PICTET WEALTH MANAGEMENT
ASSET ALLOCATION & MACRO RESEARCH
13 May 2022

US - A HIKE AROUND MOUNT RECESSION

FED SOWS DOUBTS ABOUT ITS RECESSION INTENTIONS TO CALM WAGES AND INFLATION

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SUMMARY

- The Federal Reserve's (Fed's) recent communication is very clear: the priority is fighting high inflation and avoiding a wage-price spiral like in the 1970s.
- Less clear is how far the Fed is willing to go to calm these nascent inflationary pressures.
- Some current and recently-departed policymakers allude to the idea that if this means an economic recession then so be it as inflation credibility needs to be restored.
- Nevertheless, we think the Fed has a profound DNA – which we believe is to avoid a slide into recession above all matters – and this DNA we think will re-emerge later this year and make the Fed halt its monetary-tightening plans as it reassesses US macro data.
- However there is a risk that the Fed may tighten in straight line and realise, but too late, the extent of the sharp tightening already under way in market and credit conditions; by then, the US economy may have already fallen into a dangerous recession spiral especially if collective psychology pivots. The risk of a Fed policy mistake is high.

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US economy in buoyant shape, but risk now is Fed tightens too much

As of now, the US economy is in buoyant shape as demonstrated by the ongoing **strong gains in employment**. The 3-month average in non-farm payrolls was a solid 523,000 as of April. This underlying US macro strength is not really displayed in headline GDP data, which fell 1.4% quarter-on-quarter (annualized), but that GDP data is distorted by strong imports (+17.7%, technically, a drag on GDP).

As of now, we believe the near-term US recession risks remain moderate, but they are higher when looking at the medium-term macro picture. Usually near-term recession risks depend on macro momentum, which is so far strong, while medium-term recession risks depend mostly on the state of the business cycle, which is showing late-cycle characteristics, and therefore potentially more fragile.

The fact the unemployment rate (3.6% in April) is well below its long-term equilibrium (or 'NAIRU' in economic parlance) and that **wage growth is accelerating is usually a sign of being late-cycle**, when recession risks start to rise. But late-cycle without clear 'recession trigger' like a fall in macro momentum or a sharp tightening in financial conditions can last several quarters if not years.

The question is now: what's going on with financial conditions. That's where the picture gets more complex given the Fed's recent hawkish communication, and its putting on the table aggressive rate hikes (including the last one of +50bps, the first such hike at a single meeting since May 2000). Fed's hawkishness is not only transpiring into higher long-term interest rates, but also rapidly-increased risk premia across financial markets.

Financial-market conditions can rapidly destabilise the 'real economy', for instance when the credit and sentiment channel start to take a hit. The US economy remains a debt-driven economy with sizeable influence of the financial sphere on the 'real economy' (the real word of production and exchange of goods and services). Collective psychology can play a bigger role than pure economics, especially if business sentiment and household sentiment start to turn. For instance if there is a sudden self-persuasion that a recession is inevitable, a recession can be self-fulfilling as households cut back on purchases (especially on long-shelf items) while businesses cut on investment and new employment.

This brings us to the Federal Reserve, which has (1) sounded **very hawkish** in recent months, leading to a sharp ascent in long-term bond yields and, more recently, a sharp **ascent in risk premia across financial markets** (2) sent confusing signals about the potential trade-off between growth and inflation, seemingly **ignoring any signal on potential growth risks**.

