While it’s garnered less attention in recent months, any time markets rallied through the Fed’s hiking cycle we would inevitably hear the refrain that financial conditions are easing and that just means the Fed will have to hike further to rein inflation back in. We’ve long pushed back against this concept as the market’s understanding of financial conditions, which tend to be equity market centric, differs greatly from the financial conditions the Fed is concerned with to dampen growth and inflation. Powell has alluded to this theme in various speeches, but with the release of a new financial conditions index by Fed researchers, we now have an index that is more consistent with how the FOMC generally relates financial conditions to economic activity. The resulting Financial Conditions Impulse on Growth (FCI-G) uses seven key financial variables to generate an estimate as to how much they are contributing to or detracting from GDP growth. Unsurprisingly, the FCI-G moved swiftly from accommodative territory in 2021 into significantly restrictive territory over the course of 2022, and while conditions have eased modestly thus far in 2023, they remain restrictive. As we’ve stressed time and again, 2022 was all about rapidly moving into restrictive territory, while the first half of 2023 was about closing in on the appropriately restrictive level of rates, and the remainder of the tightening cycle will largely be about the duration of keeping rates and financial conditions restrictive. As this index reveals, the Fed can continue to tighten even without rate hikes via that duration lever as inflation continues to slow. That’s how higher for longer works.

Source: Portfolio Analysis & Consulting, Federal Reserve.
Financial conditions have certainly tightened as the stance of monetary policy has moved into restrictive territory, but someone tell the economy that. Across nearly every key category of economic data, prints have continued to come in ahead of expectations, pushing US economic surprise indices to their highest levels since early 2021. The only pocket of weakness has been within soft survey data, which have increasingly diverged from the picture the hard data is painting. Indeed, expectations for slowing growth and a looming recession have set a lower bar for beats, but the data has impressed, nonetheless. While market participants and economists alike have been loath to capitulate on their recession calls, the resilience of the economy is likely to force a reassessment and catch-up of expectations to the data leading to some mean reversion in surprise indices. But the bottom line remains: The economy is far more resilient than consensus believed and the long and variable lags the remaining economic bears are hanging their hats on are unlikely to change that as the most rate-sensitive portions of the economy are in fact reaccelerating. The economy simply isn’t teetering on the edge of recession, and that’s driving considerable repricing across asset classes.

Source: Portfolio Analysis & Consulting, Bloomberg.
Wind Up

Decomposition of Change in 10Y Treasury Yield (5/3/23–7/7/23)

As the data has continued to come in ahead of expectations, we’re finally seeing a redux of the February no landing overshoot we cautioned about on the back of that. But as we pointed out last month, this repricing has a markedly different tone to it. The February repricing witnessed a sharp surge in front-end inflation breakevens which did the majority of the heavy lifting pushing nominal yields higher. The hallmark of the repricing since May has been breakevens remaining well anchored as real yields pushed higher. While breakevens have drifted modestly higher since late June, the surge in nominal yields has been the result of pricing out those pervasive recession fears. But markets always have to take things a little too far, and once again we appear to be witnessing an overshoot as the pendulum seems to have swung too far into the no recession camp, suggesting we may be approaching the peak in long rates. Markets have already nearly fully discounted a July hike, and with a slew of disinflation in the pipeline as shelter costs continue to slow and new and used cars are likely to decline, the greater risk is now that the pace of disinflation is faster than consensus currently appreciates. Put that together with a market that remains underweight duration and a consensus that has simply pushed out recession calls to the end of the year and there’s a likely a strong bid to rates waiting to pounce on any signs of economic weakness after this slew of strong prints.

Source: Portfolio Analysis & Consulting, Bloomberg.
When Mr. Market speaks we listen. One of the best leading indicators is the market itself – the aggregation of billions of viewpoints utilizing all available data. That’s not to say the market can’t be wrong, but it nonetheless can provide a useful glimpse into what the consensus is discounting. With that in mind, thematic baskets can be a useful tool to decipher just what Mr. Market is saying and how to best position against that backdrop.

Growth and inflation are the dual forces that now more than ever are driving market outcomes, and the performance of baskets of industries that tend to perform in various growth and inflation regimes is speaking volumes. After lagging for the entirety of the hiking cycle, the soft landing basket, composed of pro-cyclical industries that outperform in softening inflationary environments, has been rapidly mounting a recovery. And the No Landing basket, which gave back much of its outperformance in the wake of the March bank turmoil, has quietly been putting in a bottom at the expense of stagflation and hard landing beneficiaries, as more classic defensives lag. A soft landing has been widely regarded as a pipe dream by many pundits, but the odds have been slowly but steadily rising and markets continue to reflect that.

Source: Portfolio Analysis & Consulting, FactSet.
Even as markets show some signs of recessionists capitulating, growth prospects remain underappreciated. Consensus Q2 GDP expectations now sit at 1.3%, up from just 0.1% at the beginning of May, but even that remains well below the 2.1% estimate from the Atlanta Fed’s GDPNow forecast, which tends to grow increasingly accurate through the quarter as the data accumulates. But the sources of that growth are as equally important as the headline figure itself. Consumption, the key growth engine of the US economy, continues to hold up and should remain supported well into the second half of the year as robust labor markets and further disinflation bolster real incomes. Government spending continues to be additive while the surge in construction spending we highlighted last month contributes to a bounce in nonresidential investment. But the two key headwinds to growth over the past year we’ve repeatedly cited, inventories and residential investment, are finally set to flip to tailwinds. While you may have to squint to see the contribution from residential investment, the key is it’s no longer the sizable drag it was in 2022. And after shaving off over 2% from GDP growth in Q1, inventory investment is on track to contribute over 50 bps to GDP growth as demand holds up and inventories have been drawn down. The economy has increasing momentum and inflation continues to decelerate. Sounds a lot like a soft landing.

Source: Portfolio Analysis & Consulting, Bloomberg.
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