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CIO Viewpoint

Fed's data-chase continues amid volatility and banking turmoil

Investment Solutions

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A year after starting to raise interest rates, the Federal Reserve is still chasing evidence that higher borrowing costs are slowing the US economy. The path to cooling demand was inevitably going to be volatile but is delivering surprise after surprise in inflation, job and consumption data. Now, the Fed is also working to contain financial risk, following some small bank failures.

A mixed set of signals leave the Fed more cautious about its next steps and focused on limiting financial contagion after the failure of a series of small US banks that started last week with Silicon Valley Bank (SVB) in California. More restrictive financial conditions have started to affect banks that have poorly managed their balance sheets, of which SVB is an extreme example. SVB's collapse on 10 March led to contagion concerns, resulting in the failure of a second, Signature Bank. That prompted the Fed to launch a new funding programme to shore up confidence in the sector. This provides loans of as long as one year to banks experiencing deposit outflows.

A joint statement from the US Treasury, Fed and Federal Deposit Insurance Corporation, a government agency, said on 12 March that depositors would have access to their money and taxpayers would not bear any losses. If the Fed succeeds in limiting contagion, the recent bank failures should not impact its inflation outlook. When it next meets on 22 March, the Fed may therefore raise its benchmark again by another 25 basis points.

Data chase

Before the banking sector turmoil, the Fed was entirely focused on inflation and US economic data as it sets a course for interest rates. February's employment data, published last week, suggested that January's surge of more than half a million new jobs was not a one-off. Nonfarm payrolls increased by 311,000 in February (see chart 1). That was higher than consensus forecasts of 225,000 new jobs, which have now underestimated the strength of the US labour market for 11 consecutive months. The unemployment rate, which has remained low, lifted last month from its five-decade lows by 0.2% to 3.6%, while average hourly earnings slowed to a 0.2% rise, compared with 0.3% in January (see chart 2). Meanwhile, the labour participation rate rose slightly, offering some hope that workers are returning to the job market after a post-pandemic slump.

Although they do not draw a simple picture - labour demand is still strong and wage growth needs to slow further - taken together these numbers underline that the Fed's rate hikes, amounting to 425 basis points since March 2022, have not yet been enough to slow the economy.

Stéphane Monier
Chief Investment Officer, Lombard Odier Private Bank

Key takeaways

- The Fed is now fighting inflation as well as potential financial contagion following the failure of two small US banks
- In an unusually uncertain environment, the US central bank is highly data-dependent as jobs, consumption and inflation reports remain volatile
- One year after the Fed started to raise interest rates, the full impact of higher borrowing costs continues to filter into the US economy
- We maintain a balanced portfolio positioning, and are carefully monitoring developments in US economic data and the banking system.

We believe that the broad trend toward lower inflation is on track: energy prices have fallen, prices for goods and supply chain disruptions are normalising. Market based measures of rents have dipped sharply and this should show up in official inflation figures. Leading indicators such as the 'prices paid' component of manufacturing surveys show prices continue to fall, although more slowly in recent months and globally, trade is weakening. In contrast with 2022's economy when prices were rising across the board, commodities from petrol to natural gas and grain have all steadied or fallen and the logistical bottlenecks in supply chains have dramatically improved.

Exceptional jobs?

It is possible that the job market is an exception to other parts of the economy and monetary policy is having less impact on demand for labour, because post-pandemic shortages are still a factor. Growth in gross domestic product slowed to just 0.9% in 2022, and manufacturing is persistently weaker. While consumer spending is proving resilient thanks perhaps to accumulated consumer savings through Covid, which must eventually run out, rate sensitive areas of the economy have decelerated. The property market has quickly digested rising rates; banks have tightened lending standards, slowing private and residential investment. While mortgage rates eased slightly in January and new home sales rose on the previous month, they were down 19.4% on the previous year.

