US Rates: Are recession fears overblown? Post-mortem

Thurs Dec 29th 2022

On the surface of it, my titular thesis was wrong very soon after I wrote it: US real GDP dropped 1.6% in Q1 and 0.6% in Q2. So technically, recession fears were right on the money.

But really my note was highlighting the sharp about-turn in sentiment around mid-June. On the back of some sour data and gloomy Powell comments, the market felt that the Fed would be forced to pivot much sooner than had been previously anticipated. However, on the ground, as I travelled through 11 states, I saw overheating local economies that were being held back by labour shortages post-covid. In addition, a deeper interrogation of the economic data illustrated an economy that had good fundamentals and could probably withstand higher rates for longer.

At the 15th June FOMC, the Fed predicted it would raise rates all the way to 3.4% by the end of the year, and 3.8% by the end of 2023. Here we are, at the end of the year, and the Fed Funds rate is 4.5% after multiple 75bp jumps. At the 14th Dec FOMC, the Fed now predicts rates will be 5.1% by the end of 2023.

So, how did I do?

Short 2yr note (enter: 3.06%)
Fig 1 below shows that it took a couple of months for the market to realise rate hikes were here to stay. It would have been most profitable to take this position off just after the last 75bp hike on 2nd Nov – which, being at the very upper end of the survey, took markets by surprise. Nevertheless, the 2yr is now at 4.37%. That's a profit of 131bp (ignoring rolling / repo costs) – underwater by at most 24bp for a few days. This view could probably have been more efficiently expressed with a short-end bond ETF.

Pay 1y1y OIS (enter: 3.25%)
Almost exactly six months on, this position would now represent a 6m1y OIS. The market is currently valuing these at 4.60% - a profit of 135bp. This trade was pretty correlated to the above.

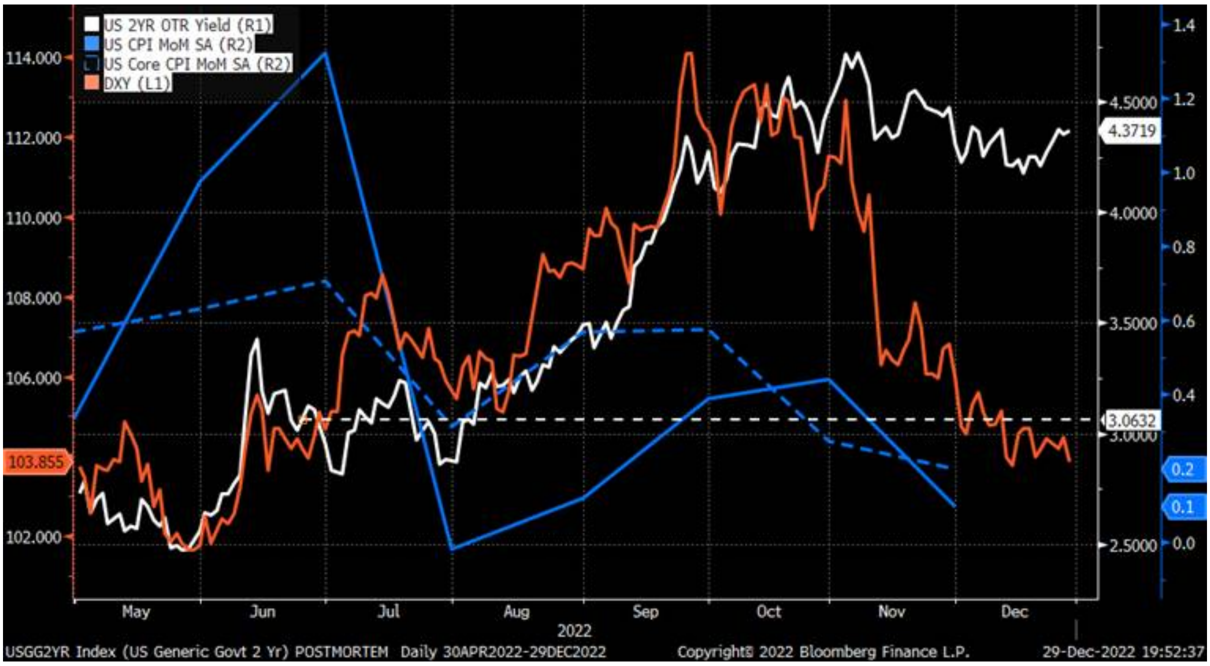
We could ask ourselves the question: why liquidate these positions now? The economy still looks relatively strong: US GDP grew in Q3 and Initial Jobless Claims are still at historic lows. However, other indicators do point to demand destruction: manufacturing orders and existing home sales are falling off a cliff. The Fed is beginning to dent headline inflation and, very quietly, claim a victory, so I expect the bulk of hikes are behind us.

Pay 1y CPI swap (enter: 5.15%)
Back in June, headline YoY inflation was 8.6% and 1y inflation swaps dipped as the market expected an impending recession to break the inflation spiral. The next MoM CPI print came in strong at 1.3% and appeared to confirm my view. But then a global pullback in demand, at the national, corporate and consumer level, caused a steep drop in oil prices. Oil demand was much more elastic than I had expected. This caused the next CPI print to come in slightly negative, though it has increased a little since then – see **Fig 1**. Headline YoY inflation now stands at 7.1%.

Almost exactly six months on, this position would now represent a 6m CPI swap – for which there are no streaming dealer prices. This makes it slightly difficult to value, but we have a couple of data points. A 1y CPI swap starting today is currently priced at 2.43%, whilst the total 6-month CPI change since June is 1.85%. These suggest that we have probably overpaid for our position. Nevertheless, whilst headline inflation has slowed considerably, core inflation is proving much more stubborn – see **Fig 1**. The volatile fuel component is handing the baton over to other, stickier, sectors like rent and health. Given this, I still see inflation risk as skewed to the upside and so recommend holding onto this position even though it's currently in the red.

I suppose two of out three aint bad.

Fig 1. US rates higher for longer



Hindsight is 20/20

Another way to express this original view would have been in the FX market. USD had a similar stumble in mid-June as the market bet on an impending Fed-induced recession – see DXY in **Fig 1**. As other major central banks (Australia, Canada, UK, ECB, Switzerland etc) caught up throughout Sept/Oct the interest-rate differential driving USD began to close, signalling the time to take-profits. Deeper FX liquidity, compared to US Treasuries, could have made this a more efficient vehicle.

Thanks – any comments/criticisms well received,

Tom

All opinions voiced are my own