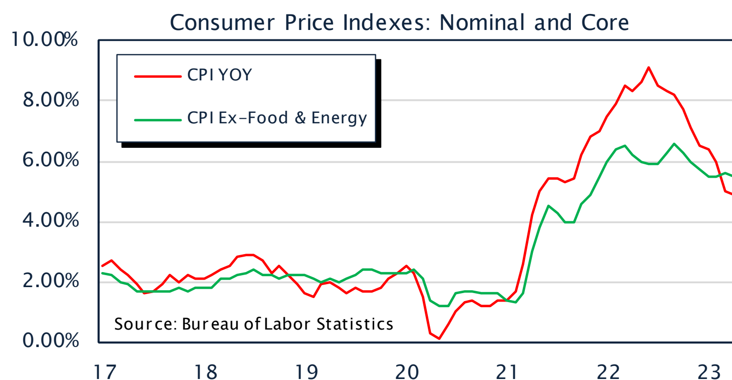
JUNE 2023

INVESTMENT UPDATE

Nearly eighteen months have passed since the Federal Reserve embarked on a new policy path, implementing progressively tougher monetary policies designed to slow the pace of US economic growth, and thus, the rising rate of consumer price inflation. Early in 2022, with the shadow of the COVD crisis fading, the Fed realized that the combination of massive fiscal stimulus and a resilient labor market meant that household demand for goods and services was outstripping a still-hobbled global economy's ability to meet that demand. Inflation was rampant and needed to be throttled.

Since then, the Fed has raised its overnight lending rate by more than 500 basis points, ramping up borrowing costs for households and businesses, and while longer-term interest rates have moved up, they remain well below the level of shorter rates, as the Treasury yield curve (the line connecting bonds of various maturities) has inverted—a harbinger of impending recession. Meanwhile, as the chart on this page shows, broad measures of inflation have dropped from their recent highs, yet remain well above the Fed's 2% inflation target. As you can see, there are different measures of inflation (more on that later), but any way you slice it, inflation remains too high for the Fed to declare that its job is done.



Nevertheless, the Fed has slowed the pace of rate hikes over the past six months, moving from increases of 75 basis points (0.75%) every meeting for most of 2022, to 50 basis points, and finally to 25 basis point hikes over the first three meetings in 2023. After the failure of three large regional US banks this Spring it was expected that the Fed might soon pause further rate hikes, in order to assess the cumulative impact of the most aggressive tightening policy from the Fed in 30 years. In the Fed's Open Market Committee (FOMC) meeting this week, it did just that, opting to keep the Fed funds rate at its current range of 5.00% to 5.25% , while also implying that there were likely more rate hikes to come this year.

The Fed is in a no-win situation. If it keeps raising rates, it runs the risk of smothering growth and sending the economy into the proverbial ditch, especially if it turns out that the economy is weaker than it currently appears to be. If the Fed backs away from further hikes while the economy is still accelerating, inflation pressures could grow. And if inflation remains elevated for a protracted period, there's a real risk that inflation expectations become embedded at a higher level, which in turn would force the Fed's hand to reintroduce another round of tightening. For these reasons, the Fed is under pressure to get inflation down to a reasonable level now, not later.

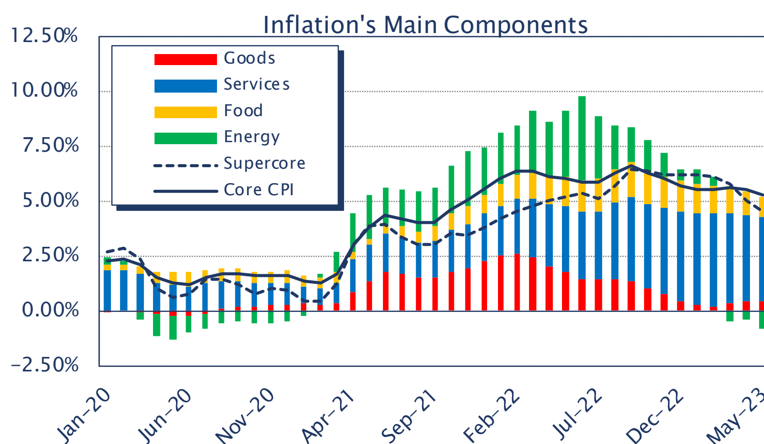
What's a central banker to do? In the current environment, there's little choice but to remain willing to adjust policy based on the latest and most reliable economic data. But the incoming data is still providing little clarity on whether the current level of rates is sufficiently suppressing economic growth. Even interest rate-sensitive sectors like housing and auto sales remain strong. Personal consumption expenditures, even after inflation, have held steady, with little monthly variability at a healthy 2.3% annual growth rate nearly every month since the Fed began hiking. And, of course, the US job market remains very strong, supporting consumer spending, despite high interest rates.

