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CIO Flash

Recession risks rising, as Fed's inflation fight is far from over

Investment Solutions

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The Federal Reserve (Fed) raised interest rates by 75bps on 21 September, as expected, continuing its relentless pace of monetary tightening for the third straight meeting. More worryingly for markets, new forecasts show officials now expect to raise rates to 4.25-4.5% by year-end, and for them to peak at 4.5%, while growth expectations were marked down to 0.2% this year and 1.2% in 2023. Chair Jerome Powell maintained the determined tone he struck in August, unequivocally reiterating the need to quash inflation, whatever the cost to growth and jobs. The Fed's decision on rates was unanimous, and Mr Powell noted that the Fed still intends to move 'purposefully' towards rates that actively restrict growth, with the current 3.00-3.25% level now on the cusp of that territory.

Stéphane Monier
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August inflation – a reality check

The Fed had little choice but to keep up the pace of rate hikes. Inflation remains persistently high and broad-based, with August's consumer price index (CPI) data proving a stark reality check for markets. The big disappointment was that shelter – or housing – costs rose, leading headline inflation up twice as fast as expected month-on-month, even as it declined slightly to 8.3% year-on-year. With house sales tumbling and mortgage costs rising, many had hoped that this component of the CPI would start to ease. Meanwhile, prices of food, medical care, household furnishings and new cars also rose, as did core inflation as measured by August's Producer Price Index (PPI). Risks to inflation continue to be weighted to the upside, Chair Powell reiterated.

Still, high inflation rarely declines in a smooth and predictable fashion and August's disappointing data came after better than expected figures for July. In the 1980s, CPI's fall from double digits saw huge month-on-month swings. Upcoming monthly reports will likely follow a similar 'lumpy' pattern, triggering market volatility.

Prices are trending downwards

The longer-term trend remains in place: price pressures are easing, even if many have yet to show up in the CPI. As growth slows, commodity prices, supply chain hiccups and shipping costs are falling. Retailers will cut prices to shift inventory. Dealers report used car prices are already coming down. The falling cost of petrol – a very visible price marker – should help keep longer-term inflation expectations in check, while a strong dollar will help curb imported inflation. We expect a further

Key takeaways

- The Fed raised rates by 75bps, while its new forecasts show them between 4.25-4.50% by year-end. Officials reiterated a determination to bring inflation under control
- The overall trend in prices is easing, amid slowing growth and falling goods, shipping and commodity prices. Yet bringing down wage growth and housing costs will prove harder
- High inflation rarely declines steadily. Future months' inflation prints will likely bring more surprises, triggering more market volatility
- We expect rates to peak around 4.50% and stay there for most of 2023. While we think this will trigger a recession, rates above 5% would likely cause an even more severe contraction, with sharper falls for risk assets. The margin for error is very limited.

easing in price rises for goods, food and energy by year-end (see chart), and average CPI for 2023 falling to 3.4% year-on-year, from more than double that rate in 2022.

Wages prove problematic

Yet bringing inflation back down to the Fed's 2% target will be tough. Housing costs (around two thirds of the inflation basket) and wage growth remain too high. Rents could stay strong for months: leases are often fixed for a year, and the index tracks rents being paid, not those being asked for empty units, which may have fallen. Meanwhile, as Chair Powell noted, the tight labour market is perhaps where the biggest adjustment needs to be made, amid evidence of considerable resilience. Wages are still rising at levels consistent with 6-7% annual inflation. Workers retain their bargaining power in a tight jobs market with historically high job vacancies – nearly two for every unemployed person. The risk is that the Fed is forced to continue hiking rates into a recession in a bid to restore the supply/demand balance and bring rents and wages under control, even if the former are just taking time to adjust, and the latter will force significant job losses.

