Insights: The Fed’s communication problem
December 2022

The Fed’s communication problem.

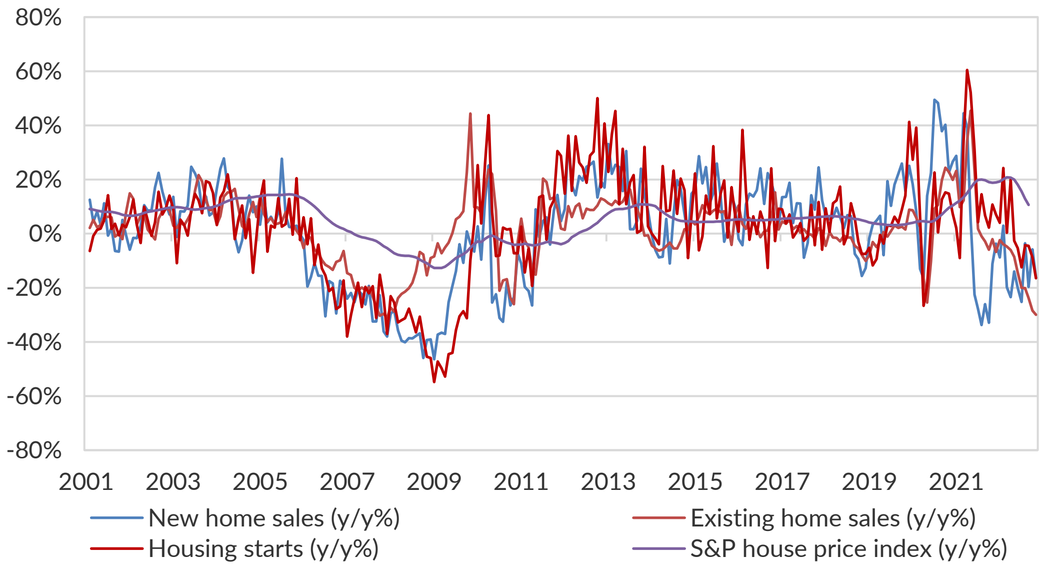
The US Federal Reserve has a communications problem. It is no longer seen as a credible manager of monetary policy. And it is easy to see why. The US economic data are slowing rapidly. The housing market is in free fall. Core inflation has peaked and is set to plunge. Inflation expectations point to the Fed missing its inflation target on the low side over the next decade. The data are screaming at the Fed to pause.

Against this backdrop, Fed Chair Powell has committed to at least three more 0.75% rate hikes in 2023. The rates market has said “You’re bonkers!” and is pricing in three cuts from the Fed by end-2023. In this Insight, I share how the Fed may influence the outlook for 2023.

The data are screaming for a pause

The US economy is slowing. The housing market has already capitulated. Year-over-year sales of new and existing homes is starting to look very pre-GFC like.

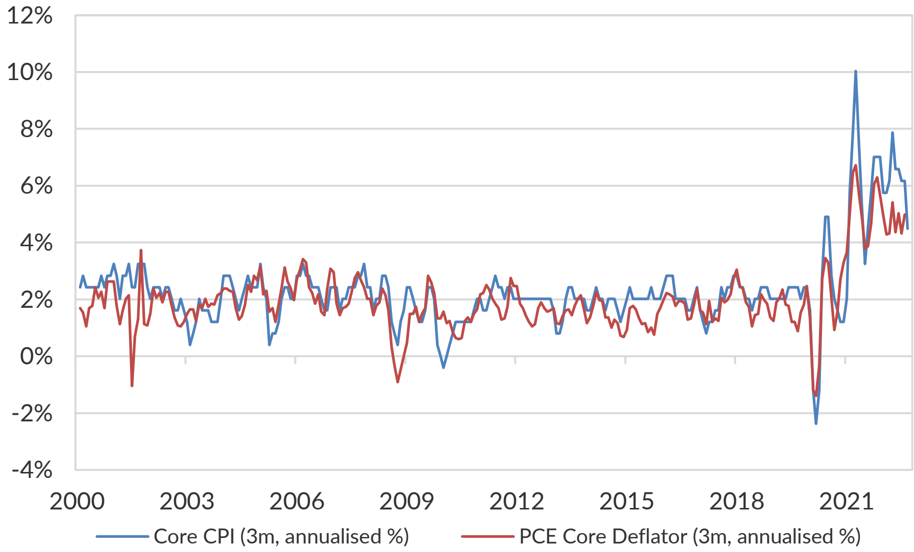
Chart 1: US housing data are collapsing as the Fed hikes rates.