With the economy chugging along, is it any surprise that while headline inflation has been dropping rapidly, core US inflation is making a lot less progress? A detailed look at the latest inflation measures may be in order.

The chart on the next page breaks down the major components of the CPI (Consumer Price Index)—goods, services, food, and energy. You can see that the major run-up in the CPI began in 2021, coinciding with the re-opening of global economies and the full impact of COVID-related relief payments to households and businesses. You can also see that the main drivers of inflation during this period were higher energy and goods prices (and food, to a lesser extent). Total CPI peaked at over 9% in

mid-2022. Since then, inflation in the cost of goods and energy have all but evaporated, while service inflation has nearly doubled over the same time period.

In short, the factors that originally caused this round of inflation to spike—durable goods (which were supply-constrained during the COVID period) and energy prices (driven higher by Russian sanctions)—have eased, only to be replaced by steady increases in the prices of services. Making matters worse for policymakers is that spending on services represents the lion's share of consumer purchases; the services component comprises almost 60% of CPI and nearly 75% of core CPI. Worse still, services prices are stickier than goods prices, especially compared to "noncore" food and energy prices. In the eight years prior to the onset of COVID, the annual change in services prices never moved out of a 1% range (2.3% to 3.2%). The recent run-up in services prices (most recent data point: +6.6%, year-over-year) is highly problematic and is the primary reason why the Fed is so concerned about the path of US inflation.



The service sector is also more labor intensive than goods-related industries, and is therefore more vulnerable to increases in labor costs. For this reason, the Fed is waging a sort of proxy war against wage inflation with its rate hikes, which, if effective, will suppress demand enough to lead to companies needing fewer workers, which eventually leads to layoffs, declining payrolls, and higher unemployment. The fact that unemployment remains near 50 year lows is just another indication that the Fed isn't getting enough traction yet from its stringent monetary policies.

We're of the opinion that the Fed will continue to find progress on core inflation difficult to achieve over the next few months, as service sector prices alone contribute almost 4% to the current level of CPI, and as we've seen, service prices are very sticky. The easy work on inflation has been done; further gains in this battle can really only come at the expense of jobs, and nobody wants to take the blame for that, not even the Fed.

This may help explain why Fed Chair Jay Powell has been talking up an alternative inflation measure, the so-called "supercore" inflation. Core inflation removes the volatile food and energy components, which tend to be "noisy" and don't really help explain underlying trends of inflation. Supercore takes core measures of inflation one better by also subtracting housing inflation. "Better" is a relative term here; housing expenses can hardly be dismissed as noisy, as they tend to rise and fall at key points in the business cycle. It's hard to imagine getting inflation under control without getting housing costs to at least level off.

Nevertheless, taking out the cost of shelter from the current inflation data results in a lower rate of inflation, which makes supercore an easier hurdle (*ahem* moveable goalposts), as certain other areas of the service sector are showing some easing of prices, including medical services and new vehicle prices. As the chart on this page shows, taking housing out of the equation means that supercore is now trending down at a more rapid pace than core CPI.

Thinking optimistically, whether it's core or supercore, inflation is trending lower, and even slow progress is progress. This week's FOMC meeting showed that the Fed believes that it's on the right track, but also that there's work to be done—the FOMC's "dot plots" (committee members' forecasts of the future path of Fed funds) showed the consensus pointing towards two more rate hikes in 2023.

Will a couple of more rate hikes do the trick? Nobody knows for sure, not even the FOMC. But as long as the Fed is making progress and not wrecking the economy, the markets are likely to remain supportive. And if investors begin to accept supercore inflation as a viable benchmark, that could change the path of Fed funds; if current trends hold, supercore will continue to drop more quickly than more established inflation measures. In fact, it's no stretch to predict that supercore inflation (currently +4.6% YOY) will drop below the service sector's entire contribution to the CPI (+3.8% YOY) over the next few months. An easier hurdle puts the Fed closer to its goal.

As we've mentioned in previous *Investment Updates*, we're not convinced that a 2% inflation target is the appropriate end-goal anyway—it's so low that it effectively puts the Fed in a bind (the dreaded "zero rate bound") whenever the economy gets into a recessionary environment. More importantly, 2% inflation penalizes bondholders by driving all interest rates to rock-bottom levels, leaving the bond market with little income to "cushion" the impact of falling bond prices when interest rates rise in the expansion phase of the cycle. When it comes to the policy rate for inflation, maybe 3% should be the new 2%.