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RESEARCH | MACRO

Macro Thoughts

22 August 2022

Caleb Sevian
Chief Macro Strategist
1.303.328.8686
csevian@focuspointlmi.com

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Thought to ponder…

"Greater knowledge of a danger permits greater safety."

The Misbehavior of Markets
Benoit Mandelbrot, Richard L. Hudson

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The View from 30,000 feet

With Q2 earnings in the rearview mirror, all eyes and ears are fixed on the Fed and economic data for signals on the ultimate terminal Fed Funds rate and how long it will stay elevated. As the Fed tries to regain the narrative from an optimistic market fixated on cuts in 2023, nervous investors grapple with understanding the consequences on the multitude of outcomes.

- Dueling views fight for the consensus, pitting soft versus hard landing pundits against each other
- The onslaught of negative economic news continues, with budding signs of decelerating negative trends
- Evolution of wage inflation has yet to provide evidence that the Fed should slow its pace
- The most *Frequently Asked Question* from client’s this week: What macro themes will drive the markets in coming years?

Dueling views fight for the consensus, pitting soft versus hard landing pundits against each other

- There a three distinct views of economic paths developing, with the prevailing market direction being dictated by which view is being favored most forcefully in the news headlines, and then exaggerated by algorithmic trading.

Soft-ish Landing

This is the Fed's targeted goal. Rates move from the current neutral range (there is a hot debate of what *neutral* means when inflation is at almost 9%) to restrictive by yearend and then hold at there, with the economy growing below trend, until inflation works its way lower over the next year or so. In this scenario, the roughly 2:1, ratio of job openings to unemployed workers is reduced back to 1:1, with only a mild increase in unemployment, while the economy chugs along in low gear. This has been affectionately called "fantasyland".

Hard Landing

The three-leg stool (Earnings, Jobs, Balance Sheets) crumbles under central bank pressure. ***Earnings*** fall 20% to 30% (in-line with typically recessionary earnings reductions) based on falling demand and higher costs. ***The Job Market*** deteriorates faster than the Fed expects. The consumer can no longer live off their ***Balance Sheet***, propped up by pandemic government handout money and cheap debt, because they are both gone, except for the wealthy, who are immune from inflationary pressures, leading to increased wealth disparity and greater social unrest, further polarizing the political environment. A potential controlled burn in the housing market threatens to turn into a raging inferno. The good news is inflation comes down relatively quickly because the economy is so weak, providing the Fed with flexibility.

Persistent Inflation and Shallow Growth

Rates move from neutral to restrictive, but inflation remains persistently high (not in the 8% to 9% range, but perhaps something more like the 4% to 5% range), driven by falling Goods prices, stymied by sticky Services and Energy costs, making it difficult for the Fed to do anything but pause and leaving the economy wallowing in the doldrums (an area with no wind in the sails, languishing in the hot sun on a desolate sea) and flirting with recession. This is similar to a Soft-ish landing but with higher inflation, lower growth and extends out over a longer period, and can best be characterized as stagflation.

