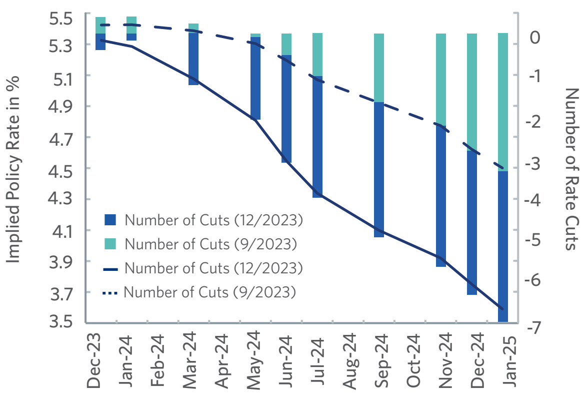
Exuberant Expectations

Our proclivity to rationalize and simplify often results in the adoption of single factor solutions to complex problems that are, in the words of HL Mencken, "neat, plausible, and wrong." This time may be different. The single most dominant determinant of the direction of markets in 2023 and so far in the new year has been widely fluctuating expectations for the direction of monetary policy. Market sentiment has swung from concern that tight Fed policies would reduce price pressures at the cost of a recession to jubilation that the Fed will tame inflation without derailing growth or destabilizing markets. The fourth quarter of 2023 marked a watershed in market expectations for the future path of monetary policy, as a much steeper decline in the Fed funds rate was priced into futures contracts on the Fed funds rate (Exhibit 1).

EXHIBIT 1: MARKET PRICES IN AGGRESSIVE FED RATE CUTS

Source: Bloomberg. Forward Fed funds rate implied by futures market.



This shift in expectations was a prime catalyst for a fourth quarter rally that sent U.S. stocks and long-dated U.S. Treasuries and corporate bonds up over 12%. This combination made the fourth quarter one of the best for 60/40 portfolios of the past century. With this move, markets appeared priced to perfection, and the basis for this pricing appeared largely to rest on expectations for a rapid easing of monetary policy culminating in a rare episode of rapid disinflation combined with sustained economic growth. History suggests that this would be an exceptional feat.

Market Races Ahead of the Fed

The market appears to have more faith in the Fed's powers than the Fed itself and expects the Fed funds rate to decline faster than the Fed's own projections. Current market pricing suggests that inflation will rapidly fall to target, the economy will remain resilient, markets will remain stable, and profits will grow sufficiently to justify current high equity valuations. There are two main ways that these expectations could be disappointed.

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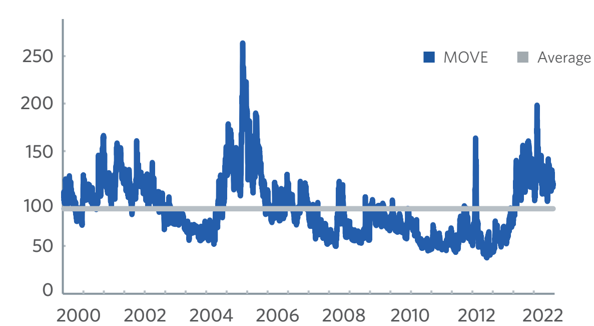
First, the economy may yet fall into recession as a result of the lagged impact of past tightening. Some of the factors supporting strong consumer demand, notably including the accumulation of excess savings during the pandemic, are dissipating. Moreover, monetary policy works with a lag as it takes time for the effect of a higher cost of capital to work its way through the economy. There are already signs of the impact of tighter policies. Credit extended by commercial banks is contracting, interest on credit card balances and credit card delinquencies are up, corporations face a higher cost of capital, and higher mortgage rates have disrupted the sale of existing homes. While the economy has so far been resilient, the lagged effect of tight policies may yet be manifested in slower growth.

Second, inflation may not be so easy to quell. A recent IMF analysis of 100 inflation shocks across 56 countries since 1970 highlights important lessons for our current predicament. History suggests that price pressures are persistent. Inflation inertia can be hard to overcome. Successful disinflations require central bank perseverance and have taken 3-5 years of tight policies. Central banks ignore inflation's persistence at their peril. There are many past instances of a premature relaxation of policies that allows inflation to reignite and ultimately increases the economic costs of disinflation. The sustained policy tightness needed to dampen inflationary pressures typically lowers output and employment, at least for the short term.

Reflecting these risks to the market consensus, uncertainty appears high. Survey-based data on economic forecasts for inflation and interest rates suggest an unusually wide dispersion across forecasts. Market-based measures of expected interest rate volatility derived from option prices also point to high levels of uncertainty about the future path of interest rates (Exhibit 2). Past history suggests that doubts about the market consensus are warranted.

EXHIBIT 2: HIGH IMPLIED BOND MARKET VOLATILITY POINTS TO UNCERTAINTY

Source: Bloomberg. MOVE Index of implied U.S. Treasury volatility.



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