Source: Bloomberg, Oreana

Manufacturing is moving into contractionary territory. Inflation has clearly peaked – core inflation measures are moving back towards target on a 3-month annualised basis.

Chart 2: US core inflation has peaked and is set to fall through 2023.

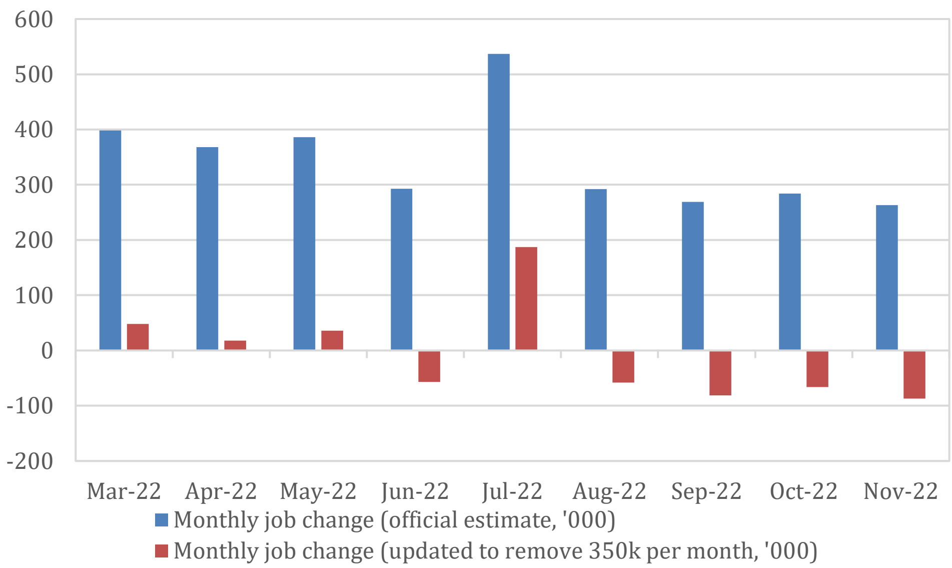


Source: Bloomberg, Oreana

The Fed has pointed to the labour market as a key area of resilience. The unemployment rate remained impressively low. Jobs growth has been strong with an average of more than 300k jobs added each month since June.

But a recent article from the Philadelphia Federal Reserve published on 13 December (a day before the Fed's meeting) casts doubt on this assessment. The authors indicate that between March and June this year, only around 10k jobs were added instead of the official estimate of around 1.1 million jobs. That is, the monthly numbers were overstated by around 350k on average! If that gap persisted since June, then Chart 3 shows the US may already be in labour market recession.

Chart 3: Recent research suggests the US may already be in labour market recession.



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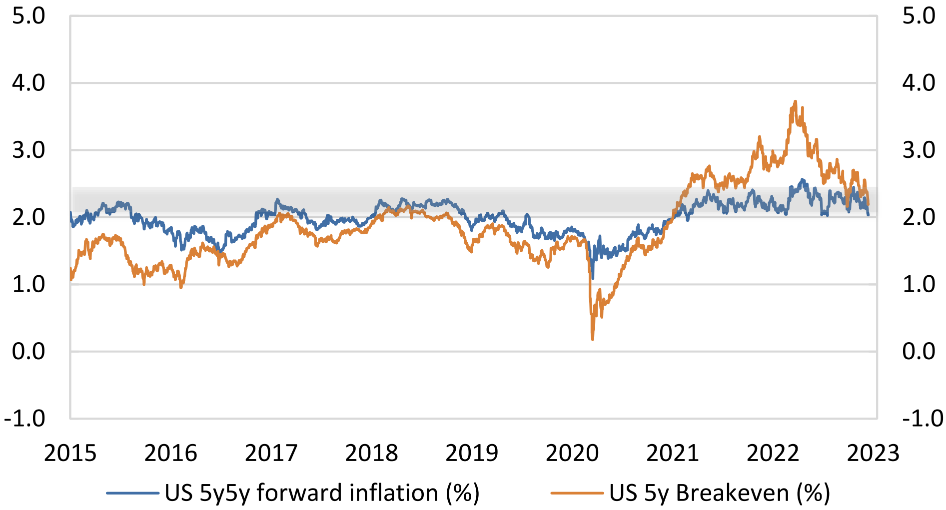
Source: Bloomberg, Oreana