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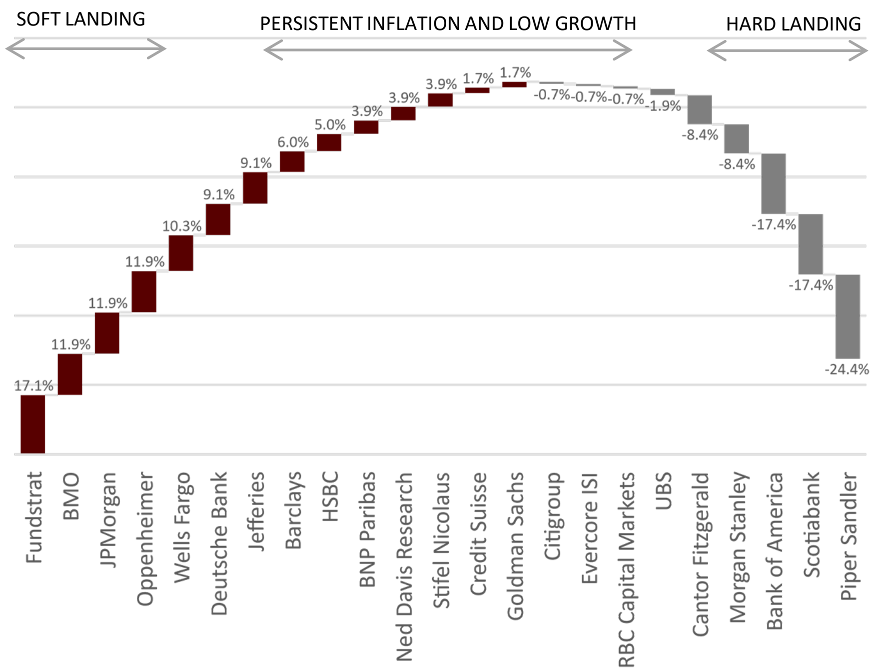
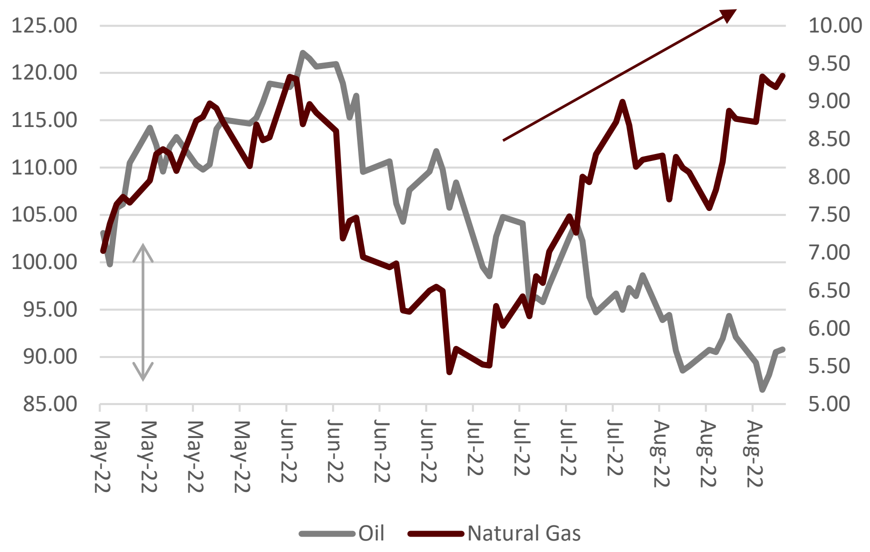
Wide range of Strategist outcomes and scenarios hinge on how quickly inflation is contained

WALL STREET STRATEGIST PERCENT S&P500 UPSIDE OR DOWNSIDE FROM 8/19/22 CLOSE – OVER 40% SPREAD



Source: Bloomberg

OIL VS. NATURAL GAS – OIL CONSOLIDATING IN TRADING RANGE, NAT GAS BREAKING HIGHER – BAD NEWS FOR CPI



Source: Bloomberg

Negative economic news continues, with budding signs of decelerating negative trends

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- Although negative data continues to pour in for housing, at the margin, there are signs that negative trends are easing.
- The complicated part is that the Fed does not want to see the economy stabilizing *yet*, because inflation is still too high. If their goal is to reduce inflation, and the mechanism they want to see act is tighter financial conditions leading to demand destruction, what they want to see is a controlled bleed in the economic data that eats away at aggregate demand. Signs of an uptick in forward expectations are unwelcome news to the Fed with inflation still running near 9%.
- Signs of negative trends easing:
  - Better than expected Q2 earnings and relatively small earnings estimate revisions
  - Jobless Claims increases and announcements of layoffs are slowing down
  - Forward looking indicators of the regional Fed surveys rebounding off their lowest levels
  - Oil prices have stopped falling (which was the driver of lower inflation surprises) and Natural Gas is moving higher
  - Financial Conditions indicators loosening to levels last since in early June
  - High Yield Credit Spreads moving from over 600 bps to with in striking distance of 450 bps (40% retracement)

Although data is deteriorating, the pace of deterioration is slowing and bouncing at the margin

