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The Chairman's Speech

Higher Interest Rates for Longer

When Fed chairman Jerome Powell speaks, the world listens.

As with each of his predecessors at the Fed, Powell's speeches are always eagerly anticipated, carefully listened to, and then painstakingly analyzed by economists, investors, and journalists. Their goal is to detect the slightest nuanced differences from his prior pronouncements in order to gain clues that would allow them to stay ahead of the interest rate curve. That may be a fruitful endeavor at times, but in Powell's case the wording of each speech has been so clear that no further speculation is needed about his intent.

For months, Mr. Powell has been delivering the same message to investors and to the world: inflation in the United States has declined considerably from post-pandemic highs, yet remains elevated in key areas such as housing, food, and energy. As a result, beyond the eleven rate hikes the Fed has already enacted since March 2022, others may be needed in the months ahead. One of the Fed's most watched inflation metrics, the Personal Consumption Expenditures (PCE) price index, remains too high for the Fed's comfort. PCE inflation has fallen from about 6% last year to 3.7% now but remains above the Fed's 2% target.

The key Fed Funds interest rate, which the members of the Federal Open Markets Committee control, is used by banks to determine their own interest rate programs for their clients. That rate currently stands in a range of 5.0% to 5.5%. In March of last year, just prior to the Fed's first rate increase on March 17, the Fed Funds rate was in the 0.25% to 0.50% range. This steep increase over a short year-and-a-half highlights two things, namely the Fed's need to demonstrate their ability to control inflation, and their tacit admission that rates were too low for too long, thereby encouraging inflation.

Hence, their decision to keep interest rates higher for longer.

The Fed's Challenge: Reducing Inflation in Housing, Food, and Energy

U.S. economic growth has been slowing in recent months. Yet, it remains stronger than many economists had expected it to be at this point after both the Covid pandemic and the eleven interest rate hikes. After the pandemic and the lockdowns, demand for goods and services rebounded with the force of an erupting volcano, creating “revenge travel” and “revenge spending”, popular phrases that graphically describe pent-up consumer demand.

This economic strength may have had to do with four factors: first, the unprecedented 25% increase in the nation’s GDP through the federal government’s fiscal spending programs aimed at supporting businesses, families, and individuals; second, the Fed’s monetary stimulus programs that were aimed at encouraging borrowing and economic activity during and after the pandemic; third, the continuing rebound effect of consumer demand from the pandemic’s lockdowns; and fourth, the lag effect that normally accompanies rate increases, allowing consumers to continue spending as before, until the restraining effects of higher interest rates kick in.

It is this fourth point that is starting to create negative cracks in the economy – the Fed’s rate increases are now visibly making their way through the economic system to discourage spending and borrowing.

Among the negatives is the growing pile of consumer debt. Much of today’s consumer spending is being done on credit. The average credit card account now carries a balance of $6,000 according to a recent Forbes report. Overall, consumers have over $1 trillion in credit card debt. This is not a good sign for future solvency rates. It also means that in a rising interest rate environment credit card use could become more expensive. According to Experian, the credit monitoring firm, the average credit card interest rate currently stands at about 21%. Since there are no legal limits on how high that figure might go, as the Fed raises interest rates, credit may be harder for the average consumer to afford.

Not surprisingly, rate hikes are having a pronounced negative effect on one key area of the economy, housing. The effect here is perhaps more pronounced than in any other sector. Housing accounts for almost 18% of U.S. GDP according to the National Association of Home Builders. It has seen a marked slowdown throughout the country, with mortgage originations falling almost 30% from the same time last year. The average 30-year fixed mortgage now stands above 7%, or almost 4 percentage points higher than it was in early 2022 just prior to the Fed’s first hike.

Housing is now at its lowest affordability level since 1984 according to a recent CNN report. The average home buyer can expect to spend more than 38% of his or her income on principal, interest, and taxes. Mortgage lenders often use 30% of gross monthly income as their threshold for granting loans to prospective home buyers. This highlights the current mortgage burden many borrowers face, and the reason why some may be priced out of the housing market.

Yet, despite markedly higher mortgage rates home prices have remained relatively high. Housing experts attribute this to low inventory levels relative to demand. Low inventory in turn reflects the reluctance of current homeowners to sell their homes in an environment where they themselves may in turn have to purchase a new home at higher mortgage rates.

This dichotomy in the housing sector is not lost on the Fed. It is one more reason why further interest rate increases may be necessary.

Adding to the Fed's concerns, food inflation has also remained tough to control. Food prices overall rose nearly 10% in 2022 and are now trending in the 7.5% range versus roughly 3.5% historically. One significant cause of this is the shortage of food industry workers in agriculture, processing, trucking, and restaurants, among other areas of the food sector. These labor shortages have led to higher wages for workers and are now resulting in higher prices for consumers. Once granted, wage increases add to inflation and cannot be reversed easily or quickly. This is yet another point of frustration for the Fed.

Inflation's recent downward trajectory may not reach the Fed's 2% target in an expedient timeframe. While the Fed has some control over the U.S. housing market and food prices, it has far less control over global energy prices.

