By the Way

Monthly commentary from Jack Way

"spoken persuasion"

The Jackson Hole symposium, which was held last week in Wyoming, brings together central bankers from around the world. It's an odd venue for such an august group, but was chosen 40 years ago as a means to attract then Federal Reserve (Fed) Chairman Paul Volker to attend, given his love of fly fishing. In any event the purpose of the gathering is to share potential policies and theories that would deal with the current economic situation. The keynote speaker is almost always the Chair of the Fed, and the speech is anxiously awaited by all who have an interest in the future of monetary policy and the economy. As a result it tends to be a rather lengthy discussion of esoteric and theoretical concepts which require much parsing in order to understand where policy might be headed. Chairman Powell took the opportunity last week to take a very different tack in his address, speaking for less than 10 minutes, and being extremely precise and emphatic about the intended Fed policies meant to bring inflation under control. He spoke of the obvious; interest rate increases, a decline in the Fed balance sheet, and for the first time (at least for me) warned that the result is likely to involve some pain. Of course this is from a man who sounded much more dovish about policy only a couple of months ago, and who pronounced inflation as "transitory" at last year's symposium. A word you don't hear much anymore is "jawboning". The dictionary defines it as "the use of spoken persuasion"; to which I would add; and avoid the necessity to force compliance. It has long been a useful tool for central bankers, and I believe Mr. Powell is hopeful his strident tone will change behaviour without requiring the use of the most painful policies. At the end of the day, I think the Chairman wants to transition to a place where the level of regulated rates matters more than the size of the increase (as is currently the case). He hopes it can happen without the market assuming he has thrown in the towel on the inflation fight.

The outlook for inflation remains complicated. It seems a simple matter of supply and demand coming into some kind of balance, but it is impossible currently to make an accurate forecast of either of those inputs. We are seeing some signs of weakening demand; real GDP in the U.S. declined in the first two quarters, housing demand is lower, as are gasoline prices. However, employment and wages remain robust. Other U.S. economic soundbites are almost universally negative. The University of Michigan Survey of Consumer Expectations has fallen 10 points, which has always been followed by a recession; ISM New Orders are below 50, indicating a contraction; the Conference Board's Index of Leading Economic Indicators (LEI) is declining etc. etc. Nevertheless, estimates for 3rd quarter GDP stand at +1.4%. The biggest positive on the supply side is that the worst of the supply chain problems seems to have passed; delivery times are rapidly improving and as an example of lower costs, the Freightos Index shows the price of moving product by ship from China to the U.S. is down 50% from the 2021 highs. As a caveat, don't get too excited as CPI drops (which I believe it will); as someone suggested getting to 5% will probably be easy, from there to the Fed's 2% target will be a lot tougher.

Say what you want about the abilities of Fed Chairman Powell, he can move markets when he speaks (or at least so it seems). His dovish comments in June sent the S&P 500 on a two month surge higher to the tune of 17%, and then last week's much more hawkish speech took the index down well over 3% in one day. Whether coincidently or not, the market rally was turned back at the 50% retracement of the previous decline, and at the 200-day moving average line. Trading volumes have stayed extremely low making dependable analysis very problematic. However, if Powell means what he says, and the old maxim "don't fight the Fed" holds true, it's very hard to argue a strong bull case.

I have been a proponent of the belief that Republicans would take control of the U.S. Senate in the upcoming mid-term elections. Historically the mid-terms go in favor of the party not in power, especially when the sitting President has a poor favourability rating like Mr. Biden. However, my resolve is weakening as the results of special elections and party nominations are rolling in. Democratic candidates are doing better than the polls were indicating in many of the special elections, and nominated Republicans are in many cases Trump followers, perhaps to a fault. After the Supreme Court abortion decision and the FBI raids on the Trump home, I can see more moderate Republicans (I'm assuming there are some) being unwilling to support the more entrenched advocates of Mr. Trump and his beliefs. Normally an election such as this one wouldn't be expected to have much impact on financial markets, but given the large differences between the two parties, potential outcomes are more diverse than usual. For example: Democrats would raise taxes; Republicans would lower them – Democrats would raise regulations on corporations; Republicans would lower or abolish many – Democrats would spend and cause others to spend more on climate change and green energy programs; Republicans not so much. In summary, Republicans are more market friendly because of, or despite, what you might think are the correct policies.

Global geopolitics still leaves much to be concerned about. The war in Ukraine is now over six months old and shows no hope for resolution as Putin increases the size of his army (in many cases by putting criminals in uniform). Europe's largest nuclear plant is in the midst of the fighting and officials are handing out iodine pills (just in case). The world's second largest economy, China, is dealing with a host of problems: COVID lockdowns, a property debt crisis as values slump, drought, energy costs, etc. None of that has dissuaded leader Xi Jinping from confronting the U.S. on just about every front, particularly the future of Taiwan. I find it interesting that both Putin and Xi still intend to attend the G20 meeting in November, and there are rumors Xi and President Biden will have a one-on-one meeting. Try as I might to believe politicians are acting in the public interest, I come across stories like that of former German Chancellor Gerhard Shroeder. Only days before leaving office in 2005 he signed a guarantee to cover any debt default on the Nord Stream pipeline which would bring natural gas from Russia to Germany. That pipeline has made Germany dependent on Russia for energy supply. Not coincidentally, only days later he was made the head of the pipeline construction company, and has since been given major positions at Russian energy companies Rosneft and Gazprom with total compensation estimated at $1 million.

As they say these days, there is much to unpack and little definitive information to help make informed decisions about the market outlook. Bulls and bears both have good arguments but as I said earlier, the Fed is no longer a friend to markets. As long as its policies are focused on slowing growth it will be wise to keep exposure to risk at a minimum.

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