Does A Determined Fed = Recession?

Ever since the morning of August 26, when Federal Reserve Chair Jerome Powell addressed the crowd at the Fed's annual Jackson Hole symposium, Fed officials have seemingly taken every opportunity to stress how determined they are to bring inflation back down to 2% - even if this means some economic pain along the way.

Just last week, two seasoned Fed officials – Minneapolis Fed President Neel Kashkari and Fed Vice-Chair Lael Brainard – both came out firing:

> *"The one mistake that I'm acutely aware of – that I want to avoid repeating from the 1970s – is when policy makers saw the economy weakening, saw inflation start to tick down, and then they cut rates, thinking they had done the job. And then inflation flared back up again – that, I believe, is a mistake we cannot make and will not make."* – Neel Kashkari to *The Wall Street Journal* on September 27.

> *"It will take some time for the full effect of tighter financial conditions to work through different sectors and to bring inflation down. Monetary policy will need to be restrictive for some time to have confidence that inflation is moving back to target. For these reasons, we are committed to avoiding pulling back prematurely… Proceeding deliberately and in a data-dependent manner will enable us to learn how economic activity and inflation are adjusting to the cumulative tightening and to update our assessments of the level of the policy rate that will need to be maintined for some time to bring inflation back to 2 percent."* – Lael Brainard in a speech on September 30.

Remember in July, some investors seemed convinced that a one-month slowdown in the rate of inflation was a sign that the Fed was going to pause – if not pivot away from – their efforts to tighten monetary conditions in order to slow the economy to the point where inflationary pressures would subside.

However, that fallacy proved to be short-lived as more recent data has surprised to the upside, and economic activity – especially in the labor market – isn't showing any signs of significant slowing. Just last week, consumer price data from August indicated that the Personal Consumption Expenditure index rose 6.2% from a year earlier. Stripping out volatile food and energy costs, the "Core" PCE index rose 4.9% in August from a year ago – an acceleration from an upwardly revised 4.7% yearly gain in July.

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These readings are a far cry from the Fed's target inflation rate of 2%. And, as Fed Vice Chair Brainard said in the above quote, "monetary policy will need to be restrictive for some time to have confidence that inflation is moving back to target."

So what could "for some time" look like?

The table below might give us a hint. Along the top of the chart are month-over-month inflation rates. The numbers going down the table indicate what year-over-year changes in inflation would be if the month-over-month rate stayed constant. So for instance, if inflation stayed at +0.1%, by July of next year the annual change in inflation would be 1.7% - below the Fed's 2% target.

Year-Over-Year Inflation Would Be:	If Month-Over-Month Inflation Stays Constant At:					
	0.10%	0.20%	0.30%	0.40%	0.50%	0.60%
Sep '22	6.15%	6.26%	6.37%	6.47%	6.58%	6.68%
Oct '22	5.62%	5.83%	6.05%	6.26%	6.47%	6.68%
Nov '22	5.18%	5.49%	5.81%	6.13%	6.44%	6.76%
Dec '22	4.69%	5.11%	5.53%	5.96%	6.38%	6.80%
Jan '23	4.19%	4.71%	5.24%	5.76%	6.29%	6.82%
Feb '23	3.77%	4.40%	5.02%	5.65%	6.28%	6.92%
Mar '23	3.54%	4.27%	5.00%	5.73%	6.47%	7.21%
Apr '23	3.06%	3.88%	4.72%	5.55%	6.40%	7.25%
May '23	2.51%	3.44%	4.30%	5.31%	6.26%	7.21%
Jun '23	1.90%	2.92%	3.95%	4.99%	6.04%	7.10%
Jul '23	1.68%	2.80%	3.94%	5.08%	6.24%	7.41%

Source: Strategas. Inflation data reflects Core CPI as of August, 2022. Month-over-month Core CPI averaged 0.37% between 1970-2007.

The problem is that month-over-month inflation has recently been running in the 0.4%-0.8% range, so a constant +0.1% rate of inflation sounds unlikely. It's also worth pointing out that, in the pre-Quantitative Easing period that began wih the Financial Crisis (from 1970-2007), month-over-month inflation averaged +0.37% per month. Looking at the table again, constant inflation in the 0.3%-0.4% range would still leave the Fed at twice it's target rate come next July.

