Good signs, bad signs

… Or no matter what they decide, the Fed is quite likely to get it wrong

You have to feel for Jerome Powell. It can't be easy being the Fed Chairman at this stage. Inflation or Recession? It's a fine balancing act to avoid either of these outcomes. Undoubtedly, there will be some that will debate whether he has been up to the challenge.

To start, the US Fed claims to be data driven when determining their interest rate policy. In practice, this seems reasonable and self-evident. The challenge for any central bank, of course, is that when the data is unclear, and sometimes even contradictory, it makes most decisions difficult, with the threat of policy error becoming more pronounced.

The challenge for the Fed is that it is fighting the highest inflation in a generation, while, on the other hand, still facing unparalleled criticism over its actions up to this point. At the same time, the US economy is sending conflicting signals, where even the rear-view mirror remains unclear at times.

Take a look at something as basic as GDP (Chart A). Growth in the last quarter was an anaemic 1.3%, part of a pattern of slower growth overall. Yet, if you were to strip out a rather volatile element such as Inventories to get to a better view on the underlying performance of the economy, then growth had accelerated to 3.4%.

Bradley Mitchell
Senior Investment Strategist, Collidr

www.collidr.com
hello@collidr.com
+44 (0)808 281 2900
Connect on LinkedIn
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Which of these two measures of GDP should the Fed be paying attention to?

Chart A - US GDP

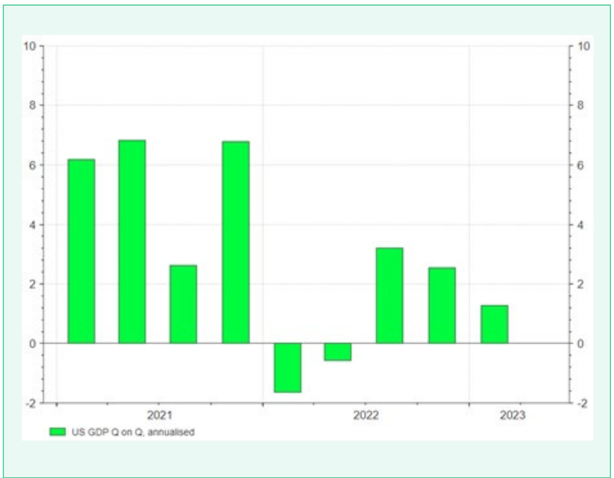
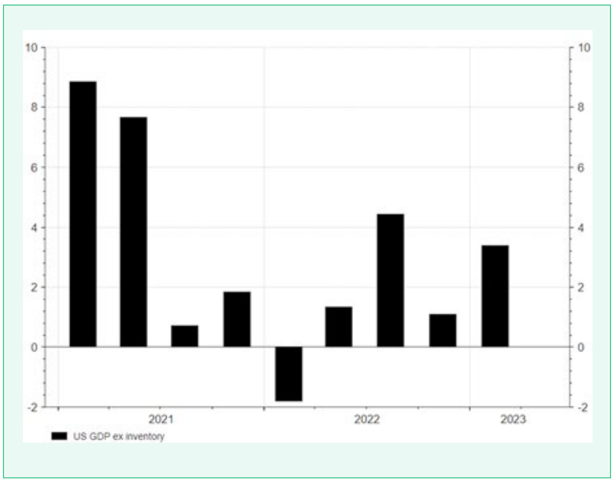


Chart B - US GDP ex. Inventories



Source: Collidr & Refinitiv/Datastream

For the last few quarters, the Fed has embarked on an unprecedented tightening of monetary policy, not just in terms of the speed and scale of the rate rises, but also the shrinking of the Fed Reserve balance sheet. QE has become QT. Meanwhile money supply growth has turned negative.

Housing

We can easily see the impact of this in housing activity levels, which have fallen away sharply since early 2022. Chart C shows the annual change in the level of new houses started over the past 10 years. Equally, house prices seem to have stabilised with the latest data showing prices starting to rise again (Chart D).

While the Fed is getting the reaction it wants from housing activity levels, those pesky house prices are not playing ball.

Chart C - Annual Change in US Housing Starts

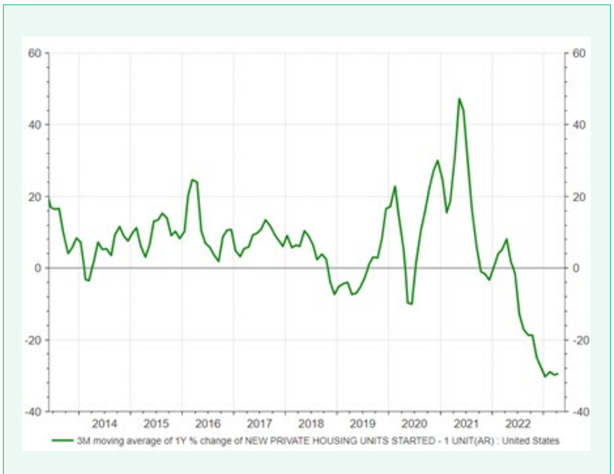
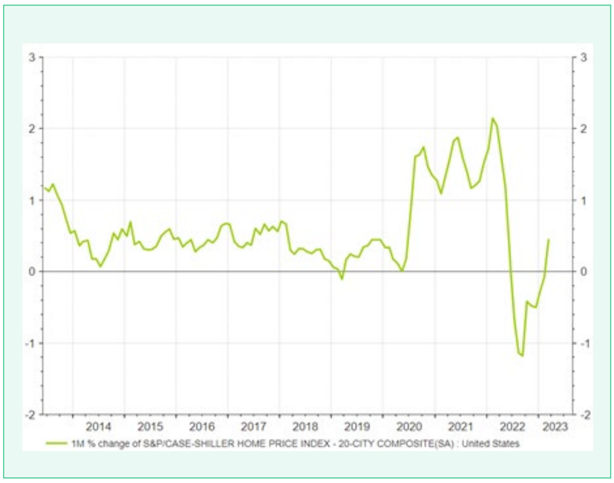