Markets are closely tracking the Fed's moves as it fights inflation and potential financial contagion. Fed Chair Jerome Powell told Congress last week that the Fed has more work to do, pending more economic data, and may consider further large hikes. Both consumer price inflation and the personal consumption expenditures index rose in January month-on-month. Estimates of first-quarter GDP growth from the Atlanta Fed point to growth reaccelerating. With the exception of the housing market, there is little evidence of core services inflation falling. It hardly needs saying that leaves the headline figure far from the Fed's average 2% target.

Delayed reaction?

There is also a case for waiting to see whether the impact of considerable tightening has taken hold yet. Conventional economic theory tells us that hikes may need between a year and 18 months to hit the economy. The pandemic may have shifted that timetable by putting more savings in consumers' pockets and so cushioning the impact of higher prices. But that won't last forever. Milder than usual weather this January will also have helped retail sales, and possibly employment figures.

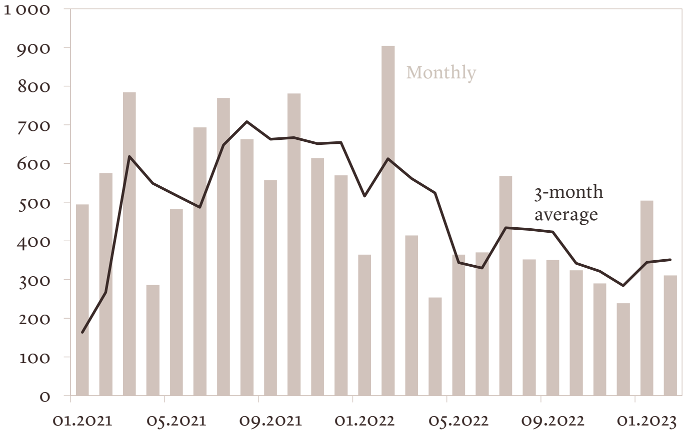
The Fed is now even more than usually data dependent and it will have much new material, including developments in the banking sector, core inflation, industrial production, producer prices and retail sales to consider before then.

The growth impact from further monetary tightening will continue to trickle into the economy in the months ahead. Still, if rates rise higher to counter unexpected economic strength, the hit to future growth could be greater. We expect US unemployment to continue to rise, with recessionary episodes postponed until late 2023, or perhaps early in 2024.

Movements in economic data, and confidence in the Fed's ability to manage US slowdown, will continue to drive markets. Following the sharp repricing of interest rate expectations and declines in bond yields, we take profit on our positions in US Treasury Inflation-Protected Securities (TIPS). We maintain a balanced investment positioning overall and remain prudent as we monitor any risk of financial contagion.

1. Still adding jobs, unemployment rate near historic low

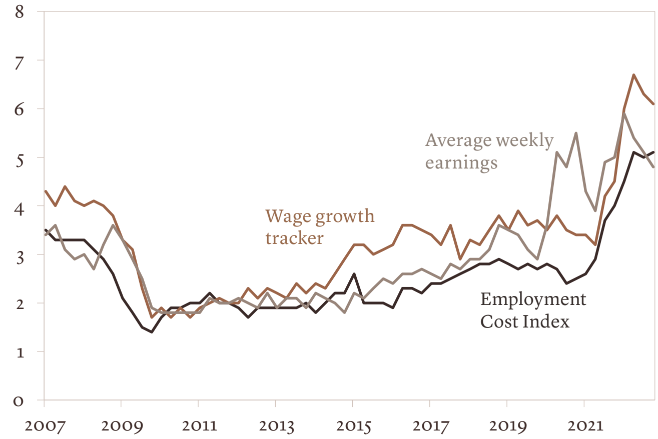
New jobs created, monthly and 3-month average (in thousands)



Sources: Bloomberg, Bureau of Labor Statistics, Lombard Odier calculations

2. Wage growth measures have also peaked

Year-on-year change in wage growth measures (in %, quarterly)



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