MV CAPITAL MANAGEMENT

Weekly Market Flash

Fed Versus Market On Inflation

February 3, 2023

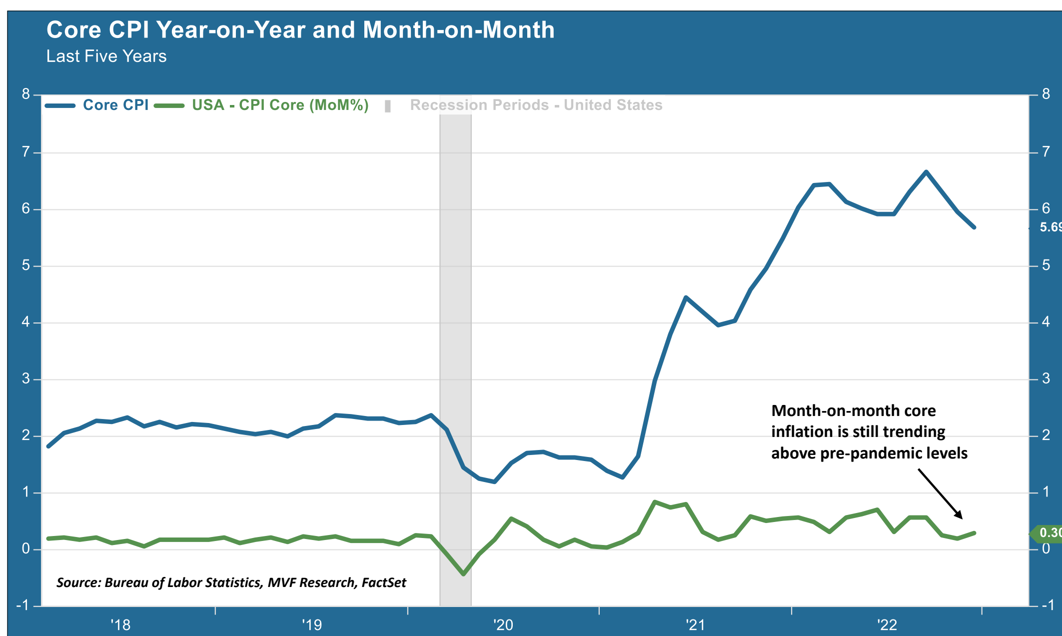
When the yield curve inverted before the 1990 recession, the widest spread between the 10-year and 2-year Treasury yields was (0.43) percent. Ahead of the 2001 recession the curve inverted again, with a maximum distance of (0.46) percent. Before the financial Category 5 event struck in 2008 the inverse spread between the 10-year and the 2-year never got wider than (0.20) percent. With this perspective, what are we to make of the fact that the 10-2 spread today is around (0.70) percent, the steepest inversion any time since the crazy days of the Volcker Fed in the early 1980s?

Getting Real

The question as to whether nominal spreads today are properly priced or not ultimately comes down to one thing, and that one thing is inflation. What matters ultimately are real (i.e., inflation-adjusted) rates. If you believe (as the market seems to believe) that inflation is coming down fast and we will be back at two percent core inflation lickety-split, then a nominal yield of 3.5 percent for intermediate-maturity Treasuries is not unreasonable. If, however, you are focused on the stickier parts of the CPI basket (like the Fed), then you don't think inflation is going to be close to that two percent target any time soon, and financial conditions in the market today are thus looser than you think, rationally, they should be. With regard to inflation the Fed has one view, the market has another. Powell said as much during his press conference after the FOMC meeting this week, noting on several occasions that the Fed and the market are not on the same page in terms of near-term inflation expectations (on the other hand, Powell didn't push back much on questions from reporters about whether financial conditions today are too loose, and that seemed to be the catalyst for the market's torrid rally Wednesday afternoon and yesterday).

Coming Down, Slowly

So who's right? Let's look at the data.



The chart above shows core inflation, since that is the measure driving the Fed's monetary policy decisions. As you can see, year-on-year core inflation has been trending down since it hit a peak of 6.6 percent last September. That's good. But the month to month data is somewhat stickier, and still trending solidly above pre-pandemic trendlines. In the FOMC press conference on Wednesday Powell called out a number of consumer service areas where inflation has not really been receding at all. Overall it's a mixed picture. But there is not much, if any, evidence supporting a linear downtrend that gets inflation back to two percent within a twelve month period. That's especially true if – and this is the other facet of the market's optimistic pricing of assets today – that fabled "soft landing" actually comes to pass. We don't think it will, for reasons we have discussed in other recent commentary. But if we are wrong in our expectation that consumer spending is due for a major speedbump in the coming months, then higher inflation is likely to persist even longer.

Un-inverting

So what does any of this tell us about where rates are today and where they might be heading? As far as the yield curve's persistent inversion, history isn't really much of a guide. The 10-2 inversion lasted fourteen months in 1989-90, but reversed – "un-inverted" – five months before the 1990 recession actually began. In 2000 the curve stayed inverted for ten months before righting itself out in December of that year, which was again four months before the 2001 recession began. And in 2008 the curve was back in its normal upward-sloping shape by March 2007, a full nine months before the Great Recession began.

Each of those events was unique in terms of the critical inputs – where rates were coming into the cycle, economic and financial market conditions at the time and, critically, the Fed's operational playbook. It would be facile to extrapolate from any of those patterns in trying to predict when today's steep inversion between intermediate and short-term rates will start to unwind.

Our expectation is that the Fed will orchestrate another 0.25 percent Fed funds rate hike in March, and then let things sit there indefinitely. So for the short end of the curve we don't see things moving much from a Fed funds tether of around 5.0 percent. If the Fed's view of inflation is correct (which is our current base case assumption) then we think conditions favor an upward movement in intermediate rates.

In other words, from where we are sitting today we think it is more likely that the 10-year yield winds up over four percent than that it falls towards three percent. If we're wrong about that, the likely culprit will be faster-falling inflation. But for that to happen, something will have to shake loose those sticky prices in consumer services – and that's something we are not seeing yet.

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