ClearBridge Investments

AOR Update: Fast & Furious 75

June 16, 2022

Key Takeaways

- The Fed's 75 basis point hike and signaling of a more aggressive tightening path in the second half of the year increases the risk of a policy error, making a recession modestly more likely than a "softish" landing.
- Monetary policy is ill suited to handle supply shocks such as higher energy prices, and aggressive hiking could have a smaller impact on inflation and inflation expectations if energy prices remain high or rise further.
- A recession is not a certainty and the ClearBridge Recession Risk Dashboard maintains a green expansionary signal. However, Credit Spreads have turned red and further deterioration in the dashboard appears likely in the coming months.

Fed Slams on the Inflation Breaks

CPI inflation at 8.6% against the Federal Reserve's 2% target is akin to doing 73 miles per hour in a 25 zone: it's a big problem. Since last fall the Fed has been pushing progressively harder on the brakes, hoping to slow down the economy before an accident occurs. Yesterday, it slammed on the brakes with a 75-basis point (bps) interest rate hike. This increases the chances of a policy error where the Fed overtightens and in trying to solve one problem (inflation), inadvertently creates a second by slowing the economy so much that a recession occurs rather than a "softish" landing. Sticking with the speeding car analogy, the economy is now at risk of a spinout from the Fed's abrupt maneuvers.

Until one week ago, markets were priced for a second consecutive 50 bps rate hike. On Friday two datapoints came out that set in motion the switch to 75. First was the May Consumer Price Index (CPI), which topped expectations driven by higher energy prices. Second was the University of Michigan Index of Consumer Sentiment preliminary June number, which missed badly and is now at its lowest level in history. Importantly, 46% of respondents to the survey attributed their negative views to inflation, with gas prices appearing to be the main culprit as half of all respondents mentioned gas during their interviews. The long-term (5–10 years) inflation expectations subcomponent of this survey jumped by 0.3% after remaining largely stable over the prior year, suggesting a potential unanchoring of inflation expectations.

On Monday afternoon, a series of articles suggested the Fed could consider a more aggressive 75 bps hike given the high CPI release and concerning consumer sentiment data. With several coming from "unofficial mouthpieces" and suggesting an intentional leak, markets moved to price a 75-bps hike in a matter of minutes. They also projected 3.25 additional rate hikes this year. The Fed followed through yesterday on the first, while the latter projection is now endorsed by the Fed "dots," which indicate a much higher year-end policy rate from Federal Open Market Committee (FOMC) participants.

If these additional hikes come to fruition in the second half of the year, they would represent the second-largest cumulative rate increase in the 12 months following liftoff since the mid-1950s. This rapid and substantial tightening will eventually cool the economy, which was already slowing given post-pandemic and reopening normalization as well as higher energy prices.

Exhibit 1: Is This Cycle Special?

U.S. Hiking Cycle Summary Statistics

Hiking Cycle Timing			Fed Funds Rate (%)				Next Recession	
Start	End	Months	Starting Rate	Ending Rate	Total Change	Change in First Year	Start Date	Months
Jun. 1955	Sept. 1957	27	1.5	3.5	2.0	**1.3**	Sept. 1957	**27**
Aug. 1958	Oct. 1959	14	0.5	4.0	3.5	**3.0**	May. 1960	**21**
Aug. 1963	Jul. 1969	71	3.0	9.0	6.0	**0.5**	Jan. 1970	**77**
Mar. 1972*	May 1974	26	3.5	13.0	9.5	**3.3**	Dec. 1973	**21**
Dec. 1976*	Feb. 1980	39	4.8	20.0	15.3	**1.8**	Feb. 1980	**38**
Aug. 1980	Dec. 1980	4	9.5	20.0	10.5	**10.0**	Aug. 1981	**12**
May 1983*	Aug. 1984	16	8.5	11.8	3.3	**2.0**	Aug. 1990	**87**
Dec. 1986	Sept. 1987	9	5.9	7.3	1.4	**1.4**	Aug. 1990	**44**
Mar. 1988	Feb. 1989	11	6.5	9.8	3.3	**3.3**	Aug. 1990	**28**
Feb. 1994	Feb. 1995	12	3.0	6.0	3.0	**3.0**	Apr. 2001	**86**
Jun. 1999	May 2000	11	4.8	6.5	1.8	**1.8**	Apr. 2001	**21**
Jun. 2004	Jun. 2006	24	1.0	5.3	4.3	**2.3**	Jan. 2008	**42**
Dec. 2015	Dec. 2018	36	0.3	2.5	2.3	**0.5**	Mar. 2020	**51**
Average		**23**	**4.1**	**9.1**	**5.1**	**2.6**		**43**
March 2022	???	???	0.3	???	???	**3.4****	???	**???**

