MV CAPITAL MANAGEMENT

Weekly Market Flash

End of the Cycle?

July 28, 2023

It may be, or it may not be, the last time the Fed raises interest rates in the monetary tightening cycle that began in March 2022. After Wednesday's FOMC meeting, when the Committee voted unanimously to raise rates by another 0.25 percent, we figured the likelihood of another hike at the next meeting, in September, was more or less a coin flip. Then came the second quarter GDP report on Thursday, showing that the US economy grew by 2.4 percent (annualized) from the first quarter, a much stronger showing than expected. Then came this morning's Personal Consumption Expenditures report, the inflation reading that is less of a household name than the Consumer Price Index, but that is the Fed's preferred measure for its policy deliberations. That report showed a month-on-month increase of just 0.17 percent for the core PCE (i.e., excluding energy and food prices).

Taking the GDP and PCE reports into account changes our calculus somewhat. We think there is a decent chance, not only that September will come and go without an additional rate hike, but that this past Wednesday may in fact turn out to be the final act of this tightening cycle. Take this with the grain of salt that any prediction deserves; there are plenty of data points due to come out between now and September 20, when the Fed next meets. But here's what we have right now: inflation of both the headline and core varieties moving in a steady directional trend downwards, while the jobs market remains strong, consumer confidence is high, and the economy continues to grow. Modest growth alongside falling prices is the very definition of that overused air traffic control metaphor of the soft landing.

Supply and Demand

How is that even possible, though? The consensus opinion among economists, looking at comparable historical periods, is that a monetary tightening program as dramatic as this one has been (the sharpest and fastest increase in rates since the Volcker Fed in the late 1970s) was bound to create the conditions for, if nothing worse, a mild cyclical recession. That was our view earlier this year as well, and, to be sure, the probability of a recession is still greater than zero in our opinion. But there are factors at play this time around that don't have good analogies to past tight money cycles. Some of those factors, indeed, have little or nothing to do with anything the Fed can control or influence.

Recall that, when consumer prices started to rise in a meaningful way in the middle of 2021, there were both supply and demand forces at work. Pressure on the demand side came from pent-up spending energy on the part of US consumers as pandemic shutdown conditions eased. That is what the Fed sought to influence, expecting that higher interest rates would act as a deterrent on consumer spending and help bring prices down.

But there was also supply side pressure as finely-tuned global supply chains went bonkers. Fewer goods came to market, and the obvious outcome of more money chasing fewer goods was the sharp increase in prices that reached a peak last summer. There was nothing the Fed could do about the supply side of the equation. Over time, though, those bottled-up supply chains have mostly worked themselves out. So even while consumer demand remains positive, the relative increase in goods supplied has had a cooling effect on prices.

That trend also helps explain why many of the stickiest categories in the consumer basket have been services. Prices for electric bikes, microwave ovens and the like may be lower than a year ago, but those for hotel rooms, airfare, concert tickets and restaurants remain elevated. This fact has some observers concerned that the “last mile” back down to the target level of two percent inflation will take longer than the time it has taken to get from last summer’s peak rates to today’s levels.

Those observers may well be right. On the other hand, a month-on-month gain of around 0.2 percent, such as reflected in both this week’s core PCE and the most recent core CPI report two weeks ago, implies an annual rate of inflation only slightly above that two percent target. We have two more CPI reports and one more PCE report to digest before the FOMC’s September meeting. In the absence of an unexpected spike upwards in any of those reports, why would the Fed arrive at the conclusion that it has to raise rates again – particularly while the economy otherwise continues to hum along at a modest but comfortable rate of growth? In our view, the odds that we have reached the end of the cycle are better today than they were at the beginning of July.

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