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Navigating by stars under cloudy skies

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Only time will tell how effective the US Federal Reserve (Fed) has been in fighting inflation. Last month, when speaking about the near-term monetary policy, Fed chair Jay Powell stressed how they continue to hope for the best while planning for the worst. The daunting balancing act of controlling inflation with minimum damage to the broader economy has kept policymakers on their feet. Monetary policy takes time to affect the economy and the results are unpredictable.

Making the Fed's task even more difficult is the fact that its inflation target comprises some non-interest rate sensitive components. This means that the Fed's interest rate, the highest in more than two decades, might not tame inflation back to the 2% target. The Fed most closely follows the core personal consumption expenditures price index (Core PCE), a Commerce Department measure, rather than the Labour Department's core consumer price index (Core CPI). The Core PCE has three broad components which include goods, housing services (such as rental costs) and non-housing services. Although there has been notable progress on all three, the non-housing services component, which includes health care, food services and transportation, remains the most difficult to gauge as it is the least sensitive to interest rate adjustments.

The Fed has not given any indication for rate cuts but has emphasised that they would proceed carefully as they decide whether to tighten further or to hold and await further data. Reading between the lines, investors expect higher interest rates for a longer period with the potential for a few more rate hikes if considered necessary by the Fed. Rate cuts, which have been dismissed unequivocally by policymakers, are likely to be considered only as a response to a significant collapse in economic growth rather than an early victory lap that the inflation fight is over. The result of this, along with other various economic and geopolitical factors around the world, is a volatile investment climate. This may be contrary to the benign expectations that are being reflected by market consensus opinion of a soft landing. The months and years ahead may reward the active investor rather than the passive.

The divergence of the totality of economic data and the evolving economic outlook has been mystifying to say the least. On the one hand, fuelling concerns of the likelihood of further hikes, is the stronger-than-expected economic data. Recent readings on both the services and manufacturing sectors of the US economy has shown that prices are moving in the wrong direction. Robust growth and sticky inflation will keep the pressure on the Fed. Healthy growth also gives a further boost to oil which has been on the rise lately with prices rising above $90 a barrel for the first time this year.

From a supply point of view, two of the world's largest oil producers moved to boost prices despite much of the world grappling with higher energy costs. Higher oil prices add to concerns about a flare-up in inflation. To rein in inflation, rates would need to stay higher, which undercuts stock valuations and increases the cost of borrowing for companies.

On the other hand, a growing number of other indicators suggest that the labour market is no longer much tighter than it was in 2019 and that, as a result, wage growth is likely to slow towards pre-pandemic levels soon. This may suggest that most of the required adjustment in the labour market has already happened and the Fed would not need to raise rates any further.

A recent Bank of America survey highlighted that there is consensus among investors that inflation is not going to increase. This view is a bit worrisome from a contrarian point of view since inflation tends to surprise to the upside when few expect it to happen. Higher inflation would mean higher rates for a longer period and, in the US, that will continue to propel the dollar. A strong dollar will create a foreign exchange headwind for most US multinational companies and negatively impact earnings.

More importantly, a strong dollar in addition to rising rates would lead to a tightening in financial conditions, which would negatively weigh on the stock market. Overall, investors should remain vigilant and selective knowing that the Fed's path towards controlling inflation is like navigating by stars under a cloudy sky.

Sources: Bloomberg Economics

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