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UNCERTAINTY, INFLATION AND THE US FEDERAL RESERVE

The markets have been on a rollercoaster ride over the past couple of weeks. Initially there was a significant drop in equities and a rise in bond yields following the US Federal Reserve (Fed) statements on the 2nd of November. This was quickly followed by a large rise in the equity markets and a drop in bond yields following the latest inflation numbers being released on the 10th and the 15th of November. So what do we make of these large market moves? Is there any underlying theme which the markets are telling us? Is the Fed behind the curve? Are markets getting ahead of themselves? Or is this just noise caused by speculation and the unwinding of large positions?

The latest US Federal Reserve statements on the 2nd of November are significant because of the amount of macroeconomic uncertainty which serves as a backdrop to their policy. Powell appeared cautious about how quickly inflation will come down and how long interest rates will have to stay elevated to bring down inflation. This was in marked contrast to the markets which had previously expected the US Fed to start cutting rates as soon as it had finished its steep and rapid rate hiking. This perception of the markets quickly changed when the Fed spoke on the 2nd of November, only for those hopes to be reignited following the lower-than-expected inflation prints later this month.

At London & Capital, we believe that the real story is not the move down or the move up, the real theme is that of the underlying macroeconomic uncertainty. We believe that this heightened macroeconomic uncertainty is here with us for a while and the Fed's cautious stance is therefore justified. This is quite a significant difference from the popular belief in an all-knowing and all-powerful Fed who can control the economy and the markets with ease. To understand what has changed, we need to go back to the 1960s where this belief in the Fed's powers had its origins.

MONETARY POLICY AND FRIEDMAN'S LICENSE PLATE

"Inflation always and everywhere is a monetary phenomenon".

With these words stated in 1963, Milton Friedman turned his back on Keynesian economics and laid the foundations for monetary economics, which would be followed by most economics and central bankers for the next 5 decades. The premise for this was simple: it was monetary policy alone which was the primary determinant of inflation in an economy. The obvious implication to this was that central banks, through their monetary policy, could control inflation and keep it, at or close, to their inflation target if they chose to do so. (As an interesting aside, Friedman was so convinced of the omnipotence of monetarism that he had the monetary equation MV=Py as his license plate in California).

This economic doctrine led to the adoption of the inflation targeting regime by central banks across most major economies. Burnished by Volcker's slaying of the inflation dragon in the 1970s-1980s, it became widely accepted by the early 2000s that if a credible central bank, with independence and full control of monetary policy, were to explicitly target a certain rate of inflation then it would be able to achieve it.

MONETARY POLICY WORKS ... TILL IT DOESN'T

Looking back at the last few decades of monetary policy and inflation targeting by central banks, we can see that by and large, inflation remained within the bounds of central bank targets for most of the major economies, so Friedman's view of inflation was widely borne out by empirical evidence.

However there were occasions where monetary policy did not work exactly as planned, the most noticeable ones being Europe and Japan. In both these economies, inflation persistently remained below the central banks' targets. Monetary policy alone was unable to raise inflation to the target levels, despite the European Central Bank (ECB) and the Bank of Japan (BoJ) using both conventional monetary policy measures like low interest rates, as well as unconventional monetary policy measures like negative interest rates and quantitative easing.

With the benefit of hindsight, we can see the reasons why inflation did not yield to monetary policy. Central banks in Europe and Japan were faced with structural long-term forces which kept inflation low by suppressing demand (due to low growth and ageing demographics) and increasing supply (due to globalisation, cheap labour and cheap goods from China and Eastern Europe).

So in order to explain these anomalies we believe that there is an important caveat which needs to be appended to Friedman's monetary view of inflation:

"Inflation is a monetary phenomenon if the demand and supply curves remain smooth and well-behaved."

WHY DOES ANY OF THIS MATTER?

