Quarterly Economic Update: The Fed Chooses the Lesser of Two Evils

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Quarterly Economic Update: Speakers

David G. Eichhorn, CFA – *Chief Executive Officer and Head of Investment Strategies*

David chairs NISA's Investment Committee and is a member of NISA's Management Committee. As CEO and Head of Investment Strategies, his responsibilities include overseeing new product development and growth initiatives and day-to-day oversight of our Investment Strategies group, which develops custom strategies designed to meet client objectives. Prior to joining NISA in 1999, he was with JP Morgan Investment Management for three years. David holds a BSBA from Washington University in St. Louis, with majors in Finance and Mathematics.

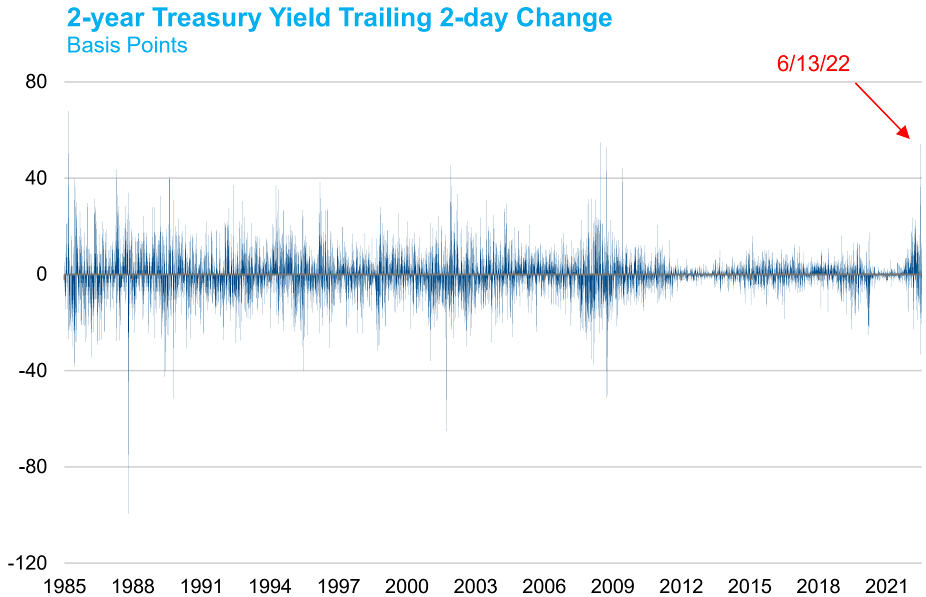
Stephen J. Douglass – *Senior Economic Strategist*

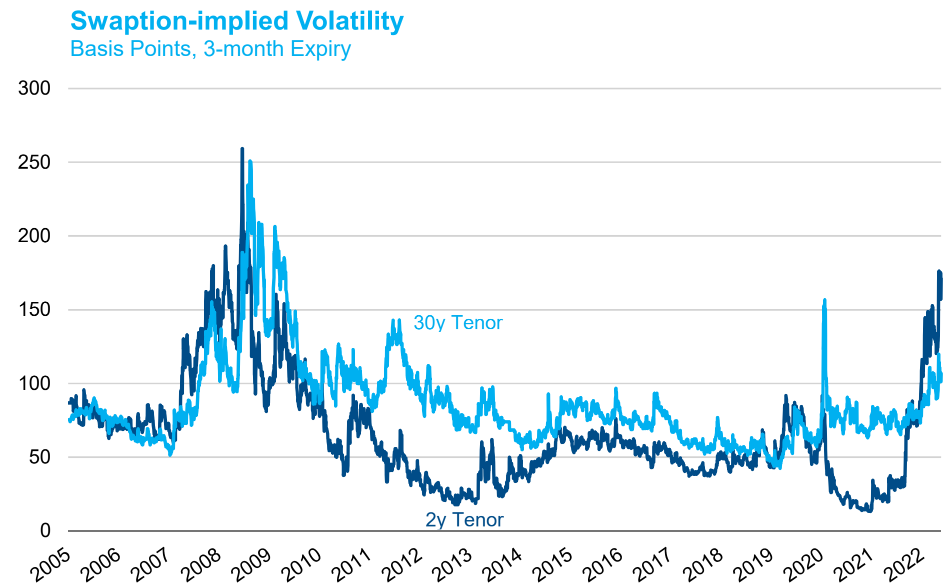
Stephen is a Senior Economic Strategist in the Portfolio Management Group and a member of NISA's Investment Committee. Stephen conducts analysis on the global economy, monetary and fiscal policy, and interest rate markets. He is a member of the team responsible for communicating economic, market and portfolio-related information to clients, and is a frequent contributor to NISA Perspectives.

