projections for global growth. India’s manufacturing and services sectors are both expanding. India’s stock market has outperformed other major markets, even after accounting for the rupee’s depreciation versus the dollar this year. After growing 5.8% in 2021, the OECD forecasts global GDP growth of 3.0% in 2022 and 2.2% in 2023, revised down from 2.8% in June.

Commodities

Oil prices continued to fall back after hitting their highest prices since 2008 in March. Global benchmark Brent was priced at about $128 in March and settled as low as $84 in September. Supply risks from the war in Ukraine and under-investment in oil production have helped support prices. OPEC and Russia agreed in early October to cut production 2 million barrels a day, despite U.S. pressure to pump more. The counter weight is lower demand due to China’s continued lockdowns, the strategic oil reserve releases by the U.S., and a potential Iran nuclear deal that would increase world oil supplies. The gold market continues to struggle in the face of unprecedented strength in the U.S. dollar. However, investors need to put recent prices in perspective compared to larger movements within financial markets. Although the gold market has seen some significant selling pressure, dropping briefly to fresh two-year lows at $1,633 an ounce, prices are still only down less than 10% since the start of the year.

Investment Perspective

Although analysts expected the Fed to aggressively raise rates this year, the new Fed forecast is for rates to stay higher for a longer period. With high inflation, the Fed is no longer willing or able to provide support for the markets whenever they dip as they have done since the financial crisis. Since 2008, the Federal Reserve and global central banks have kept interest rates at or near 0% or even negative in Europe in a policy known as "quantitative easing." This policy encouraged investors to buy riskier assets and provided corporations with low-cost debt. The new policy, "quantitative tightening," works in reverse – higher rates encourage investors to sell risky assets and purchase less risky assets (e.g., cash), while lowering demand by making loans more expensive (e.g., mortgages). It will take a while for the rate increases to work their way through the system and slow the economy, especially since the labor market is still relatively strong, but the Fed has made it clear that they will keep raising rates until inflation comes down, even if that means a recession.

After a summer rally, the markets fell back to the June lows. The S&P 500 was down over 9% in September, the worst performance since March 2020, and is down about 23% this year. In the past, fixed income would cushion the impact for balanced investors, but 10-year Treasuries fell 16.7%. According to NYU data, if this performance holds until year-end, it will be the worst year for Treasuries since 1929 and the 5th worst for the S&P 500! Earnings estimates are still positive, but continue to be revised lower with the largest cuts in earnings estimates in two years. The third quarter earnings estimate from FactSet for the S&P 500 was +2.9% at the end of September, down from +9.8% on June 30th. In a sign that current earnings may still be high relative to waning profits, Federal Express, a bell-weather of global economic activity, fell 30% in September after announcing that business was soft and could deteriorate further.

What lies ahead for investors? As we have written over the past few years, markets - both fixed income and equities - started the year at the high-end of the valuation range based on various metrics (e.g., price/sales, price/earnings, etc.). With the decline in earnings' estimates and prices, valuations have fallen, but the concern is that lower future earnings may not be fully discounting a possible recession. Cash and fixed income are finally yielding above 0% although they remain negative after accounting for inflation. Even though stocks are highly volatile, equities offer the potential for growth for investors with long time horizons. For specific sectors, we continue to like healthcare, energy, industrials, and technology. Dividends are a core component of total return. As we have for many years, we look for companies with strong financials, solid management, a favorable competitive position, while also being mindful of valuation. Even though the near-term outlook seems gloomy with the Fed hiking rates, geo-political uncertainty, continued supply-chain issues, and war in Ukraine, there eventually will be a turnaround. The economy will weaken as unemployment rises, inflation will fall, and the Fed will change from tight monetary policy back to a more accommodative policy. We already see prices of many commodities falling precipitously from their peaks. Difficult times for performance often set up better returns in the future. Bear markets usually end after the last rate cut and not while the Fed is still raising rates. That will be next year's story. The eventual landing, either soft or hard, is likely not in the next few months, but years. We remain as always patient and vigilant.

September 30, 2022
DJIA: 28,725.51
S&P 500: 3,585.62

About Bounty Management
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If you would like to learn more about our investment management services, performance, and how we can help you, please give Ray Bligh a call at (617) 357-8285 or access our web site at http://www.bountymanagement.com.

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