Weekly Newsletter

Aug 25th, 2023

Musings

"To be a successful business owner and investor, you have to be emotionally neutral to winning and losing. It is all part of the game."

-Sir Robert Kiyosaki

Last week in the markets

Jackson Hole: Easing rates is off the table for now

One key event for the markets last week was the Federal Reserve Chairman Jerome Powell's speech at the annual economic policy conference in Jackson Hole.

Below are some of the more 'useful' excerpts:

- "It is the Fed's job to bring inflation down to our 2 percent goal…. We have tightened policy significantly over the past year. Although inflation has moved down from its peak—a welcome development—it remains too high. **We are prepared to raise rates further if appropriate, and intend to hold policy at a restrictive level until we are confident that inflation is moving sustainably down toward our objective.**

- Food and energy prices are influenced by global factors that remain volatile, and can provide a misleading signal of where inflation is headed. **…I will focus on core PCE inflation, which omits the food and energy components.** On a 12-month basis, core PCE inflation peaked at 5.4 percent in February 2022 and declined gradually to 4.3 percent in July. The lower monthly readings for core inflation in June and July were welcome, but two months of good data are only the beginning.

- **Twelve-month core inflation is still elevated, and there is substantial further ground to cover to get back to price stability.**

- There are three broad components of core PCE inflation—inflation for goods, for housing services, and for all other services, sometimes referred to as non-housing services.

- Core goods inflation has fallen sharply, particularly for durable goods, but **on a 12-month basis, core goods inflation remains well above its pre-pandemic level.** Sustained progress is needed, and restrictive monetary policy is called for to achieve that progress.

- If market rent growth settles near pre-pandemic levels, **housing services inflation should decline toward its pre-pandemic level** as well. We will continue to watch the market rent data closely for a signal of the upside and downside risks to housing services inflation.

- The final category, **non-housing services, accounts for over half of the core PCE index** and includes a broad range of services, such as health care, food services, transportation, and accommodations. **Twelve-month inflation in this sector has moved sideways since liftoff.** Part of the reason for the modest decline … is that many of these services were less affected by global supply chain bottlenecks and are generally thought to be less interest sensitive than other sectors such as housing or durable goods. Production of these services is also relatively labor intensive, and the labor market remains tight.

- Restrictive monetary policy has tightened financial conditions, supporting the expectation of below-trend growth. But **we are attentive to signs that the economy may not be cooling as expected. So far this year, GDP (gross domestic product) growth has come in above expectations and above its longer-run trend, and recent readings on consumer spending have been especially robust.**

- **Additional evidence of persistently above-trend growth could put further progress on inflation at risk and could warrant further tightening of monetary policy.**

- While nominal wage growth must ultimately slow to a rate that is consistent with 2 percent inflation, what matters for households is real wage growth. Even as nominal wage growth has slowed, real wage growth has been increasing as inflation has fallen. We expect this labor market rebalancing to continue. **Evidence that the tightness in the labor market is no longer easing could also call for a monetary policy response.**

- **Two percent is and will remain our inflation target. We are committed to achieving and sustaining a stance of monetary policy that is sufficiently restrictive to bring inflation down to that level over time. Getting inflation sustainably back down to 2 percent is expected to require a period of below trend economic growth as well as some softening in labor market conditions.**

At upcoming meetings, we will assess our progress based on the totality of the data and the evolving outlook and risks. Based on this assessment, **we will proceed carefully as we decide whether to tighten further or, instead, to hold the policy rate constant and await further data."**

Clearly, the Bank is worried about a 1970s like situation where they called a 'win' too early, only to have inflation bounce back with a vengeance.

Immediate market reaction to the speech was quite muted, as most of what he said was expected. As per CME Fedwatch, **the market currently prices an 80% probability of the Fed Funds rate remaining at current levels in September** and a 55% probability of a hike in November.

Overall, a reading of the speech suggests that investors should plan for the following:

- First and foremost, **interest-rate cuts are not coming soon** and will only occur once US unemployment rises above 4%. That could be well into 2024.