*Rates shown for these dates are the rates as of the last hike within the first year and not the rate one year after the first hike of the cycle.
**Change in first year Fed Funds rate implied by Fed Fund Futures. Data as of June 15, 2022. Source: Bloomberg, Chicago Board of Trade.

Unfortunately, monetary policy is ill suited to handle supply shocks such as higher energy prices resulting from geopolitical conflict. The Fed can continue to hike aggressively, but if energy prices rise further or remain high because of geopolitics, headline inflation and inflation expectations may not improve very much. Although monetary policy acts with a lag, and slower inflation is a reasonable expectation from rate hikes, the impact of hiking could be smaller now. As a result, it seems plausible more substantial tightening is still to come before the Fed backs off, increasing the risk of a policy error along the way. While the cake is not yet fully baked, we believe the economy is now headed down a path where a recession is becoming modestly more likely than a softish landing.

The ClearBridge Recession Risk Dashboard is not yet picking up on these dynamics, which represent exogenous shocks not easily captured by available data points. Further, economic conditions are currently strong, a sentiment echoed by Fed Chair Powell himself at yesterday's FOMC press conference where he said he did not see signs of a broader slowdown. One indicator has worsened from yellow to red — Credit Spreads — with markets starting to pick up on these dynamics. In the coming months, we expect further deterioration in the dashboard from indicators such as Housing Permits, Jobs Sentiment, Jobless Claims, Retail Sales, ISM New Orders and the Yield Curve. This could take some time to appear given the health of the consumer, but ultimately, we believe the lagged effects of tighter monetary policy will overwhelm the consumer — the driver of two-thirds of the economy. We are starting to see early signs of that with cooling activity in the housing market and hiring freezes/layoffs, primarily in the technology sector.

Exhibit 2: ClearBridge Recession Risk Dashboard

		June 15, 2022	May 31, 2022	April 30, 2022	March 31, 2022
Consumer	Housing Permits	⬆	⬆	⬆	⬆
	Job Sentiment	⬆	⬆	⬆	⬆
	Jobless Claims	⬆	⬆	⬆	⬆
	Retail Sales	⬆	⬆	⬆	⬆
	Wage Growth	✖	✖	✖	✖
Business Activity	Commodities	●	●	●	⬆
	ISM New Orders	⬆	⬆	⬆	⬆
	Profit Margins	⬆	⬆	⬆	⬆
	Truck Shipments	⬆	⬆	⬆	⬆
Financial	Credit Spreads	✖	●	●	⬆
	Money Supply	●	●	●	●
	Yield Curve	⬆	⬆	⬆	⬆
	Overall Signal	⬆	⬆	⬆	⬆

⬆ Expansion ● Caution ✖ Recession

Source: ClearBridge Investments.

A recession is not a certainty as we move forward. The Fed can pivot policy again, and other positive developments may emerge. We believe tools like the ClearBridge Recession Risk Dashboard can help investors monitor the evolution of the economy, which likely will prove to be anything but a straight line. Two weeks ago we suggested that the Fed is somewhat data-independent barring a "break the glass" moment as they work to bring the fed funds rate back toward neutral in the face of too-high inflation before reassessing conditions. It appears the Fed has now had their "break the glass moment." However, our conclusion remains the same: we believe long-term investors should remain patient as we move through The Year of Transition. What has changed is the magnitude of what might transpire, not the direction of the economy.

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