Some economists are now predicting that oil will rise to $100 or more per barrel by the end of this year. This would present a challenge to the Fed's inflation fighting program. After decades of talk about replacing oil as a key energy source, the U.S. and the world are still as reliant on this fuel source as they were in the 1980s. Oil continues to be a key economic input. Beyond its use for transportation and heating, it is also used in more than six thousand consumer and industrial products. This makes oil vital to the economy and keeps a floor in its demand. Its rise from the current price of $90 a barrel to over $100 in the near future will be felt by businesses and consumers alike. It will pose a challenge to the Fed's efforts at taming inflation.

Stock and Bond Markets Already Reflect an Economic Slowdown

While we do not always think of it as being so, the stock market is a leading economic indicator that anticipates the economy's ups and downs many months in advance. At the moment, the stock market is signaling that a recession is possible in the months ahead, although the timing of that recession is uncertain.

According to FactSet Research, which surveys Wall Street analysts for their earnings estimates, full-year 2023 corporate earnings are expected to grow at 1.1% over last year. At the start of 2023 analysts had expected earnings growth of 5.5%, highlighting a marked downgrading of expectations.

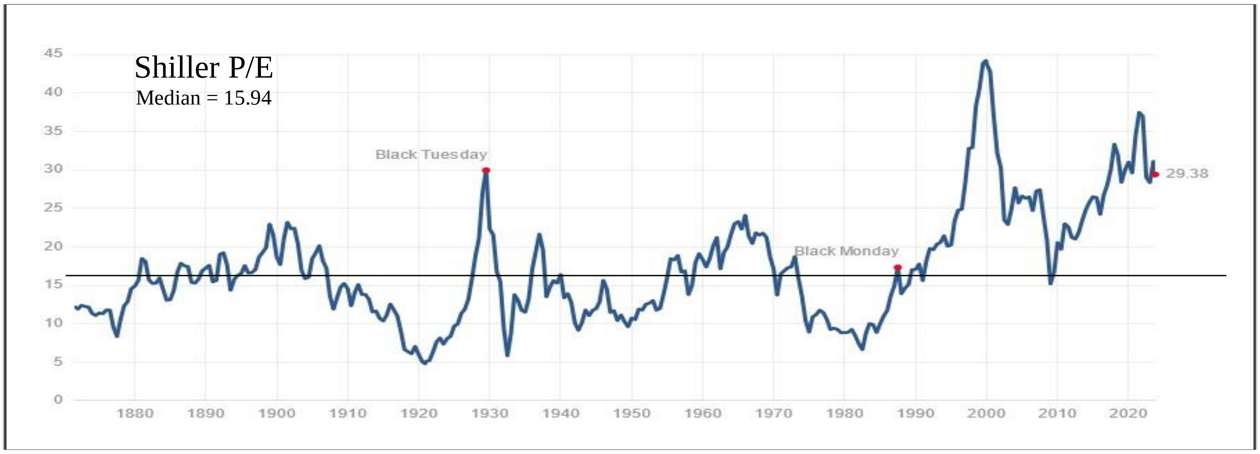
For the third quarter of 2023, FactSet reports that Wall Street is anticipating an earnings decline of -0.1% over the third quarter of 2022. For perspective, the average growth rate for third quarter earnings over the past five years has been 12% - this clearly shows the extent to which corporate profit growth is decelerating from the recent norm.

In the bond market, the inverted yield curve remains a harbinger of economic weakness in the coming months. The yield curve has been inverted since April 2022 when the yield on the 2-Year Treasury note first exceeded the yield on the 10-Year Treasury note. This signaled a flight to safety by investors, companies, and governments around the globe who gravitated toward longer-dated treasuries. Typically, when the yield curve inverts, we can expect a recession within 6 to 24 months after the inversion. While that is not a foolproof timeframe, the very existence of an inversion is reason enough to be cautious.

Remain Defensive

In this atmosphere which is characterized by economic uncertainty, slowing corporate earnings growth, and rising interest rates, prospects remain generally uninspiring for near-term stock and bond market returns.

For stocks, this assessment is made more acute by the fact that the Shiller P/E ratio continues to be elevated by historical norms (chart below). High stock market valuations make it challenging for portfolios of stocks or other equity securities to perform well, whereas lower stock market valuations tend to provide a more bullish backdrop for equity returns.



And while bond prices have come down significantly from their 2022 highs, making their yields more attractive, rising interest rates suggest that bond prices will continue to decline from here, although perhaps more modestly. Fixed income prices may stay low until the Fed's policy makers reverse their hawkish stance and embark on their next interest rate easing cycle.

For now, our primary investment goal is to be defensive and to preserve assets in anticipation of a stock market downturn, and a slightly lower bond market.

In practical portfolio management terms being defensive means preserving capital by reducing equity allocations, raising fixed income positions to benefit from higher yields and lower bond prices, while increasing cash levels in order to mitigate the effects of market turbulence. It also means being ultra selective with any purchases, particularly of stocks.

Taking Powell's words at face value on inflation and the economy, it is clear the Fed may not have reached its final interest rate hike in the current tightening cycle. More hikes could be on the way even as the prior eleven work their way through the system. In total, all of those hikes will help to temper inflation, reset investor expectations to more realistic levels, and will set the stage for more attractive investment returns in the future.

V. Henry Astarjian

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