- Second, **the US economy must now slow, which puts at risk the expected sharp recovery of corporate profits** currently expected by the consensus of Wall Street analysts for 2024.

- Third, **the Treasury yield curve will likely remain inverted and could invert further.** That's because the Fed must be willing to risk recession in an effort to restore price stability, which is likely to occur. It rarely pays to "fight the Fed," and an inverted yield curve is the logical way to express that view.

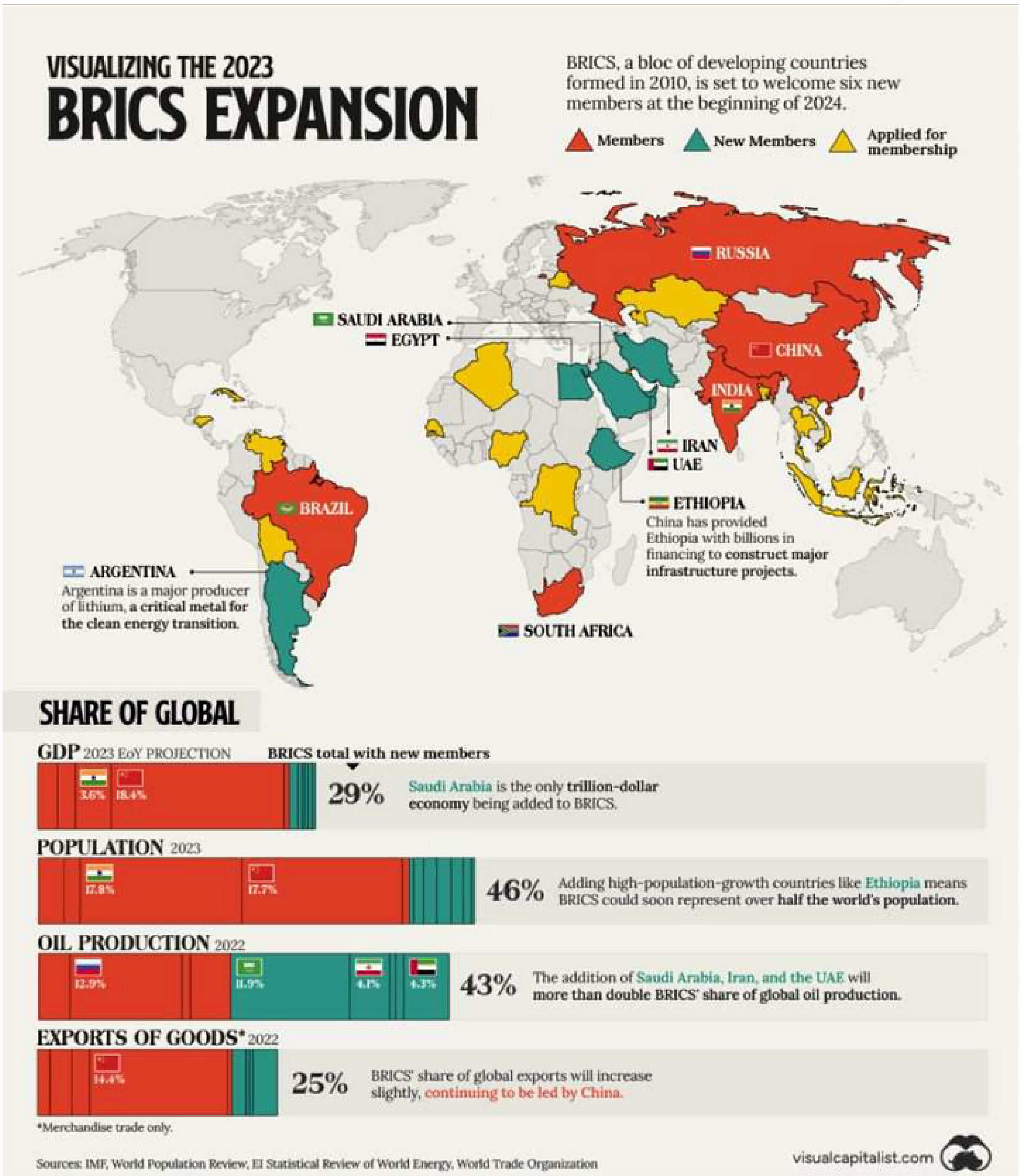
- Finally, if the Fed is wrong in the sense that inflation can fall without the need for "slack" in the economy, then it has embarked on a policy error. If so, reversing course later means undoing today's tightening much faster and more aggressively than would otherwise be the case. **Ultimately, investors may be surprised by how rapidly the Fed might eventually be forced to unwind its tightening stance.**