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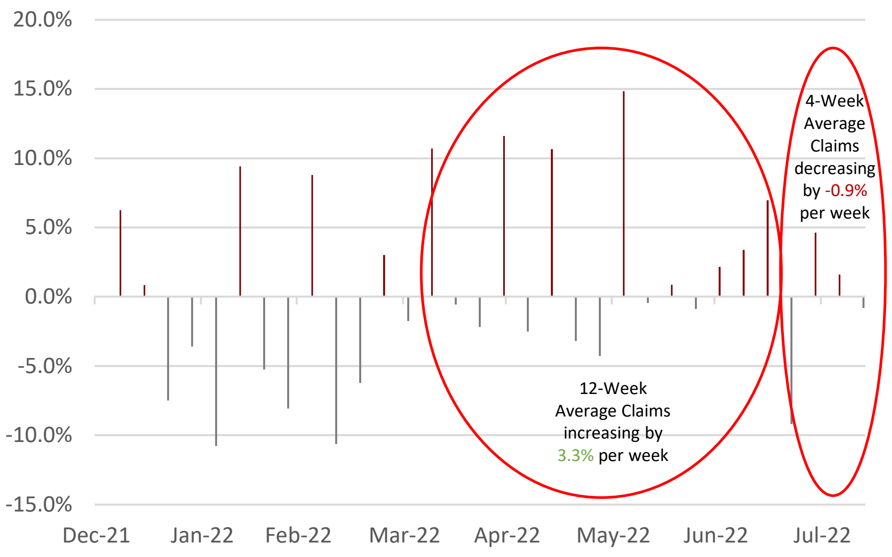
INITIAL JOBLESS CLAIMS , PERCENT CHANGE FROM PREVIOUS WEEK – MOVING TO LESS BAD

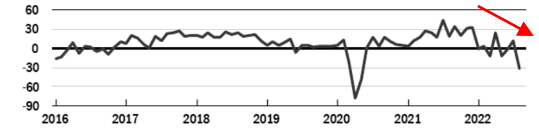


Source: Federal Reserve

EMPIRE STATE FED SURVEY – AGGREGATE (COINCIDENT) VS. NEW ORDER (LEADING) – IMPROVEMENT AT THE MARGIN

CURRENT INDICATORS

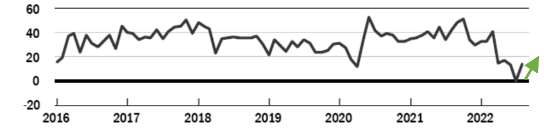
General Business Conditions



	Percent Reporting Higher	Percent Reporting Lower	Index
Jul	33.6	22.6	11.1
Aug	12.2	43.6	-31.3
Change			-42.4

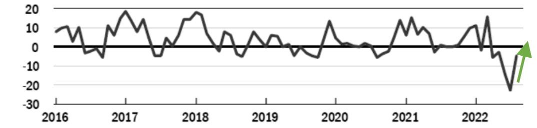
FORWARD LOOKING INDICATORS

New Orders



	Percent Reporting Higher	Percent Reporting Lower	Index
Jul	28.6	28.5	0.0
Aug	41.0	27.0	14.0
Change			14.0

Unfilled Orders



	Percent Reporting Higher	Percent Reporting Lower	Index
Jul	9.6	32.2	-22.6
Aug	19.1	23.6	-4.5
Change			18.1

Source: Federal Reserve Bank of New York

Evolution of wage inflation has yet to provide evidence that the Fed should slow its pace

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- When Powell spoke at the press conference in July, he was **very clear that the Fed would focus on <u>only</u> one side of their mandate (inflation)** until they saw weakness develop in the other side (employment).

- The markets took the Fed's statement during the press conference of transitioning to *data dependency* as a positive sign of a "pivot" but have ignored data showing few sign of a slowing of wages pressures.

	Current Annual Change	10-Year Avg Prior to 2020
• Employment Cost Index (ECI):	5.1%	2.3%
• Average Hourly Wages:	5.2%	2.7%
• Atlanta Fed Wage Growth Tracker:	6.7%	2.9%

- Although the Fed Minutes provided the first hint of evidence that the Fed is attempting to factor in the lagging effect and impacts of their policy decisions, comments from the slew of Fed Governors speaking last week showed the Fed trying to regain the narrative and cool expectations for a more dovish stance in 2023.

- Fed Funds Futures pricing a less dovish Fed in 2023 influenced equity markets lower as expectations for interest rates cuts in 2023 moved from 54 bps to 35 bps over the course of the week.