Stephen joined NISA in 2016. Prior to NISA, he was a trader/analyst at the Federal Reserve Bank of New York, where he analyzed U.S. interest rate markets and helped manage the Fed's multi-trillion portfolio of Treasury securities. He has previous experience as a trader at a multi-strategy hedge fund. Stephen earned a BA in Mathematical Economics from Colgate University, an MBA from INSEAD and an MA in International Economics from John Hopkins University SAIS.

The Fed Chooses The Lesser Of Two Evils

- The Fed responded to the May CPI report with the first 75 basis point rate hike in 28 years and signaled their resolve to bring inflation down at any cost. This caused the largest two-day increase in the 2-year Treasury yield since 1985 and drove 2-year rate volatility to the highest level since 2008.
- The Fed still hopes that they can deliver a soft-ish landing, but they will impose a recession if the alternative is a 1970s-style de-anchoring of inflation expectations.
- Chairman Powell on June 29 stated: “The bigger mistake would be to fail to restore price stability.”

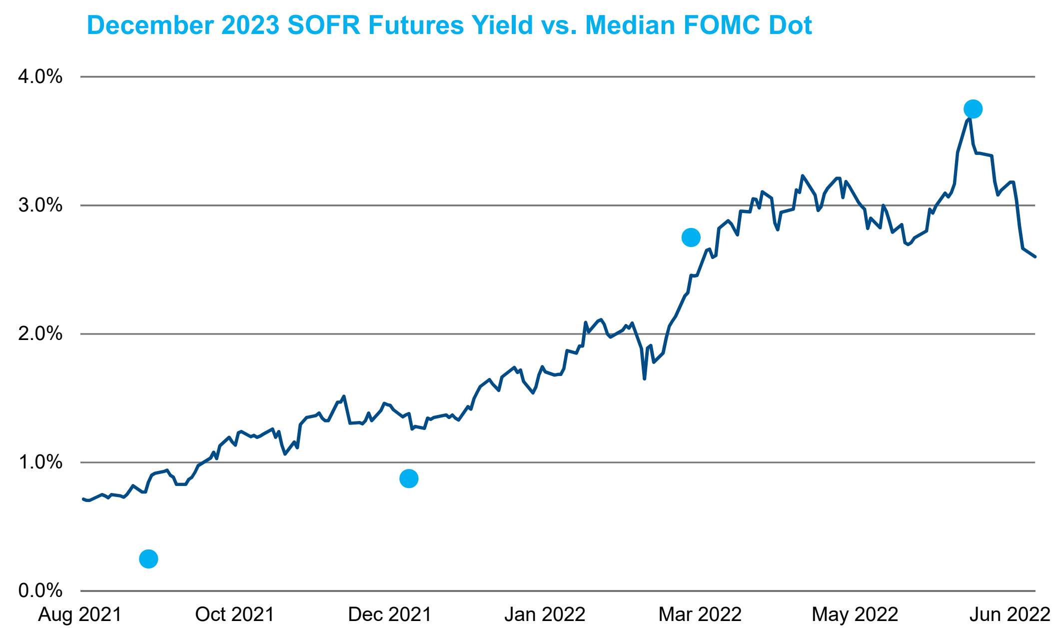




Source: Bloomberg.

Markets Are Now Pricing A Lower Terminal Rate Than The Fed

- Markets have led the Fed towards a ever-more hawkish policy stance throughout this cycle.
- In response to the lower growth outlook, markets are projecting a more dovish monetary policy path than the Fed for the first time in the cycle.

