BUMPY PATH TO THE PEAK

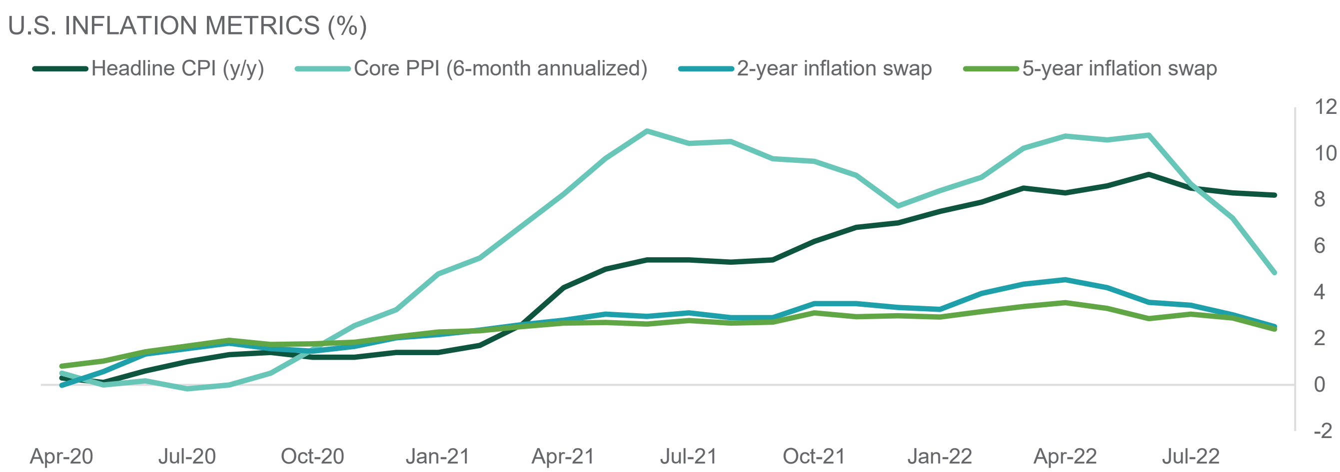
We have written for months about elevated volatility being a recurring issue as long as the market was uncertain about how high interest rates were going. Higher than expected inflation reports in recent months have led to increased expectations around monetary policy, pressuring stocks, credit and increasing the risk of recession in the U.S. This report's title, "Bumpy Path to the Peak," refers not to a peak in the inflation rate, but in the Fed funds rate. After all, it's the jump in interest rates and the resulting uncertainty about how high central banks will go that has unsettled markets. As shown below, headline CPI remains elevated relative to core producer prices (PPI) and the market's benign expectations of future inflation. With an eye on current inflation, and little weight on forecasted inflation, the Fed is likely to continue its aggressive hiking campaign at least through early 2023.

Significant and abrupt changes in monetary policy can have a dramatic impact not only on financial markets but also economic activity. One only has to look at the difficulties in the U.K. bond market in recent weeks. The combination of a mishandled fiscal proposal along with an inflation-fighting central bank led to a crisis for U.K. pension plans. This crisis and concurrent turmoil in the bond markets led to a dramatic intervention by the Bank of England and a reluctant U-turn by the Prime Minister's office. While the U.K. pension market has unique characteristics (greater leverage and use of derivatives than the U.S.), its negative reaction to the jump in interest rates is a warning sign. The sharp jump in global interest rates is already hurting economic activity as home prices are starting to fall and homeowners with variable rate mortgages (more prevalent outside the U.S.) face higher monthly payments along with higher energy costs. We think recession in Europe is nearly assured, and a U.S. soft landing is no better than even odds. We also expect Chinese growth to continue to disappoint as the property sector struggles and zero-Covid policy hinder a recovery.

We made no changes in our global policy model this month. Because we expect global growth to disappoint and monetary policy to keep tightening, we expect volatility to remain high. A solid third quarter earnings season could provide some support for stocks, but clarity on the peak Fed funds rate along with the resulting economic outlook are probably necessary for a more constructive outlook for risk taking.

IS THE MARKET TOO COMPLACENT?

Inflation swaps, along with recent PPI trends, are comforting but headline CPI remains persistently high.



CPI = Consumer Price Index; PPI = Producer Price Index; y/y = year-over-year. Data from 4/30/2020 through 9/30/2022.

BASE CASE EXPECTATIONS

Inflation-Focused Fed

In contrast to the post-GFC environment, today's Fed is less focused on financial market movements – and will keep hiking until inflation is contained. Recently elevated inflation reports have only further focused the Fed's attention on its inflationary mission – meaning monetary policy will remain tighter for longer.

Global Disappointment

Central bank response to elevated inflation creates financial market risks skewed to the downside, with recession nearly assured in Europe and the U.S. soft landing no better than even odds. Corporate earnings and labor markets have been resilient to date, but we expect deterioration as policy continues to tighten.

RISK CASE SCENARIOS

Central Bank Mistake

Central banks, in their focus on inflation, overdo it and cause "something" to break. Possible candidates: liquidity-driven dislocation in rates/credit, currency crisis, overleveraged borrowers.

Eastern Threats

Ukraine war produces knock-on effects (food/energy shortages) that disrupt the global economy; China struggles to deal with (in order of importance) pandemic pressures, bad debt contagion and Taiwan tensions.

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