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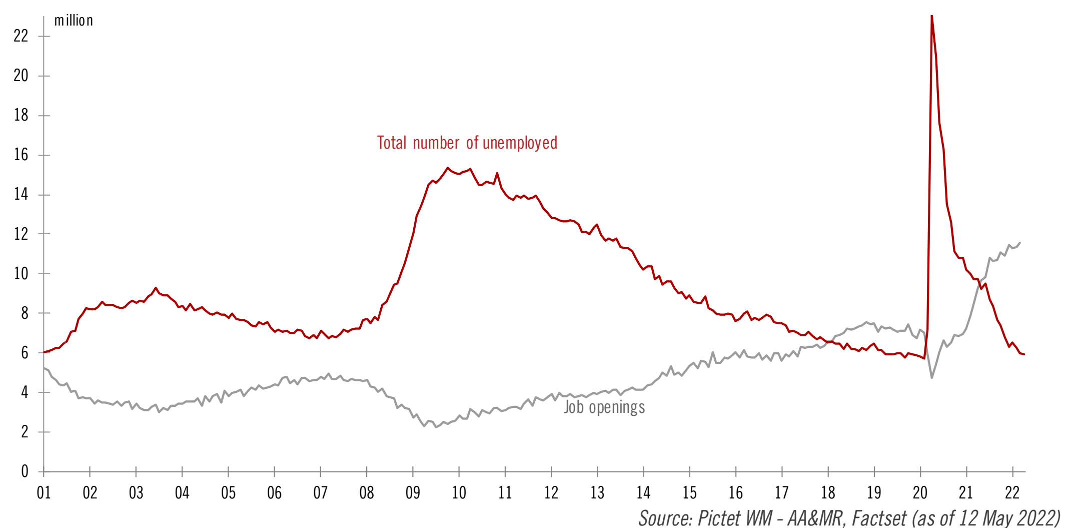
The Fed does indeed seem to be fixated with inflation fighting. At a 10 May speech, New York Fed president John Williams highlighted the need to "turn down the heat in the labor market", which is sees as key to restoring "price stability". What we think is the Fed's 'core' DNA of **'growth and business-cycle preservation'** (some would add: 'and be 'market friendly') **appears to be entirely buried at the moment**. Recently, freshly retired Fed officials have further sowed doubts about the Fed's intentions, including some Fed officials speaking at a Hoover Institution conference (the conference title was 'How Monetary Policy Got Behind The Curve and How To Get Back'). Former Fed Vice Chair for banking regulation **Randy Quarles strongly hinted that if a recession is what is needed to bring down inflation, then the Fed may be ready to get there for the sake of keeping its inflation-fighting credibility.**

Chairman Powell himself sowed doubt when he mentioned at the May post-meeting press conference the challenges of a "soft landing" in the economy in the coming months in a context of high inflation and sharp wage pressures. He mentioned a **"softish landing"** de facto acknowledging that the Fed's monetary tightening may impose some damage on the economy: landing could be bumpier than just a "soft landing". Powell alluded nevertheless that **50bps rate moves would be on the table at the next "couple" of meetings.** In a 12 May interview, Jerome Powell hinted that fighting inflation may lead to "some pain".

Our view of the **Fed tightening is that it has already happened to a large degree via the sharp shift up in the US yield curve in recent months and via the sharp tightening in risk premia across financial markets, especially in the high-yield corporate debt sector**.

CHART 1: CHAIRMAN POWELL WANTS TO BRING DOWN JOB VACANCIES WITHOUT MOVING UP UNEMPLOYMENT



Source: Pictet WM - AA&MR, Factset (as of 12 May 2022)

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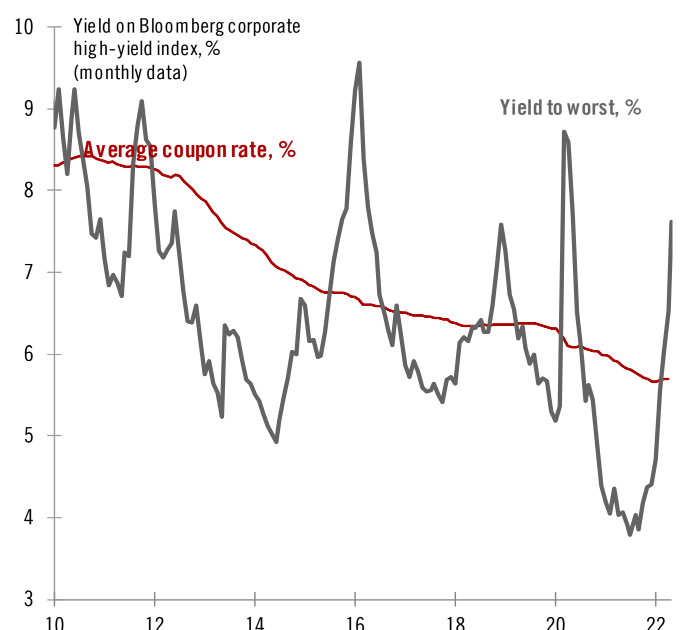
Put differently, we believe the **US monetary policy stance should be judged holistically** rather than by looking only at the fed funds rate or the Fed interest rate on banks' balances (currently 0.9%). The monetary policy stance is about the **combined impact** of Quantitative Tightening, forward guidance and communication, and the actual moves in interest rates. By **many standards in our view, the stance is already quite tight**. The rate of the five-year US Treasury yield two years away (3.05% on 13 May) already well exceeds the Fed's estimate of the nominal neutral rate (2.4%). The yield of the US corporate high-yield index has risen sharply and now exceeds the average coupon rate (approximative yield to worst of 7.6% vs. average coupon rate of 5.7% as of 13 May).