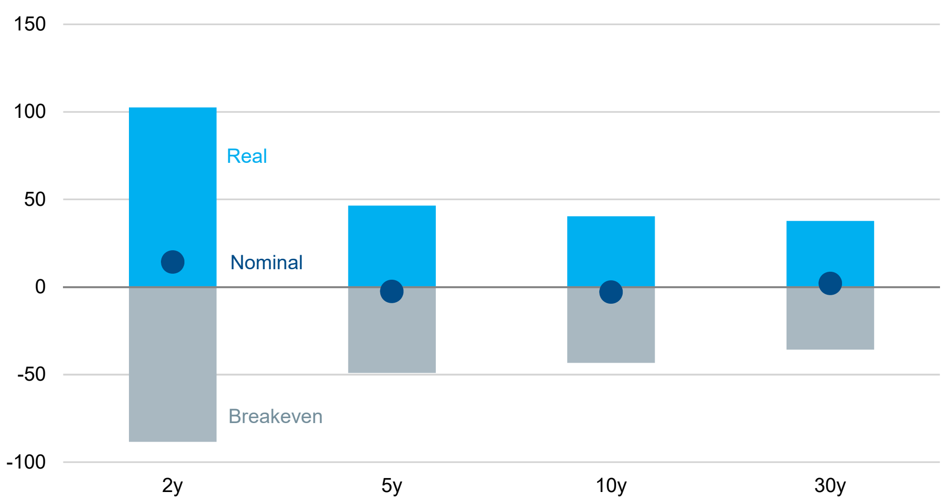


Source: Bloomberg.

A Policy-induced Downgrade To The Growth Outlook

- Breakeven inflation rates declined substantially since the May CPI release despite the upside surprise to realized inflation.
- Prices of growth-sensitive assets have declined substantially over the same time period.
- The downgrade to the growth outlook coincides with a large bear flattening in real rates, suggesting monetary policy expectations are largely to blame.