Building BRICS

Another potentially far-reaching development last week was the expansion of BRICS. This week, the grouping of developing economies – whose current members are Brazil, Russia, India, China and South Africa – announced six new members: Argentina, Egypt, Iran, Ethiopia, Saudi Arabia and the United Arab Emirates. The six new candidates will formally become members on January 1st 2024.

Over 40 countries have expressed interest in joining the forum

The expanded grouping, still named BRICS by common consent, represents 29% of the world's GDP, 46% of the world's population, 43% of global oil production and 25% of the world's exports.



Apart from geopolitics, the group's focus includes economic cooperation and increasing multilateral trade and development.

What do we think?

Though home to about 40% of the world's population and a quarter of global gross domestic product, internal divisions have long hobbled BRICS' ambitions of becoming a major player on the world stage. The vast divergence in scale, governance ideology, domestic priorities and foreign policy goals among BRICS countries will be complicating factors for the bloc's consensus decision-making model.

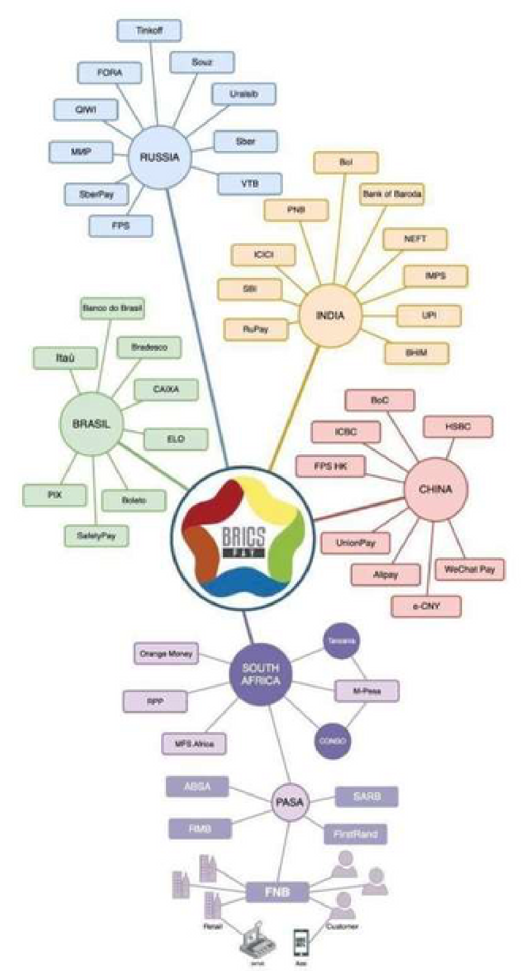
While there are suggestions that the BRICS group of emerging market powers will establish their own currency to reduce their reliance on the dollar, setting up a common currency presupposes setting up a central bank. That involves individual countries losing independence on monetary policies, which will be difficult to agree on.

However, members are already exploring other ways to reduce their reliance on the greenback, including **trading directly in their own units** and ensuring that the New Development Bank, which they established in 2014, adapts how it raises its funding. The anemic progress of the last underscores the challenges.

That being said, the bloc should over time be able to provide some sort of balance in the world by acting as the 'voice' of its members.

Chart of the Week

Are the BRICS creating a global alternative to the SWIFT system? The BRICS webpage suggests the development of a digital payment platform of the BRICS!



This platform is being jointly developed by member countries and involves major financial institutions and technology firms acting as enablers of digital payments across borders, allowing businesses and consumers to securely and seamlessly make and receive payments in their local currency without the need of converting to dollars. It is designed to reduce reliance on the greenback.

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