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INSIGHT

TRADING SECRETS

The Fed's Monkey Business

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Mr. Kane is Co-Chief Investment Officer and a Generalist Portfolio Manager in TCW's Fixed Income Group, a team that oversees over $190 billion in fixed income assets including the over $65 billion MetWest Total Return Bond Fund, one of the largest actively managed bond funds in the world. Under his co-leadership, the MetWest investment team was recognized as Morningstar's Fixed Income Manager of the Year for 2005. Mr. Kane has led the effort to launch a number of fixed income products, including AlphaTrak, Long Duration/LDI, Unconstrained, and Global. Prior to establishing MetWest, he was a fixed income portfolio manager at Hotchkis and Wiley. He also served as a Vice President at PIMCO. Mr. Kane earned a BS in Business from the University of California, Berkeley and an MBA from the University of Chicago Booth School of Business. He is a CFA charterholder.

Central Bankers, and the Federal Reserve chairman specifically, have a tough job, no question about it. Attempting to control the level of inflation and maintain maximum employment in a dynamic and constantly evolving economy through the use of a very blunt instrument, interest rates, is a nearly impossible task. Just like U.S. presidents, there's no doubt the Fed receives too much credit when the economy is performing well and inflation is contained, and too much blame when it isn't. Greenspan was labeled "the Maestro" during the non-inflationary boom in the 1990s, and was also one of the "villains" of the Great Financial Crisis (GFC) for not addressing the financial excesses that were building in the 2000s. Now, Jerome Powell is facing a similar legacy-defining moment: whether he tames the highest inflation in 40 years will likely determine whether he is revered in the history books à la Paul Volker or ridiculed like Arthur Burns, the Fed Chair during much of the hyper-inflationary 1970s.

Given the extremely high stakes, intense scrutiny and their limited control, it would be understandable if the Fed resorted to monkey business. And, in fact, part of why inflation is so high might be due precisely to the Fed's monkey business – but not the kind you might think. The Fed is not being silly, mischievous, or deceitful. No, the Powell-led Fed is earnest and serious in its responsibilities. It's a different monkey business the Fed may have engaged in a few years ago, as it was dealing with the post-GFC issue it couldn't solve, namely low inflation. During the 2012-2019 period, inflation consistently ran below its stated target of 2%. Zero interest rates and quantitative easing (QE) for multiple years couldn't budge inflation, which remained stubbornly in the 1-2% range. The Fed wished for higher inflation and even altered its inflation targeting framework in Fall 2019 (revealed at the August 2019 Jackson Hole Summit) to target average inflation of 2%, implying that periods of below 2% inflation would be followed by periods where the Fed allowed inflation to run above 2%. More than just wishing, the Fed openly articulated a plan to have inflation increase above its long range target.

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Be Careful What You Wish For is a well understood phrase that's been around for many generations and is meant to convey the warning that one's desire or greed might not lead to the outcome one expects, and in fact, might make things worse. This theme runs through literature, movies, books, poems, etc but might be best exemplified in the short story by W. W. Jacobs, *The Monkey's Paw*. In the story, a spell is put on a mummified *monkey's paw* that grants the possessor three wishes, though those wishes come with the warning that there will be consequences for each one. A poor, older couple who come to own the paw initially wish for their home mortgage to be paid. The following day they find out their son has died in a terrible accident that will result in an insurance payment to them that will enable them to pay their mortgage. The couple use their second wish to bring their son back to life, but fearing their son will be returned in a mutilated state, use their final wish to undo their second wish.

The Fed wished for higher inflation, and indeed they got their wish, complete with a global pandemic, a war, as well as food and energy shortages. Perhaps Jerome should have just returned that paw to its sender...

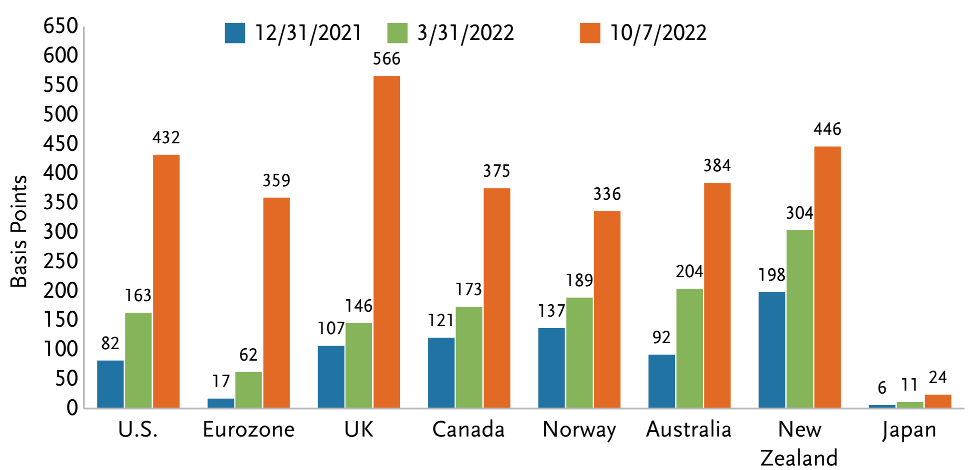
But now that the Fed's wish has come true, they are in an all-out effort to bring down inflation and return it to their long run 2% target. Three hundred basis points of tightening of the Federal Funds rate in six months, with another 125 likely on the way before year end suggest the Fed means business (they are not *monkeying around*), as does their plan to implement quantitative tightening (QT) to the tune of ~$1 trillion per year reduction in the Fed's balance sheet. The FOMC (a group of seven Governors and five regional Fed Presidents) is normally a disparate group of hawks and doves leaning in different directions as it pertains to easiness and tightness of monetary policy. No more... now, it's *monkey see, monkey do*, as we have 12 hawks circling the public speaking circuit all parroting each other trying to show their inflation fighting resolve.