Change in Treasury Yields
Basis Points, 6/9/2022 - 6/30/2022



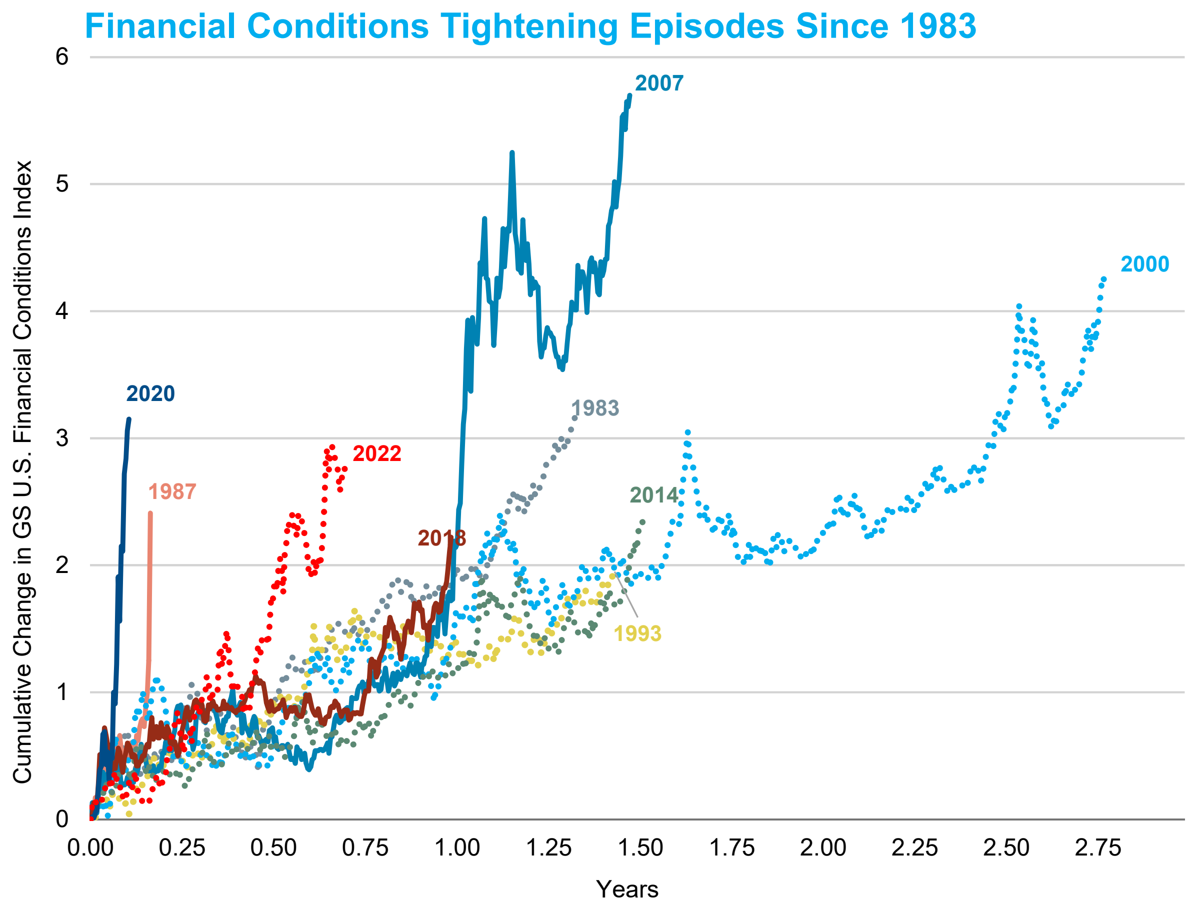
Price Response Since the May CPI Report

	06/09/2022	06/30/2022	Change
Intermediate Credit OAS (bps)	102	122	20
Long Credit OAS (bps)	163	186	23
HY Credit OAS (bps)	428	569	141
Trade Weighted USD	115.8	117	1.4%
S&P 500	4018	3785	-5.8%
MSCI EM Equities	66	62	-5.7%
JPM EM Currency Index	53	52	-1.7%
Brent Crude Oil	123	115	-6.7%
Copper	439	371	-15.5%
Iron Ore	931	803	-13.8%
Aluminum	2746	2458	-10.5%

Source: Bloomberg.

Fastest Policy-induced Financial Conditions Tightening On Record

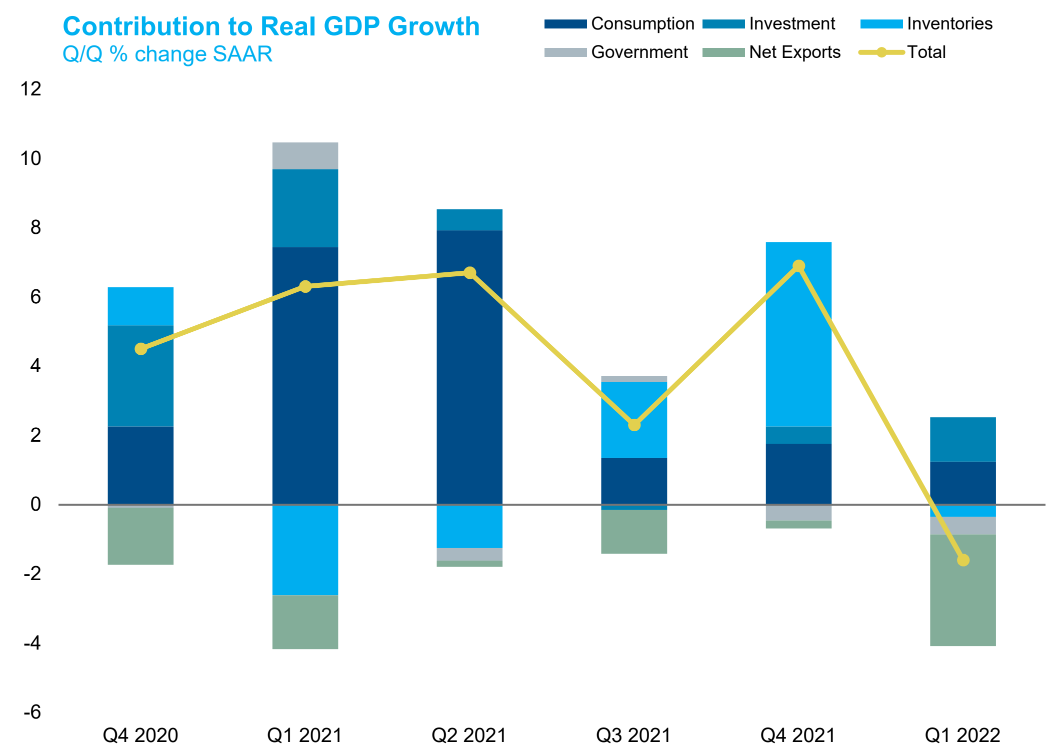
- Financial conditions have tightened this year at the third-fastest pace on record. The 2020 and 1987 episodes were caused by exogenous shocks, making this the fastest policy-induced tightening of financial conditions in the history of this index back to 1983.
- The Fed has tightened financial conditions by a larger magnitude than they did in the prior tightening cycle, in one third of the time.
- This magnitude of financial conditions tightening will significantly reduce growth in 2022 and 2023.



Dotted lines indicate a tightening of financial conditions primarily by monetary policy. Solid lines indicate a tightening of financial conditions driven primarily by market corrections or other exogenous factors.
Source: Bloomberg, Goldman Sachs.