In the near term, key will be to watch the **housing market** as it could see bumps due to this sharp move up in mortgage rates, although there is still hope that tightness in housing inventories could limit damage. More importantly will be then to switch focus to **business sentiment data**, which could also be affected over the summer. By contrast, the labour market tends to be a very lagging market when there is a slowdown, and the **unemployment rate tends to be last among big macro indicators to turn** (but when it turns it is usually too late and a recession has begun).

CHART 2: 5-YEAR INTEREST RATE 2 YEARS' AWAY VS. FED'S NEUTRAL RATE

Source: PWM - AA&MR Bloomberg LP (13 May 2022)

CHART 3: YIELD ON BLOOMBERG CORPORATE HIGH-YIELD VS. COUPON RATE



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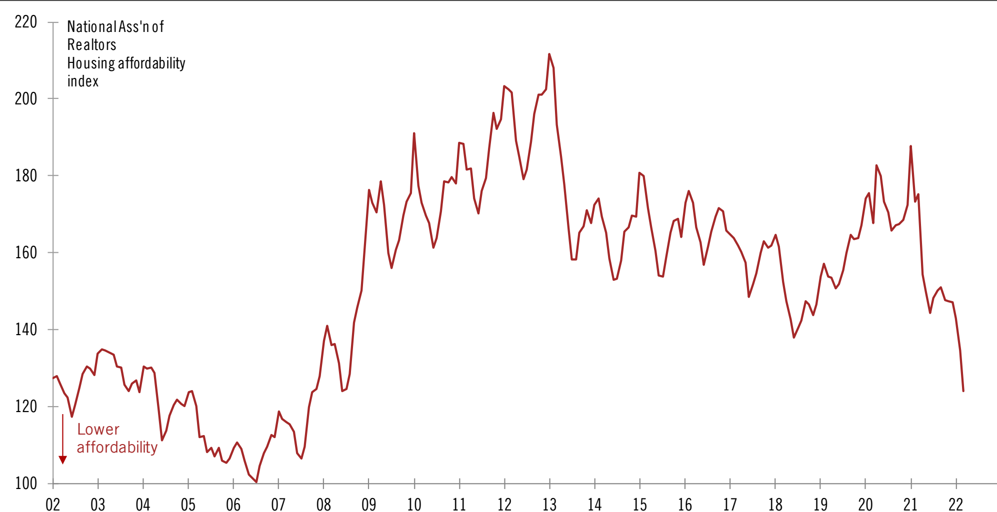
Our current scenario is that **the Fed will not want to wait for the full chain of impact before pausing its tightening**: we expect the Fed to start pausing post summer to reassess US macro data. We also think the Fed will shift its reading on inflation from just a wage issue to other considerations like the likely future erosion in consumer spending and the GDP output gap (the output gap, or the 'hole' in the economy between actual GDP and potential GDP, may increase as GDP growth slows in coming quarters; the output gap is sometimes proxied as the gap between potential supply and demand in the economy).

Recent comments from Fed officials do still pose a risk to our scenario of a growth-friendly Fed. The Fed may remain overarchingly focused on inflation and be influenced (too much) by wage growth. In other words the Fed may continue to prefer to look back at the data, rather than look forward about the future impact of rising rates (and shooting-up financial market premia) on the US economy.