Few signs that wage pressures are abating means Fed has to remain vigilant and hawkish

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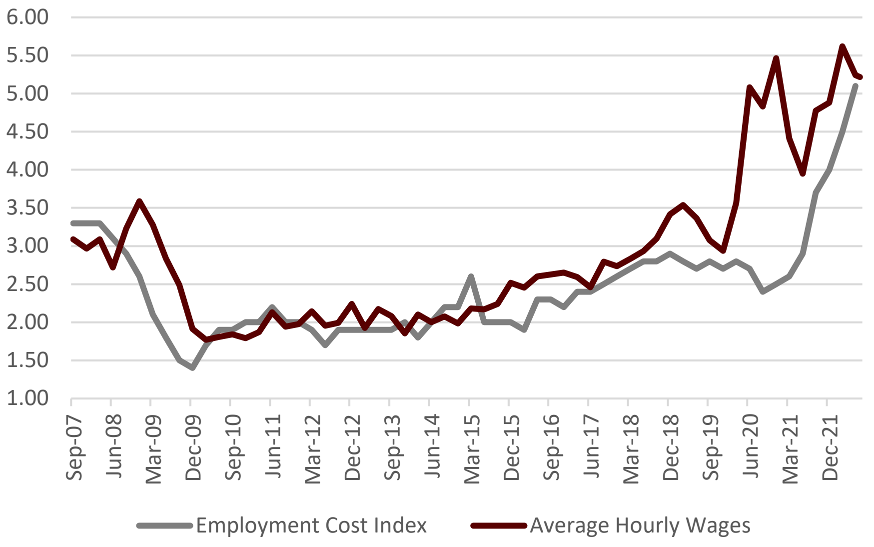
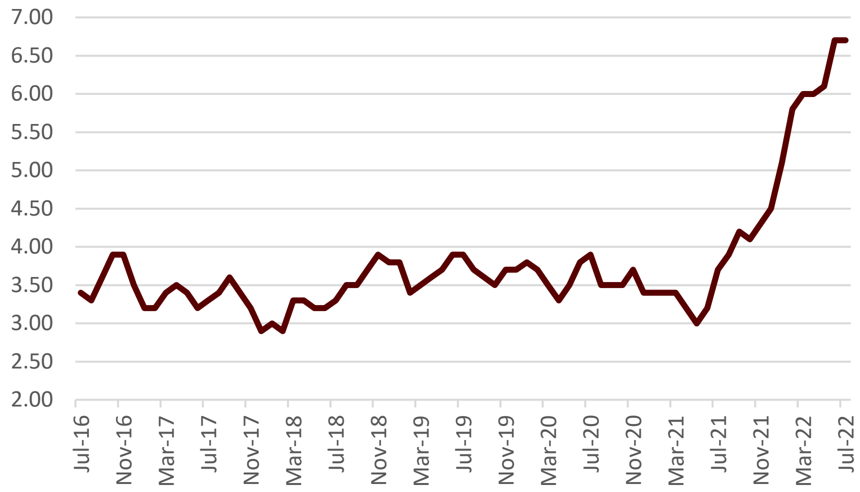
EMPLOYMENT COST INDEX VS. AVERAGE HOURLY EARNINGS TRENDING UNCOMFORTABLY HIGH FOR FED



Source: Bureau of Labor Statistics

ATLANTA FED WAGE TRACKER SHOWING A PRONOUNCED SPIKE WITH NO ABATEMENT



Source: Federal Reserve Bank of Atlanta

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FAQ: What macro themes will drive the markets in coming years? (*Macro Strategists love this question*)

- Fractured World Order
    - Russia's invasion of the Ukraine put an exclamation mark on the East (Communist) vs. West (Capitalist) divide that has been growing for decades.
    - Russia's economy is dominated by energy exports. China's economy is dominated by manufacturing exports. With signs of the world moving to alternative energy and China's initiatives switching to domestic growth as labor cost differentials are reduced with the West, both countries feel an urgency to reduce their multi-decade stances of placating the West and pushing aside ideological differences while they still have leverage.
- Reducing Over Dependency
    - Europe foolishly allowed their economy to become dependent on cheap Russian energy and is now being held hostage to Putin, in much the same way that Hitler kept Europe at bay during the early days of the Holocaust by threating to exterminate all European Jews if Europe acted to save German Jews. Threats will lead to harsher outcomes if European economies crater, and citizens begin to freeze to death.
    - The United States, is now taking a hard look at their own dependencies and rightfully concerned. Although energy doesn't represent the same risk for the U.S. as Europe, the country has become addicted to cheap Chinese goods and the Taiwanese semiconductor market. It's no coincidence that the U.S. just passed the $52.7b CHIPS and Science Act designed to re-shore the semiconductor industry.
- Scarcity
    - The Inflation Reduction Act was hallmark legislation partially designed to propel the alternative energy industry forward at a radical new rate.
    - The problem with the Bill is that it highlights Scarcity. It's incentivizing building solar arrays that are manufactured in China with metals that are mined Africa controlled by countries potentially hostile to the U.S.
    - Similarly, it's incentivizing and providing tax credits for EV vehicles where production still needs to be on-shored to get the tax credits and are built from materials mined in other countries.
    - People are another Scarcity. The combination of baby boomers aging out of the work force, fewer immigrants and more people choosing to stay at home after the pandemic will lead to chronic shortage of workers while GDP continues to expand.

