<u>US Rates: Are recession fears overblown?</u>

Mon June 27th 2022

Just a quick travel-diary-come-market-analysis that helped me to organise my thoughts this weekend.

<u>Out-Of-Office</u>

I just got back from the best two-weeker: a road-trip exploring the US South-East, from New Orleans all the way up to New York. The Big Easy to the Big Apple. As a Brit on his maiden visit to the US I was looking forward to all the unique experiences I would have: filling out the ESTA, conversing with strangers, tipping for the first time – and boy did it deliver! My approach to the trip was that of a scrupulous anthropologist: deeply embedding myself within the alien society whilst making careful field notes.

We crossed 11 states and saw lots of different Americas, always aiming to spend the night in small towns. One of my first observations was just how many "*NOW HIRING"* signs there are – see **Holiday Slideshow** at the end. They were mostly advertising for low-wage jobs: wait-staff, cooks, carers, assistants, cleaners, drivers etc. One day in South Carolina this particularly frustrated my search for native *grits*, as many diners were simply closed or running reduced hours. One proprietor explained that they currently had insufficient staff to run a lunch service. After apologising effusively, he recommended a competitor the next town over that might be open: now that's *Southern hospitality*. Which I've learnt is a real thing by the way. Throughout our trip we received an offer from a complete stranger to stay in her holiday home, secured a lunch date with one B&B owner who will be visiting London in a few months and were even asked by one proud mom if we wanted to attend her daughter's highschool graduation the next morning. We politely declined. Throughout our trip, staffing shortages manifested themselves in different ways: most hotels were not cleaning rooms during your stay despite the end of covid restrictions, overworked wait-staff were often too busy to take our order and we had to tour ourselves around a Plantation.

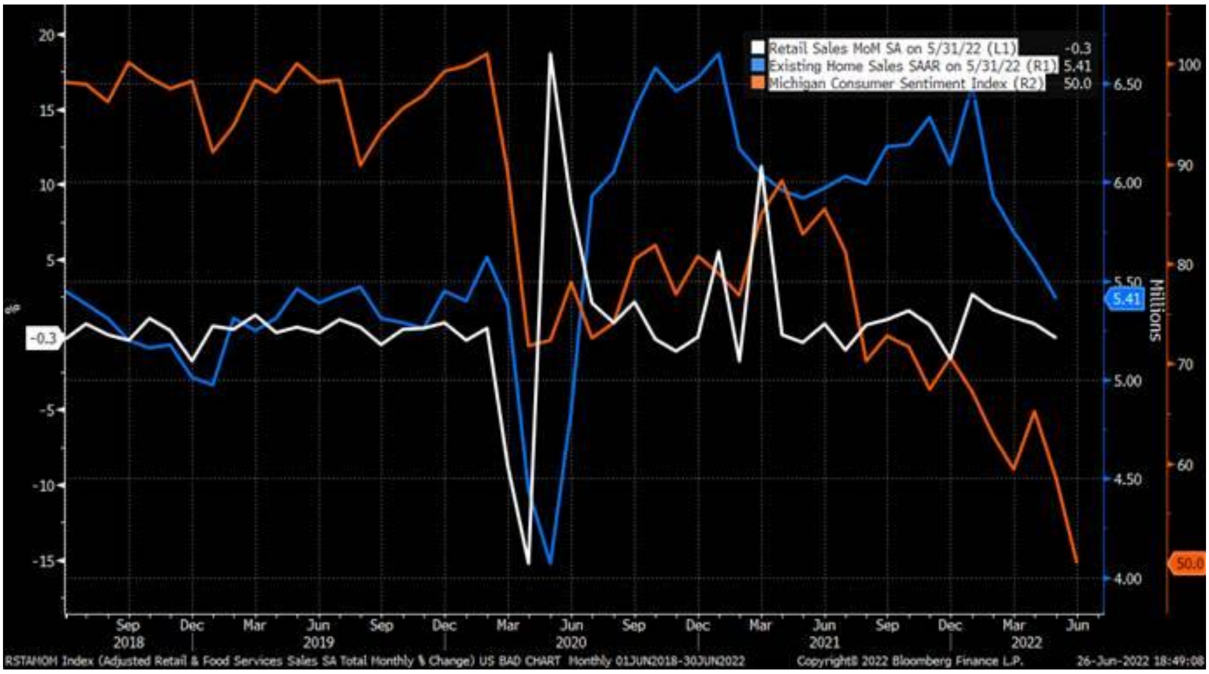
Now, none of this is news. A lot of ink has been spilt on the current US labour market, but it was interesting to see this confirmed anecdotally. Then in New Orleans, right before my eyes, I saw the inflation fly-wheel beginning to whir. I first saw a Domino's store advertising for "*DRIVERS $12 PER HOUR"*. Then, just a few blocks away in the antebellum Garden District, another sign declared "*DRIVERS EARN UP TO $15/HOUR"* on, presumably, a competitor franchisee's front lawn. Employee negotiating power is clearly on the front foot; though I hope applicants are suitably suspicious of qualifiers in job adverts. I was reminded of all the "*Top Tips on Asking Your Boss For a Raise"* clickbait I've recently seen, and only occasionally read.