The risk with escalating term premia and tightening financial conditions is that they can move into a self-fulfilling spiral with psychology, and at some stage, such a negative loop can be difficult to control. **US financial markets are particularly central to business sentiment and household sentiment, including via the 'wealth effect'.** Their vagaries can have large consequences on the 'real economy'.

At this stage our Fed scenario is for 50bps at the next meeting in June, but then we think the Fed could scale back to 25bps in July (with a high risk of 50bps) and stop in September as it reassess macro data. **The recent sharp tightening in financial conditions – with tightening now also materialising in high-yield credit markets, themselves central to the US economy in our analysis – is in our view underappreciated by the Fed and may mean even more than ever**, that a rate pause happens post summer.

CHART 4: HOUSING AFFORDABILITY IS HEADING DOWM DUE TO RISING MORTGAGE RATES



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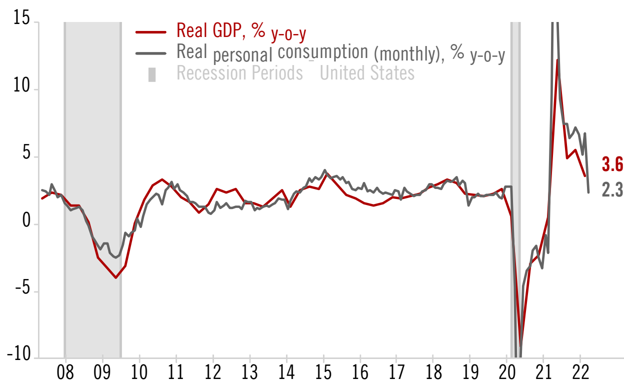
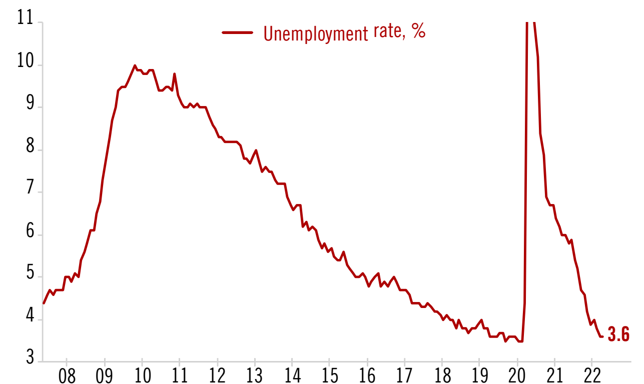
REAL GDP AND PRIVATE CONSUMPTION GROWTH, % Y-O-Y