The U.S. Economy Is Not In A Recession

- Growth was destined to slow from the historically rapid pace of 2021, but has been surprisingly low relative to the strength of the labor market.
- Volatility in GDP over the past three quarters has been caused by large inventory swings and a surge in imports. Domestic final sales have remained strong.
- Gross Domestic Income (GDI), an alternative measure of economic activity that is often more accurate, remained positive in Q1.

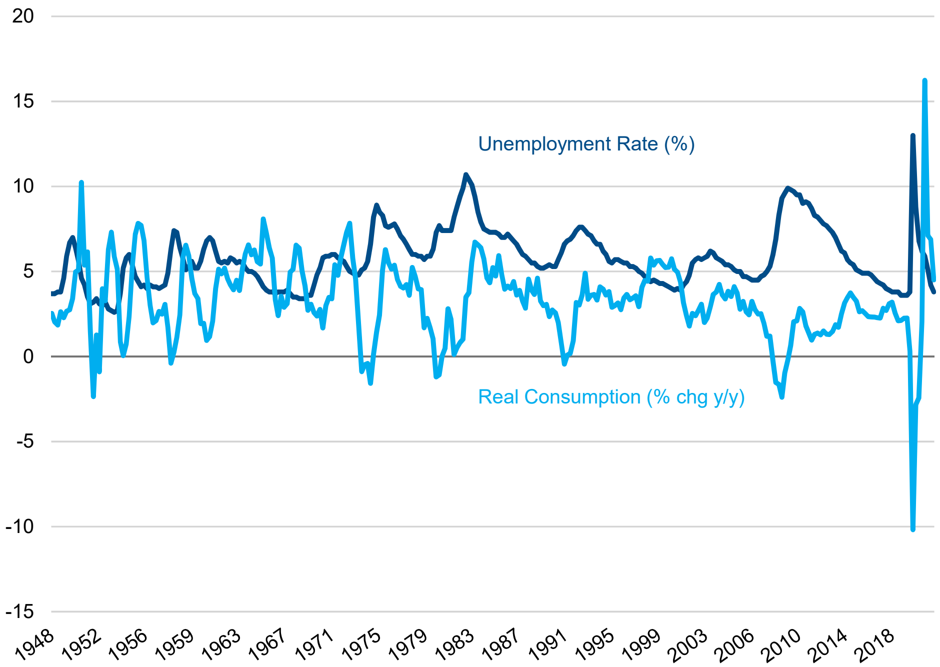


Source: BEA.

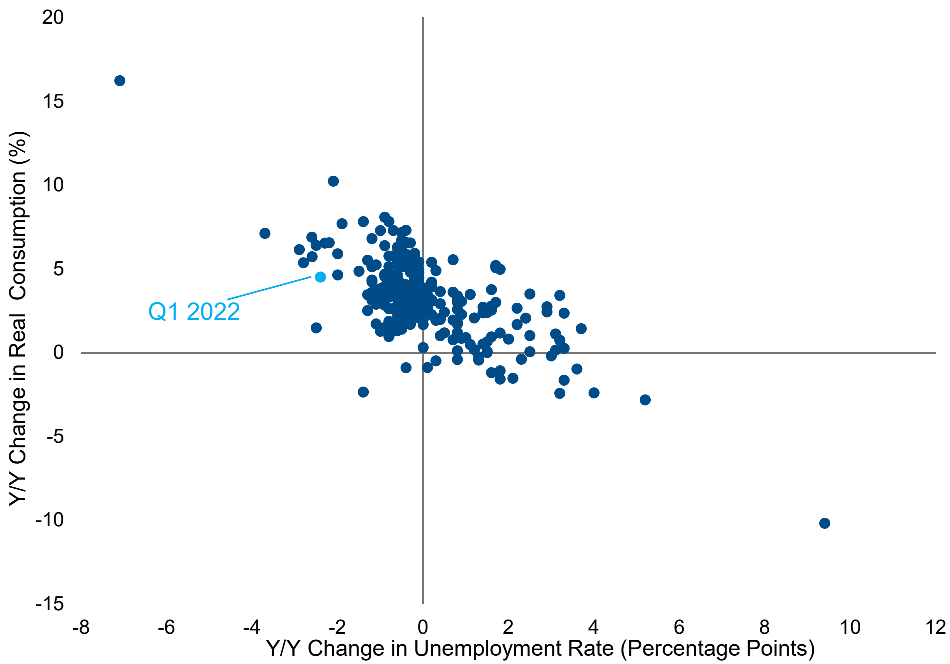
Labor Market Outcomes Drive Consumption

- The labor market is about as strong today as it's ever been. The unemployment rate is within one tenth of its 50-year low and wage growth is at an all-time high.
- Consumption rarely declines when the labor market is strong.