Chart D - US House Price Inflation



Source: Collidr & Refinitiv/Datastream

Labour Market Signals

What the Fed would never say explicitly is that what they would like to see is the labour market soften significantly. Rising unemployment, to most market watchers, will help sap wage demands, and thus prevent a wage/price spiral from developing further.

Normally, one might expect there to be a 6-to-9-month lag in terms of rate rises impacting the real economy. Since the Fed started raising rates in Feb 2022, we have witnessed rates rising from 1.75% to 5.25% in the last 12 months alone. Still, the labour market – the one area of the economy the Fed is most focused on – has been carrying on regardless.

Chart E is the Job Opening and Labour Turnover (JOLT) survey of job vacancies. Whilst it is off the post Covid re-opening peak, it is still significantly above historical norms, and ahead of forecasts. The previous month was also revised up. So, no sign of a slowdown here. And, as signals go, a buoyant jobs market will encourage the Fed to keep raising rates.

Yet, there are other signals, including measures of sentiment in the industrial sector, which are very bleak. Of course, one needs to be cautious with these signs, as they are measures of sentiment, not necessarily activity, and represent part, not all, of the economy.

Still, the latest ISM surveys make grim reading. Despite all the ways you can dice and splice the data, the survey scores for new orders and inventories tells us that purchasing managers in US factories are seeing falling new orders, while at the same time, cutting back on inventories. An ugly combination.

Chart E - JOLT Job Vacancies

Chart F - ISM Manufacturing

Source: Collidr & Refinitiv/Datastream

Sign, signs. Everywhere Signs.

So which data should the Fed be paying more attention to?

Frankly, you could review a dozen 'bull' and 'bear' macro charts at this moment. The same is true of inflation data. Not surprising, the Fed is concerned about inflation getting embedded within the service sector.

Chart G is CPI Services, less rent over the last 3 months, annualised it is just 0.8%! While a very similar measure of CPI Core (Chart H) has risen in recent months, to an uncomfortable 3.5%. Again, which measure should the Fed pay attention to?

Chart G – CPI Services

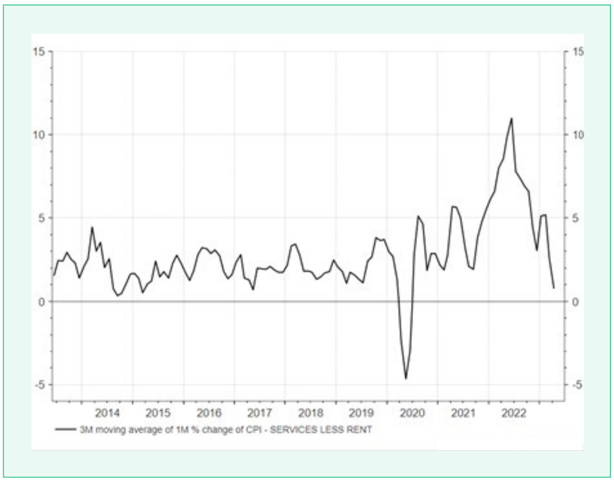
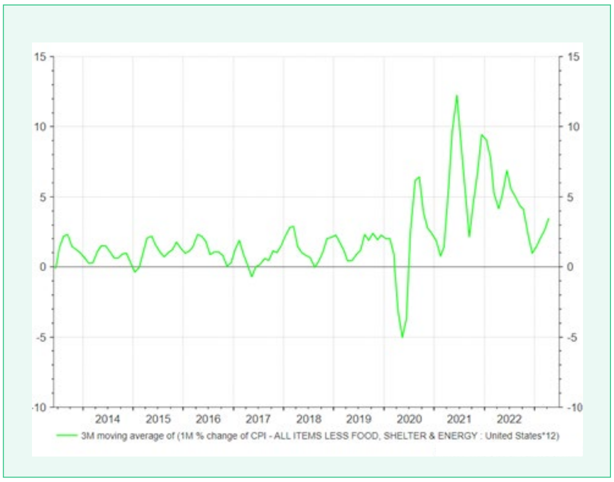


Chart H – CPI CORE



Charts represent the 'ex Shelter' – excludes the cost of housing services – value.
Source: Collidr & Refinitiv/Datastream

What we can see is that whether it's the overall US economy, or inflation specifically, the signals are ambiguous, if not contradictory. In a market where the data is so unclear, it is difficult (and potentially risky) to take significant asset allocation bets.

However, as long the 'music continues to play', investors will still want to take part. Our proprietary signals are telling us to stay invested, but to remain vigilant, particularly in terms of understanding the underlying volatility within various asset classes.

The US is just one of many markets that we monitor, and regardless of how the signs or data evolves, by using the right approach and adjusting your allocations accordingly, there are opportunities to be found in any market environment.