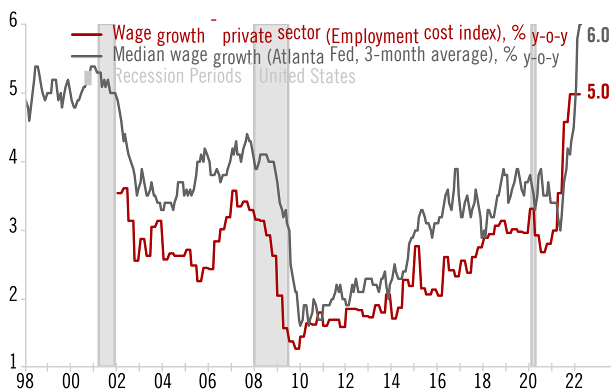
Source: Pictet WM – AA&MR, Factset

UNEMPLOYMENT RATE, %



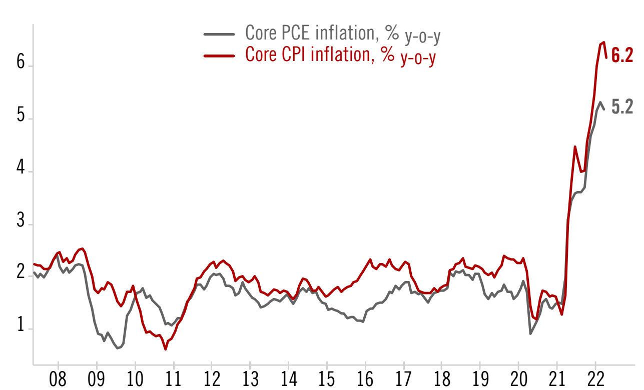
Source: Pictet WM – AA&MR, Factset

WAGE GROWTH INDICATORS, % Y-O-Y



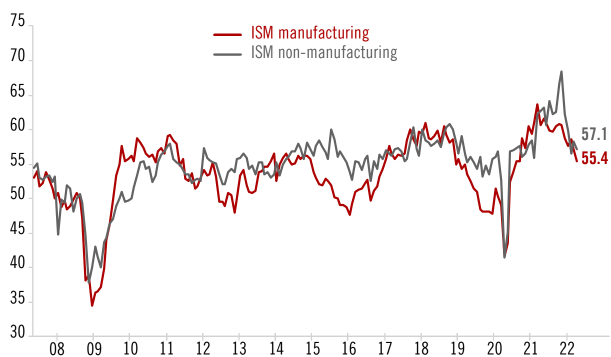
Source: Pictet WM – AA&MR, Factset

CORE INFLATION (PCE AND CPI INDICES), % Y-O-Y



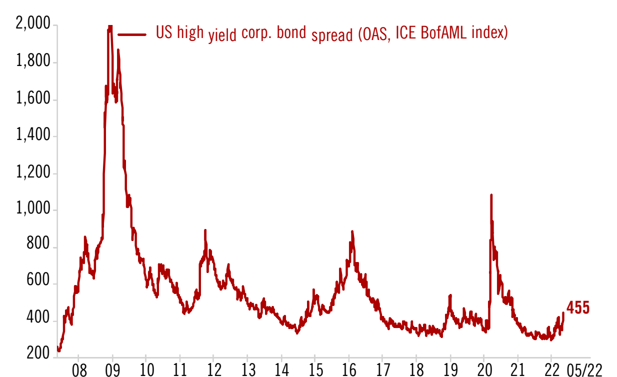
Source: Pictet WM – AA&MR, Factset

ISM BUSINESS SURVEYS



Source: Pictet WM – AA&MR, Factset

HIGH-YIELD CORPORATE BOND SPREAD, BASIS POINTS



Source: Pictet WM – AA&MR, Factset (last close)

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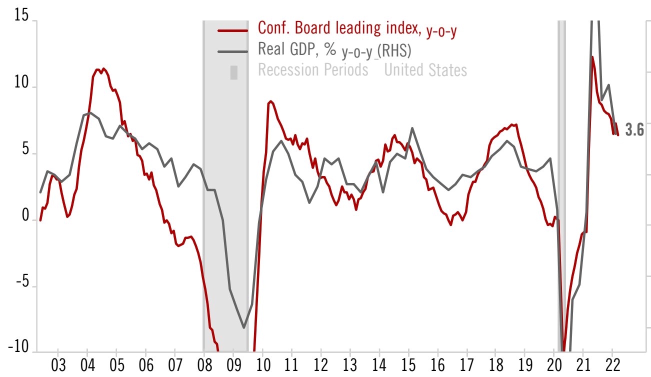
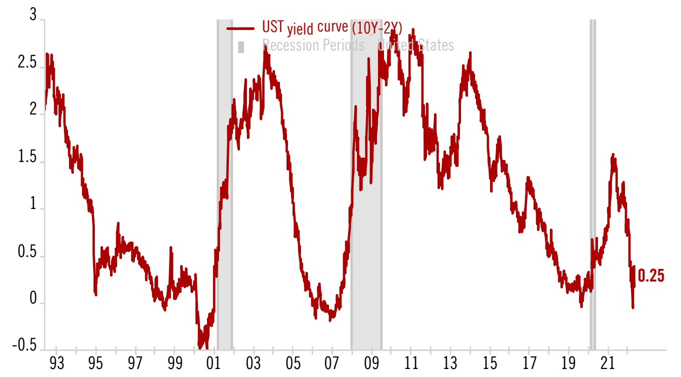
CONF. BOARD LEADING INDEX, % Y-O-Y VS GDP GROWTH, % Y-O-Y