The key questions for market participants are (1) can the Fed get it done? (2) how high will rates have to go to accomplish their goal? and (3) what will be the economic and financial market fallout as a result of their actions? Let's address the questions one by one.

Can the Fed Get the Job Done or, alternatively, can the Fed get the Inflation Monkey Off Its Back? To quote the famous sixties rock group (you guessed it) *The Monkees*, ..."I'm a Believer" they will get it done, though it may take some time to get there. The case that the Fed is well on their way to getting inflation under control is as follows:

- Monetary policy is being tightened around the globe by almost every major developed (and many emerging) market central banks. The degree, speed and breadth of interest rate change is without precedent. Toss in the degree of quantitative tightening (also unprecedented) and you have the equivalent of using a howitzer to dig a hole.

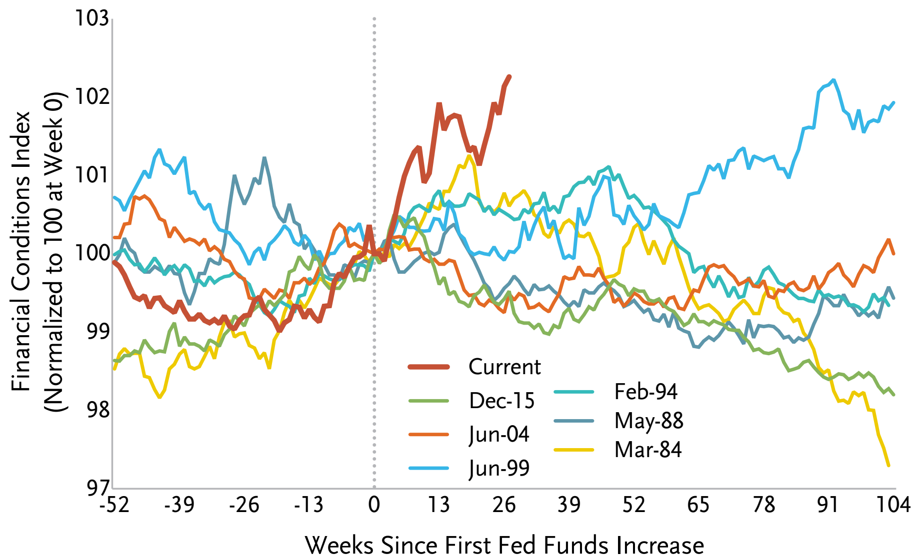
Market Expectation of Cumulative Rate Hikes in 2022-2023



Source: Bloomberg, TCW

- Leading indicators suggest that monetary tightening is already working. Commodities are down 20+% from their peak. Equity IPOs and high yield corporate bond issuance are at 10 year lows. Broadly speaking, financial conditions in the U.S., as measured by the Goldman Sachs Financial Conditions Index (comprised of the level of rates, shape of the curve, change in the value of the US dollar, and equity prices), have tightened at a much faster pace than any of the past 8 Fed tightening cycles. All the previous episodes ended with significant economic slowdowns and/or recession, and lower inflation. History likely repeats itself here.

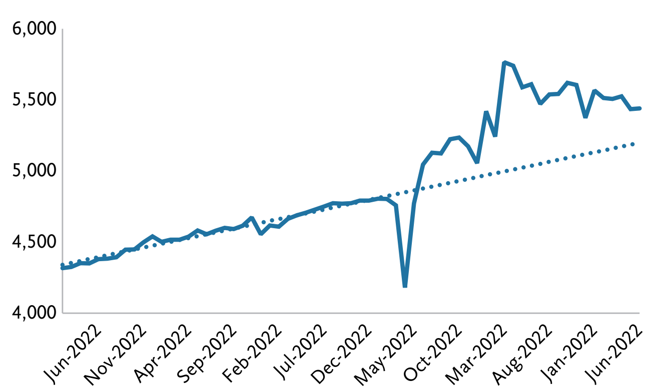
Financial Conditions Before & After Fed Liftoff