Unemployment Rate and Real Consumption Growth



Unemployment Rate vs. Real Consumption Growth
Quarterly Observations Since 1949



Source: BEA, BLS.

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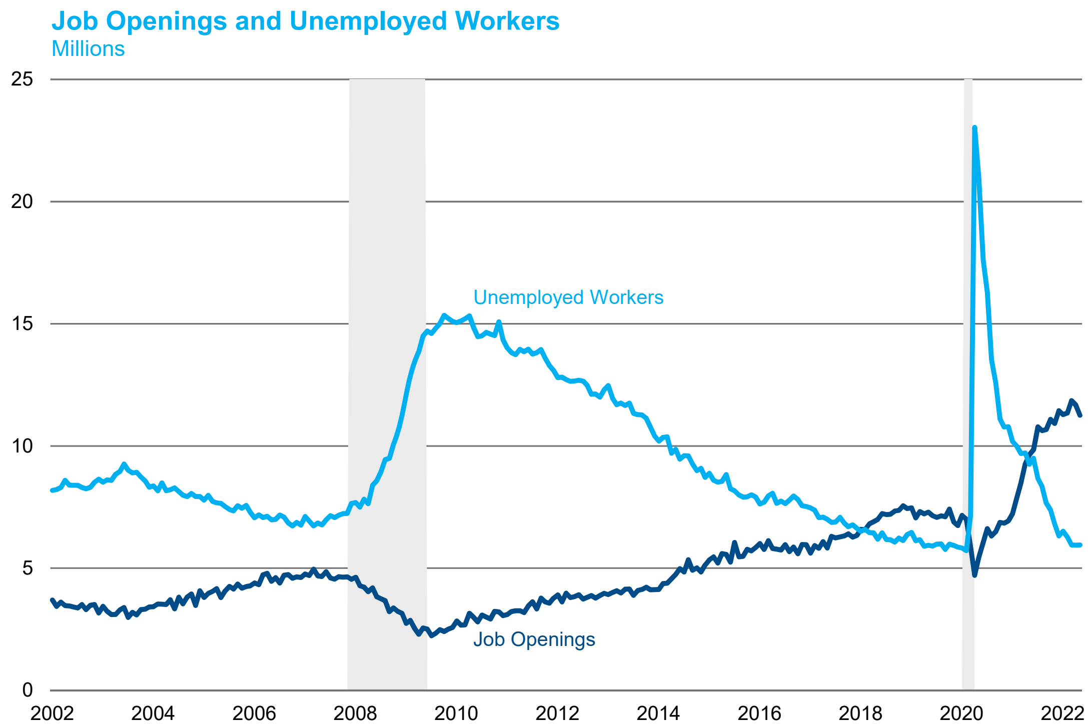
The Fed Hopes To Reduce Labor Demand

- The Fed recognizes that the labor market is overheating. Their goal is to reduce labor demand without reducing the level of employment.
- There are nearly two job openings for every unemployed worker. The Fed wants to correct this ratio from the numerator alone, but is willing to accept an increase in unemployment if required to bring inflation down.



Gray bars indicate recession.