The Fed's position is not credible

US data are overwhelmingly pointing to the need to pause rate hikes now. The only reason we can see to hike further is to give the Fed more room to cut if there is a recession. But a recession is unnecessary. We expect inflation will fall quite quickly back towards target given the slowing in parts of the US economy. Inflation expectations reflect this – inflation expectations over most timeframes now have the Fed missing its target on the low side.

Chart 4: Inflation expectations have collapsed to be lower than the Fed's target (in grey).



Source: Bloomberg, Oreana

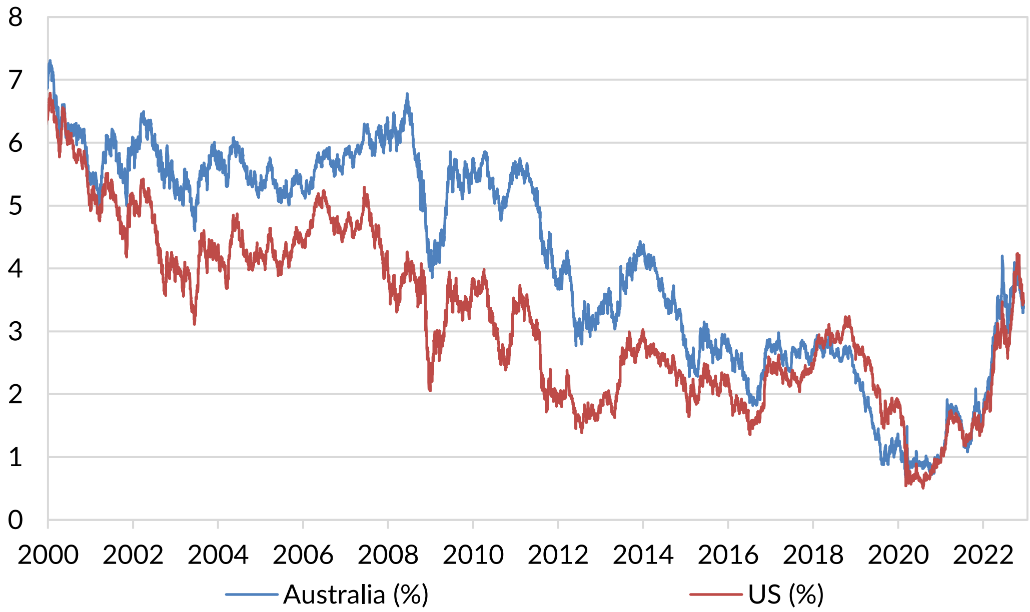
Rates markets have treated the Fed's jawboning for 0.75% more hikes with scepticism. The Fed needs to move its narrative back to a pause at restrictive levels. That will allow inflation to slow and reduce the risk of a recession.
While we think the Fed needs to pause, we are not convinced they will pause. This is a Fed that has damaged its credibility repeatedly through 2021 and 2022. And that means investors should be cautious in deciding on which battlefield they want to fight the Fed.

Fight the Fed, but focus on the front-end

US and global equity markets sold off in the wake of the Fed's meeting. There is more downside risk if the Fed hikes too far, forcing a recession on the US economy. The risk of this is evenly balanced in our view. We think it makes sense to hold a neutral exposure to US equities. For Australian investors, we think Australian equities are more attractive than US, because they will benefit from the reopening underway in China (see here for our thoughts on China) even if the US slides to recession.
We think fixed interest is a more winnable war. We have been overweight longer-duration government bonds since September, when US and Australian government bond yields surged above 4.00%. They have since rallied lower to be below 3.50% in both jurisdictions. With yields at

these higher levels, investors can get reasonable income with good diversification and downside protection benefits.