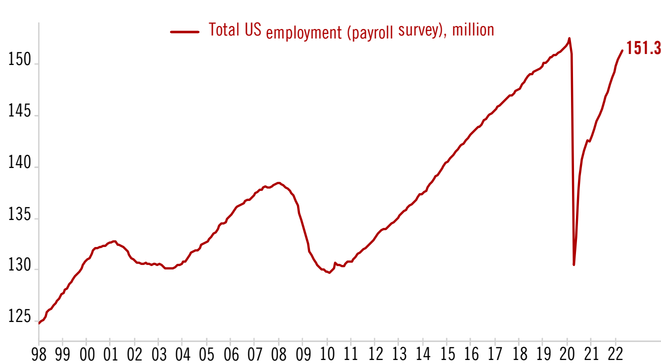
Source: PWM - AA&MR, Factset

US YIELD CURVE SPREAD (10-YEAR YIELD MINUS 2-YEAR YIELD)



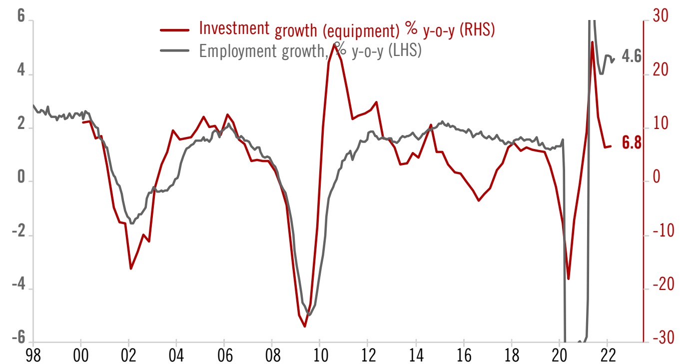
Source: PWM - AA&MR, Factset (last close)

TOTAL US EMPLOYMENT



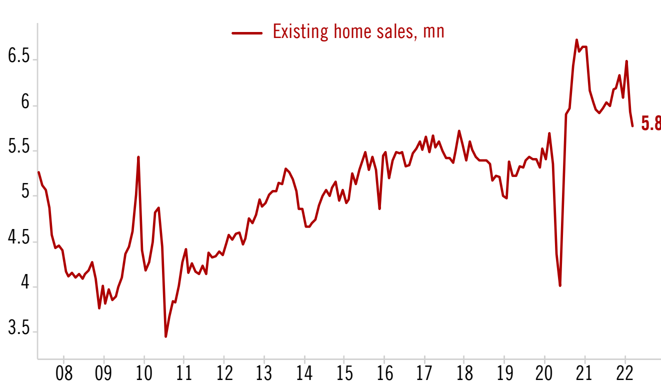
Source: PWM - AA&MR, Factset

US INVESTMENT (EQUIPMENT) VS EMPLOYMENT GROWTH, % Y-O-Y



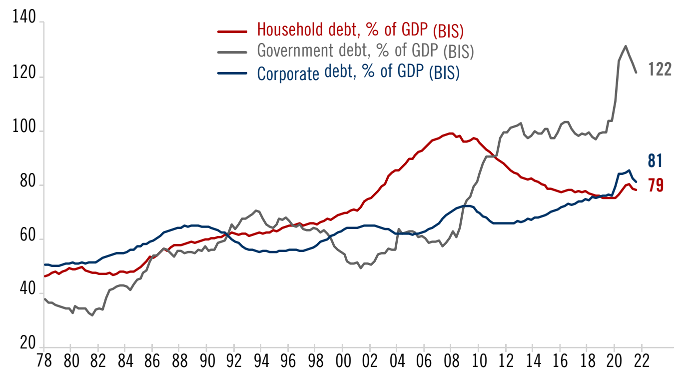
Source: PWM - AA&MR, Factset

EXISTING HOME SALES, MILLION UNITS (ANNUALISED)



Source: PWM - AA&MR, Factset

DEBT RATIOS (HOUSEHOLD, CORPORATE, GOVERNMENT), % OF GDP



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