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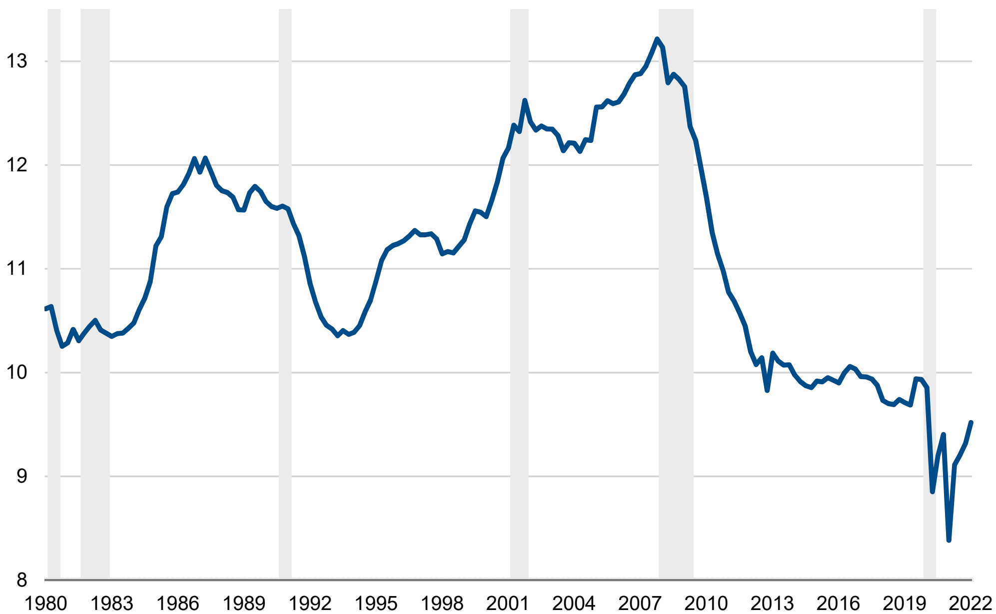
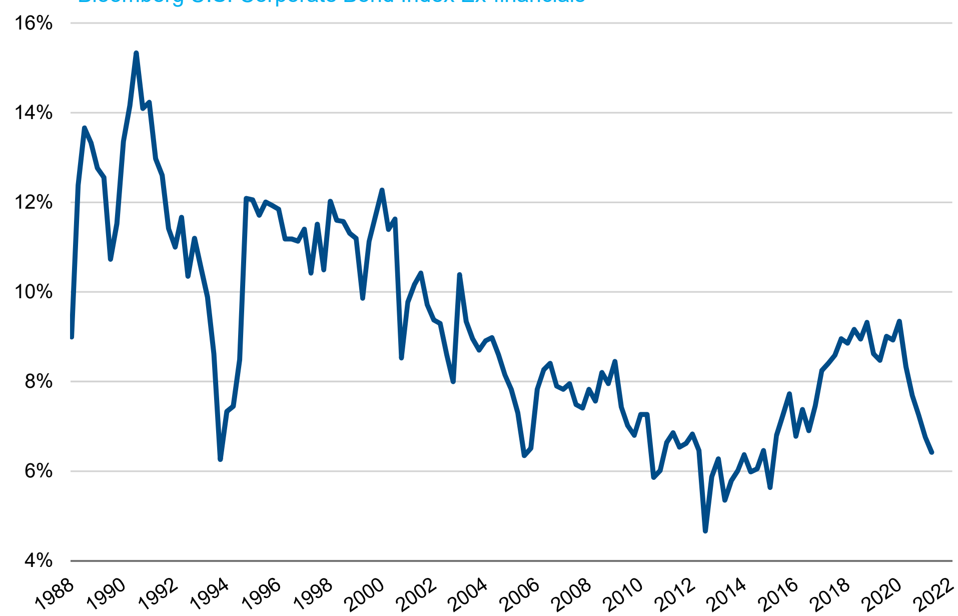
Private Sector Balance Sheets Are In Excellent Shape

- Private sector leverage and debt service costs are near the low end of their historical ranges.
- If there is a recession in the near future, it will not require the type of private sector deleveraging that dragged on growth after the financial crisis.

Household Debt Service Payments
% of Disposable Personal Income



Interest Expense as a % of EBITDA
Bloomberg U.S. Corporate Bond Index Ex-financials