<u>What a difference a week makes</u>

Back in the office, and from our comfortable thousand foot-view, it seems the narrative changed last week. Some people began the week thinking the Fed were too incompetent to rein in inflation, and ended it thinking the Fed are so incompetent they're almost certainly going to cause a recession. This happened after an accumulation of sour economic data and Powell's testimonial on Weds where he described a soft landing as "very challenging".

The data does appear to point to a slowdown – but it's nuanced – see **Fig 1**. US retail sales <u>fell 0.3% in May</u> for the first time this year. Though these numbers are not adjusted for inflation and reflect mostly goods, whereas consumers are typically returning to services post-covid. We also learnt that May's existing home sales took another leg down, though at 5.41 million they're really just reverting to pre-covid levels. Finally on Friday, the Michigan long-term inflation expectation survey, which Powell expressly used as evidence for entrenched inflation expectations at his 75bp hike, was revised down from 3.3% to 3.1%.

Fig 1: US economy slowing down



These numbers don't necessarily point to complete demand destruction – see **Fig 2**. After a decade of easy financial conditions the US economy still looks strong and able to handle higher rate hikes before wilting. Households and corporates have been deleveraging since the GFC: household debt-to-income ratios are historically low. Initial Jobless Claims have been slowly ticking up over the last few weeks, but at 229k they still signal a very tight labour market. Lastly, May's new manufacturing orders reached a 3-month high – demonstrating solid demand.

Fig 2: Strong fundamentals with robust demand

What's the market pricing in?

Last week Treasuries rallied sharply as basically every bank on the street wheeled out a model estimating a 51% probability of recession over the next year. On 14th June (pre-FOMC) the policy-sensitive 2yr note sat at 3.43%, by 24th June it had dropped to 3.06%. **Fig 3** below shows how, in just one week, the Fed's hiking path has been repriced down by around 20bp. At FOMC on 15th June the Fed predicted it would raise rates all the way to 3.8% by the end of 2023. The market now believes that a faltering economy will force them to turn more accommodative before reaching that. Over the same week headline inflation has retraced even further. **Fig 4** below shows that expectations for the next year are now lower than they were at the beginning of the month, down to 5.15%, as crude-oil prices declined this week on recession chatter. This is despite running at a current YoY of 8.6%.

Fig 3:

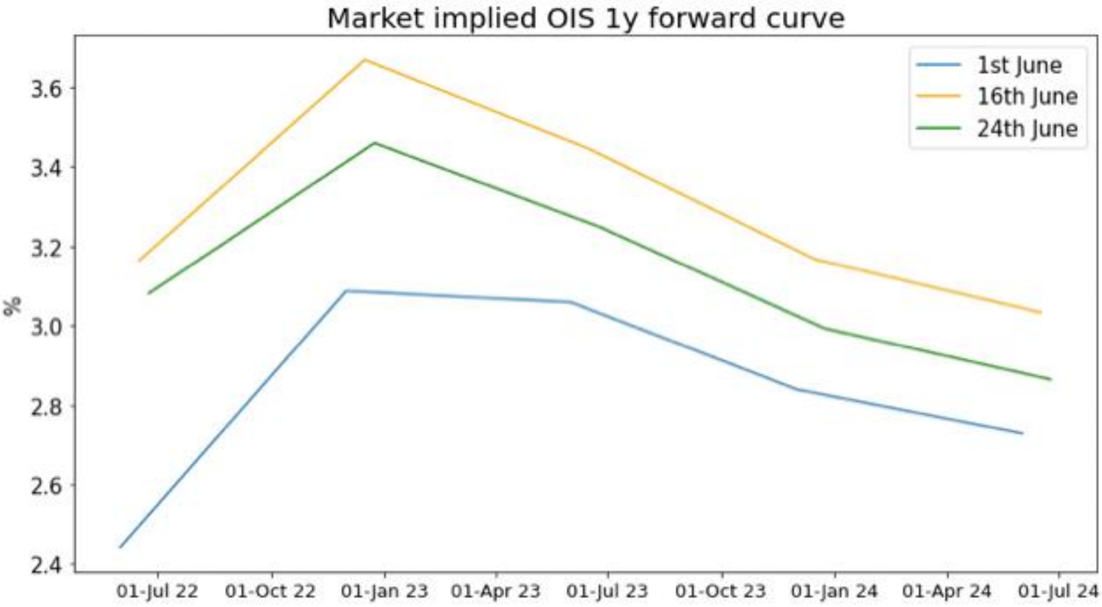
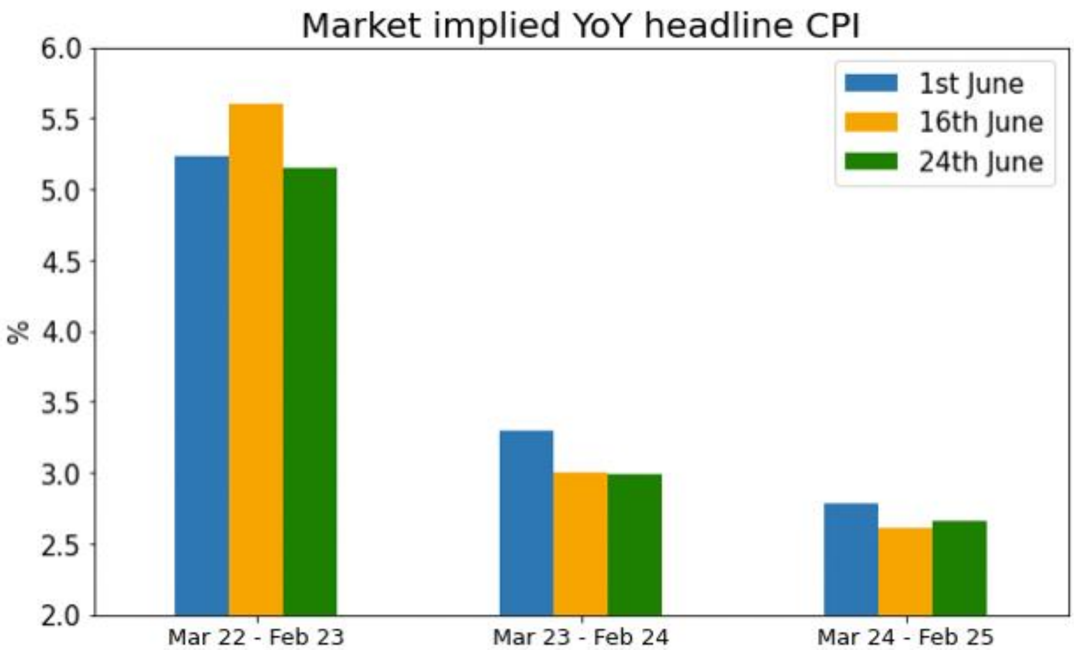


Fig 4:



I imagine rates will continue to hang on every print for a while, though, it looks like last week may have been an over-reaction given the economic data. I think the Fed will be able to stay hawkish for longer. This is best expressed by shorting the 2yr note (enter 3.06%) or paying a 1y1y OIS (enter 3.25%).

I'm not sure I buy into the de-globalisation New World Order that professes structural inflation is here to stay. I do think this is all, dare I say it, *transitory*. But, historically, inflation has been stickier than we expect; it's expensive and time-consuming to re-architect global supply-chains. If prints begin to confirm this view, paying 1y CPI swaps (enter 5.15%) will be profitable.

Other important findings from my trip include: Savannah is better than Charleston (the latter is too preppy for me) and grits are officially disgusting.

Thanks – any comments/criticisms well received,

Tom
All opinions voiced are my own

<u>Upcoming US Economic Prints This Week</u>

Mon 27 June: durable goods orders, pending home sales
Tues 28 June: advance goods trade balance, wholesale & retail inventories, FHFA house price index, Conference board consumer confidence
Weds 29 June: MBA mortgage applications, Q1 final GDP
Thurs 30 June: personal income & spending, PCE inflation, weekly initial jobless claims
Fri 1 July: ISM manufacturing PMI, construction spending

Holiday Slideshow: top-left going clockwise
a) Albany, GA b) Food Lion in Warrenton, VA c) Domino's store in New Orleans
d) A private residence in New Orleans e) Layne's Country Store in Glasgow, VA
f) I have a feeling Layne could have kept the price fixed and adjusted the filling proportions without too many complaints…