Keeping at it until the job is done

Fed Chair Jerome Powell reiterated on Wednesday that he would 'keep at it [the inflation fight] until the job is done,' echoing the words of former Chair Paul Volcker, who tamed inflation at significant economic cost in the early 1980s. Of the bank's twin mandate to maintain price stability and full employment, the former is clearly winning out. We expect a further 75 hike at the Fed's November meeting, a 50bps rise in December, and potentially another of the same magnitude in January. Looking further ahead is more difficult. Will the Fed be content to stop when inflation is falling convincingly, or only when it is approaching the 2% target? Slowing globalisation and immigration trends could make bringing price growth to heel even harder – the Fed's own projections still see core inflation at 2.1% in 2025.

Our base case scenario is that the Fed will be able to stop hiking rates around 4.5%, provided inflation shows compelling evidence of falling in the coming months. We then foresee it pausing at that level for most of 2023 to allow them to take effect. "The historical record cautions strongly against prematurely loosening policy," Mr Powell reiterated on Wednesday, cautioning against a premature cutting of rates that the market has pencilled in for the second half of next year.

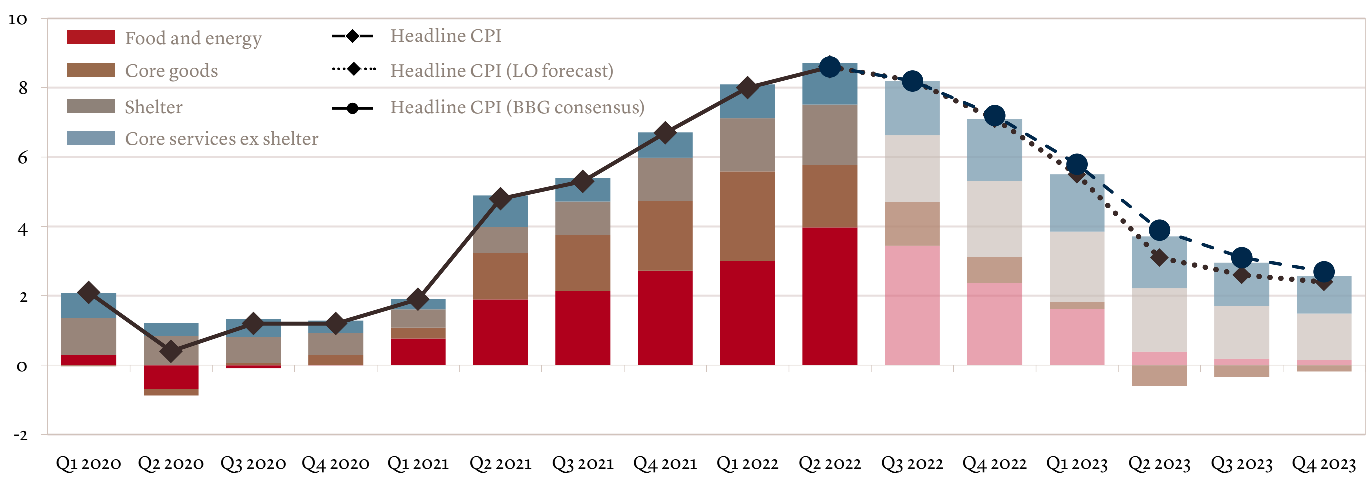
Little margin for error

If rates can peak around 4.5%, we see unemployment rising to around 5% (above the Fed's own 4.4% forecast), and the US economy entering recession. Our full-year growth forecast for 2023 is 0.5%. If inflation remains more persistent, and raises rates nearer 5% or beyond, the downturn could be much more painful – for jobs, household incomes, companies and risk assets – with further steep rises in corporate defaults and falls in commodity and bond prices, and equity markets dipping to significant new lows.

In light of the increased upward risks to rates and downward risks to growth, we are reducing risk in portfolios. We are selling our overweight positions in European real estate and broad commodities, reducing convertible bonds, and raising our allocation to Chinese debt, hedged in US dollars.

Inflation will take time to normalise

US CPI components, historical data and forecasts



Sources: US Bureau of Labor Statistics, Bloomberg, Lombard Odier forecasts

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