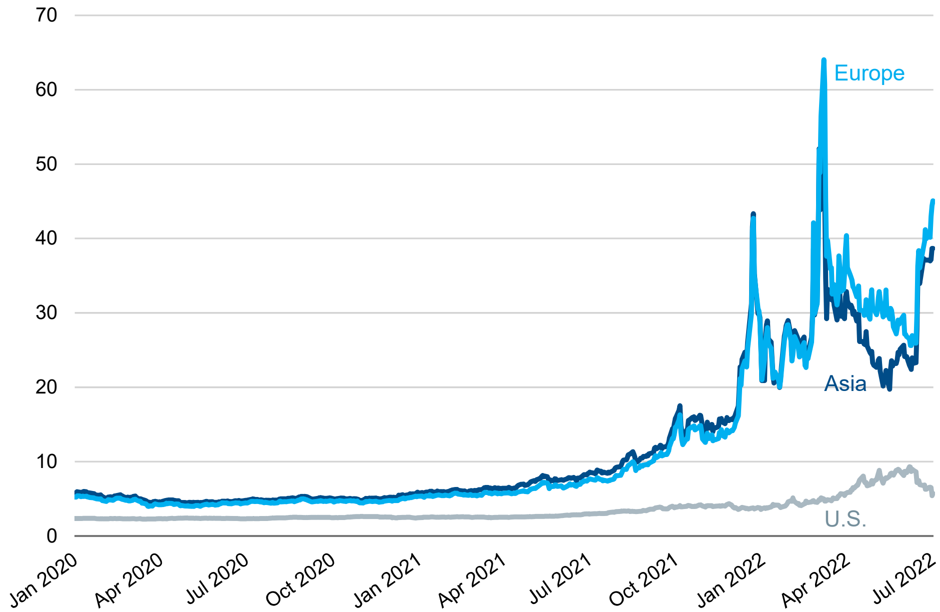


 Source: Federal Reserve, Barclays.

Recession Risk May Be Out Of The Fed's Control

- Vladimir Putin has caused a crisis in natural gas markets that is on a similar scale as the oil crisis of the 1970s.
- If he cuts off gas supplies to Europe, that economy will contract sharply, and it will be difficult for the U.S. to avoid a recession.
- A weaker foreign growth outlook has pushed the euro and yen to multi-decade lows, and complicated matters for the ECB and BOJ.

Global Natural Gas Futures Prices
USD per mBtu



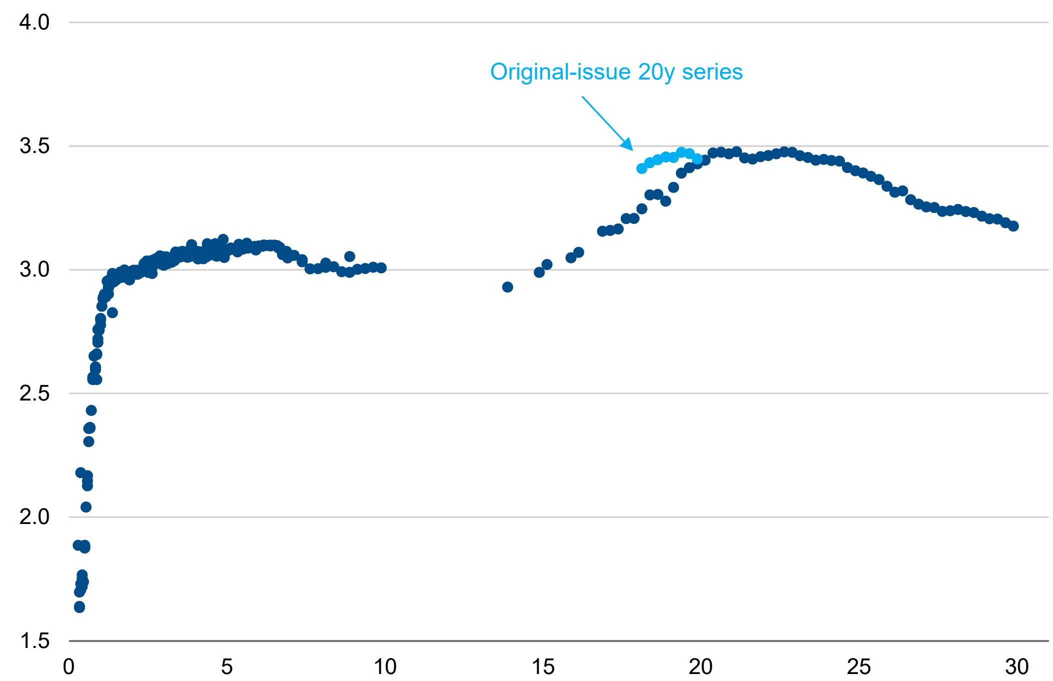
Trade-weighted Dollar Index

Source: Bloomberg, Goldman Sachs.

The 20-year Treasury Was A Mistake

- Treasury's decision to issue a 20-year security was a mistake. We argued in favor of a 50-year security at the time.
- The 20-year series trades with a significant liquidity premium and has distorted the shape of the long Treasury yield curve.
- We expect Treasury will continue reducing the size of 20-year auctions and may consider discontinuing the security if valuations do not improve.

Treasury Yield Curve
Percent, As of 6/30/22



 Source: Bloomberg.

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