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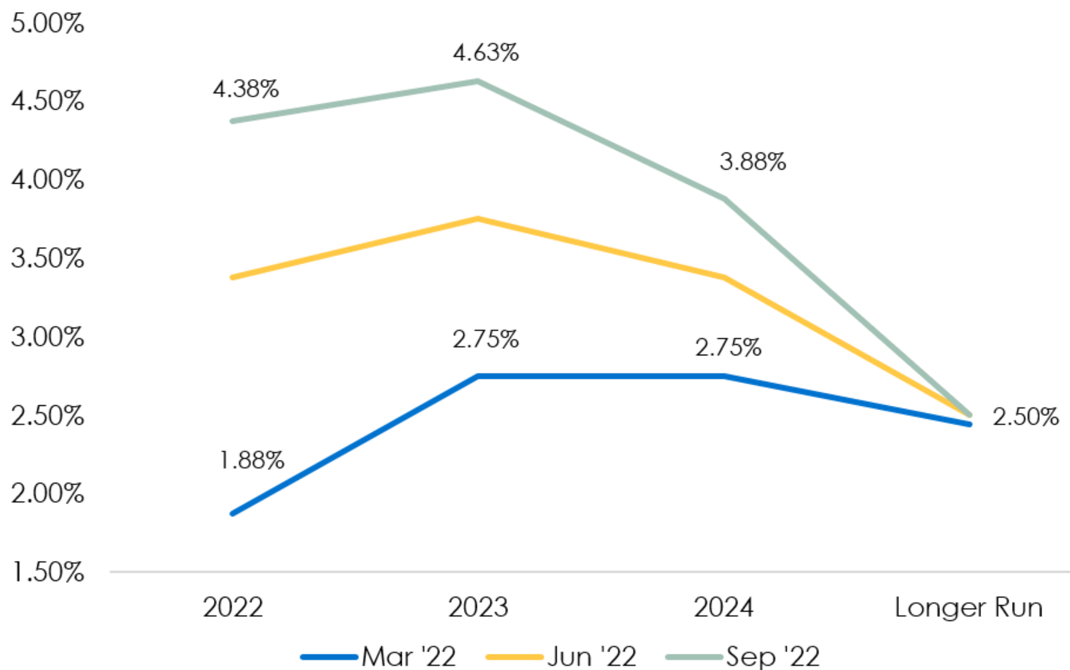
What does this mean? To us, it means that the Federal Reserve isn't going to reverse course on its tightening policy path any time soon. Directionally, this can be seen in the Fed's own estimates of where is sees its benchmark Federal Funds Rate in the coming quarters.



What's striking about the chart above is the magnitude of the increases in the past six months alone – 2022's terminal Fed Funds Rate is more than double what is was in March!

To us, this is indicative of a Fed that's hell-bent and determined to get inflation under control – recession or not. Hoping for a "pause" or "pivot" any time soon seems particularly foolish at this time.

At Yellow Cardinal, we've never thought of "hope" as a sound investment strategy. As a coach once told this author, "Hold out both hands and fill one with "hope" and the other with (*another word for "excrement"*). Let me know which one fills up first."

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In response to these circumstances, we have been careful to position our client portfolios for both the cyclical and secular environments. The cyclical environment is one of a maturing business and economic cycle, which leads us to position portfolios a little more defensively. Secularly speaking, we still believe that inflation is going to remain elevated so maintaining exposures that benefit from rising prices is necessary.

Recently, we've positioned portfolios more towards the cyclical environment by reducing exposure to riskier parts of the market. Specifically, we reduced exposure to equities and real estate investment trusts (REITs) and added exposure to fixed income.

Within equities, we continue to be slightly underweight with an emphasis on "value" and inflation beneficiaries as well as the more traditional "defensive" sectors. We also continue to avoid the expensive "growth" areas of the market.

Within fixed income, we remain underweight the riskier parts of the credit market – namely high yield and emerging market debt. We added some US Treasury exposure and lengthened duration in order to adopt a slightly more defensive posture.

Within the alternatives segment, we are overweight with an emphasis on more defensive areas. Our preference for diversified alternatives as a hedge against market volatility remains in place. Also, we remain overweight to commodities as a hedge against higher inflation. As mentioned earlier, we recently reduced exposure to REITs as a way to reduce overall risk in our portfolios.

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