A historical overview of how the Fed got here is useful in understanding the context behind Powell's statements on the 2nd of November and its probable reaction to the lower-than-expected inflation prints in November. It is said that history may not repeat itself, but it does rhyme. The US economy (and indeed the global economy) is now faced with the converse of the European and Japanese anomalies described above. We now have a supply shock caused by the Ukraine war, lockdown after-effects and Chinese zero-Covid policy which have reduced the supply of labour, commodities, and goods. We also have a demand upsurge caused by the remnants of fiscal largesse during the lockdown, wealth effects from high asset prices as well as catch-up spending after the reopening of economies.

This gives rise to a couple of uncomfortable questions for Powell and investors like us:

01 Are the current interest rate hikes sufficient for a swift and clean return to a more "normal" level of inflation?

We know that monetary policy alone was insufficient in stimulating inflation higher in Europe and Japan the last time there was a confluence of demand and supply factors keeping inflation low. So what certainty is there that this time around the Fed can use monetary policy alone to quickly overcome the demand and supply factors which are driving inflation higher?

02 How quickly can monetary policy bring inflation down?

Assuming that interest rate hikes do "eventually" bring down inflation, how long does "eventually" mean? A few months, a few quarters, or a few years?

VOLCKER'S GHOST APPEARS AT HALLOWEEN

The answer to the first question is generally assumed to be yes. Barring a few outliers like Turkey's Erdogan, it is generally believed that higher interest rates will eventually bring inflation under control. The universality of this belief is reflected in the large move following the weaker inflation prints. The more interesting question is the second one where there is a divergence of opinions on how quickly this can happen.

The proponents of Friedman's monetary school of thought have often pointed to Volcker and his success in bringing down double digit inflation, as the best example of the effectiveness of monetary policy. The bit which is often forgotten is that when inflation in the US hit double digits in 1974, it took almost a decade and numerous peaks and troughs before inflation returned below 5%. This is of course known to the Fed and was possibly the reason why Powell referred to the lag in the effects of monetary policy in his speech. Fed watchers know that each word in such statements is carefully considered and weighed up, so the statement about the lag in monetary policy was Powell's way of telling investors that monetary policy tends to work in quarters and years, rather than weeks or months.

Having said that, we do not believe that it will take another 10 years for inflation to return to "normal" levels this time, principally because central bankers have learnt the lessons of the past. However the market's assumption that inflation will quickly return to normality by mid-2023, thereby enabling the Fed to start cutting interest rates, also looks doubtful.

So what is the answer to the second question? The uncomfortable truth is that we do not know the answer with certainty. Macroeconomics is neither so precise nor so static as to allow us to make such prognostications with any degree of confidence. Even the part of the inflation puzzle which has been studied the most - the relationship between unemployment and inflation, remains shrouded in uncertainty with the Phillips Curve having shifted significantly over the past few years. If we now add the uncertainty about aggregate demand and supply disruptions in a globalised supply chain, we find that the uncertainty is too great for us to have any confidence in framing a time period when inflation returns to a normal level and when the Fed can start easing.

WHAT DOES UNCERTAINTY MEAN FOR OUR PORTFOLIOS?

Faced with such levels of macroeconomic uncertainty, our investment strategy is quite similar to the Fed's stance - be data dependent, prepare for tighter monetary policy, gear up for the long haul, and wait and watch. High levels of uncertainty means that the risk premium for all assets need to be sufficiently high to compensate investors for taking this uncertainty risk.

In Equities, we remain invested in companies with sound business models and pricing power who can withstand higher borrowing costs and grow profits at or above inflation, while steering clear of stocks with high cyclical exposure. In Fixed Income, we continue to favour the shorter end of the yield curve rather than the longer end, and we continue to invest in high quality names who can withstand a prolonged period of higher rates. At a multi-asset portfolio level, we remain cautious on risk assets, and we continue to hold high levels of cash and Cash+ investments which can be liquidated quickly and invested in risk assets when either the uncertainty reduces, or the uncertainty risk premium is adequately priced in.

Kind regards,

DIPAN ROY
Deputy Chief Investment Officer