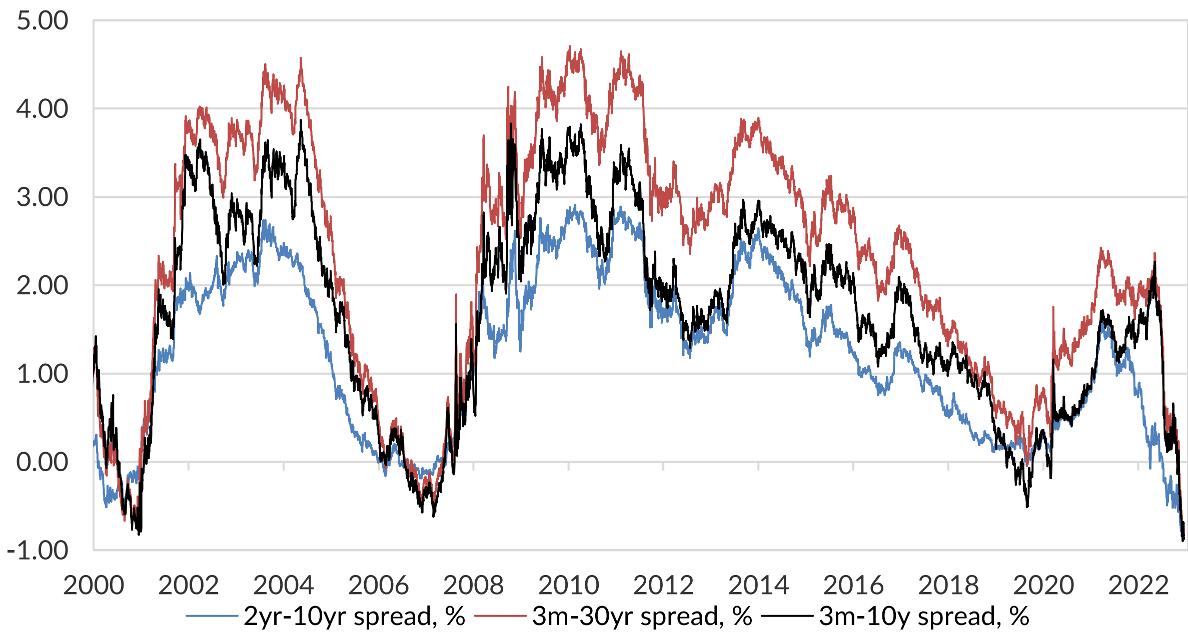
Chart 5: Longer-dated government bond yields were attractive above 4.00%.



Source: Bloomberg, Oreana

We now think it is sensible to add shorter duration government bond yields. The US Treasury yield curve is very inverted.

Chart 6: The yield curve is very inverted – so adding shorter dated government bonds is now sensible.



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Source: Bloomberg, Oreana

If the Fed hikes less than they have committed, then the 2-year yield will drift lower from its currently levels. But if the Fed does hike into recession, the 2-year yield will collapse as markets price aggressive rate cuts. That will steepen the yield curve rapidly as the 10-year yield will move less and provide some further downside protection for investors' diversified portfolios.

A better year for portfolios, but risks remain

2022 has been a very difficult year for investors in equities and bonds. We think 2023 will be better. The Fed is going to be important for returns. If the Fed listens to the data, and pauses soon, then the economic expansion could be extended. That will be positive for returns in most asset classes.
On the other hand, the Fed is fixated on hiking rates apparently even at the cost of recession. We can't fully discount Fed incompetence. And so, it is important to choose the battlefield on which to fight the Fed. From our perspective, adding exposure to government bonds across the curve provides a good combination of income, diversification, and downside protection to help support portfolio returns through 2023, whatever the Fed's actions.

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