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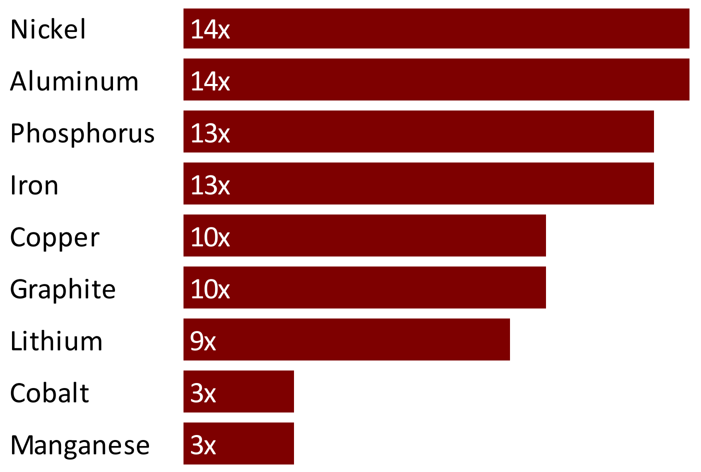
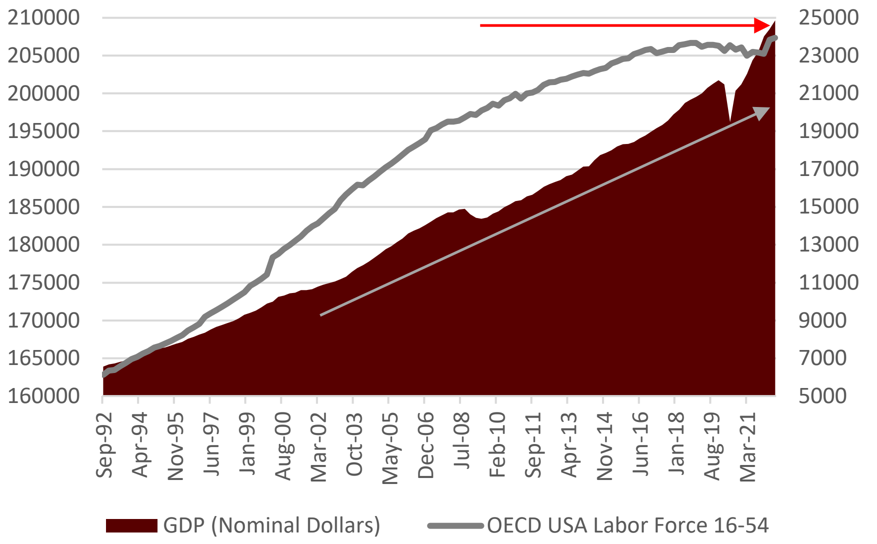
Demand for metals will out strip supply, while population growth not keeping up with GDP growth

ESTIMATED DEMAND FOR BASED AND INDUSTRIAL METALS 2019 TO 2030 – SUPPLY HAS NO CHANCE OF KEEPING UP



Source: Bloomberg, Statista

OECD WORKING AGE POPULATION (FLATTING) VS. GDP ESTIMATES (GROWING) – WHO WILL DO THE WORK?



Source: OECD, Bureau of Economic Analysis

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Putting it all together

- The markets have two cycles each quarter, the first being driven by earnings, the second being driven by economic data, news and flows. With Q2 earnings winding down, the markets are looking to economic data, news and flows for signals of the future direction of the markets.

- As the Fed moved to *data dependency* the importance of each economic release has become amplified, increasing volatility.

- Market participants have formed factions and scenarios for the path of future Fed rate hikes, the economy and the markets. Optimistic investors have recently keyed on best-case scenarios, pushing equity markets to resistance levels, while competing narratives are gaining traction, leaving the markets, stretched and vulnerable to a pullback.

    - Investors should be cognizant that between 2000 and 2002 the NASDAQ experienced seven rallies over 20%. Bottoming is a process.

- Geopolitical and policy developments since the beginning of the year have highlighted major macro trends that will shape the investment landscape for the years to come.

    - Fractured World Order
    - Reducing Over Dependency
    - Scarcity

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