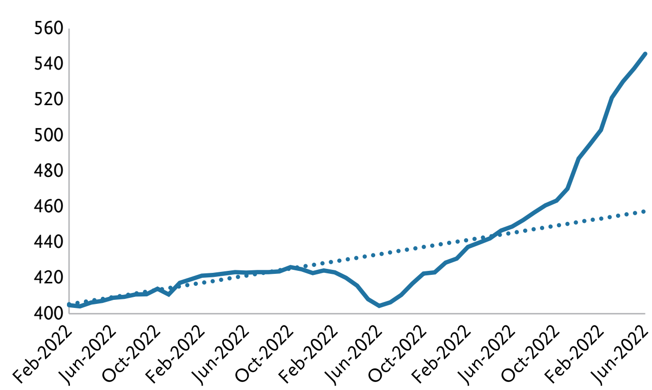
Source: Goldman Sachs, Bloomberg

- Consumer demand is being impacted (partially destroyed) by inflation and is shifting quickly away from goods. The result is building inventories at many retailers and likely discounting activity in near future.

Real Spending on Goods (2012 USD Billions)



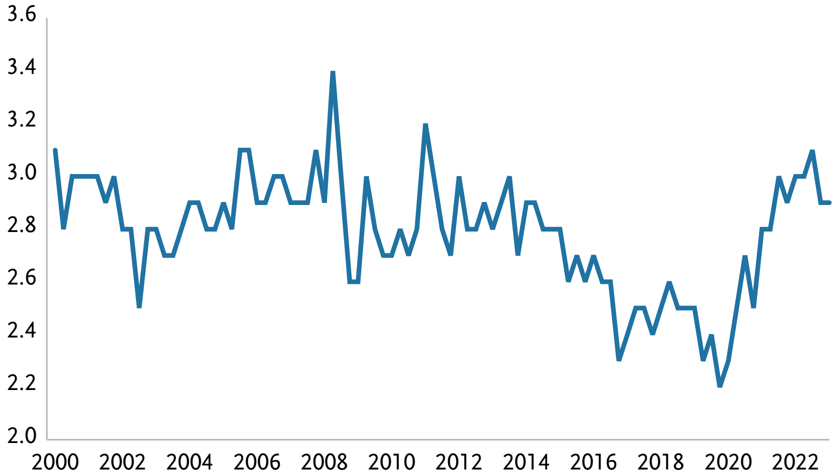
Retail Inventories ex-Autos (USD Billions)



Source: Bloomberg, Census Bureau

- Inflation expectations remain well anchored. Though higher than the lows in the immediate aftermath of the pandemic, inflation expectations (as measured by surveys and the market via TIPs) are at long term averages. Recently, long term break even inflation rates in the TIPs market have declined ~0.50% to the low 2% area. Inflation expectations have a strong self-reinforcing dynamic with consumer behavior, suggesting that a 70s style wage-price spiral is unlikely.

University of Michigan 5-10 Yr Median Inflation Expectation



Source: University of Michigan

TIPS 5Yr/5Yr Forward Breakeven Rates

Source: Bloomberg

- The Fed is looking at a lagging indicator, inflation, to gauge its policy. Because monetary policy impacts the economy with a lag and inflation with a further lag, the Fed is effectively driving the monetary policy car by looking in the rear view mirror. By tightening until inflation falls significantly, the Fed is almost guaranteeing that they will overtighten and push the economy into recession and inflation to (or possibly below) target.

How High will Rates Have to Go? This is a much tougher question to answer than the first one above. TCW's value oriented investment philosophy and process is built around the humble recognition that it is a fool's errand to try to call tops and bottoms of markets. A disciplined process of adding duration as rates rise, with the understanding of the long term self-correcting/ mean-reverting nature of interest rates is what we adhere to. We have brought our durations gradually up to be modestly above index in 2022, and will continue to add should rates continue to rise. While not knowing for sure when or at what level the peak in rates will be, real rates above 1.5% and financial conditions tightening rapidly suggest to us that we are much closer to the end than the beginning of the process.

What Will the Economic and Market Fallout Be? In terms of the economy, put us in the ain't-likely-to-be-a-soft-landing camp given our arguments above regarding the degree of monetary tightening, the lagged effects of monetary policy, and already nascent signs of an economic slowdown. Layer on the pull back of pandemic-related fiscal stimulus and the severe economic challenges facing many of our major trading partners in Europe and China, and we find it hard to see anything but a recession for the U.S. in 2023. In terms of the market fallout, we are collectively feeling it nearly every day as stocks are down 20+% and bonds -15% year-to-date. The good news, at least from our standpoint, is that the downside economic risks are fairly fully priced into much of the fixed income market. Agency mortgaged-backed securities are at historically deeply discounted prices and wide spreads. Senior non-agency residential mortgaged back securities are priced attractively at 2-3% yield premium to Treasuries with solid credit fundamentals even in a declining housing market. Likewise, certain areas of the investment grade corporate bond market, including senior debt issued by U.S. money center banks, at spread above 200 bps offer great value. These are sectors we've increased our allocation to in 2022 and are overweight relative to indices. Other areas of the fixed income market, notably high yield and emerging market debt, while more attractively priced than a year ago, are still not at levels typically associated with the recessionary environment we believe is coming.

Final Thought As we gradually prepare client portfolios for the eventual end of the current Fed tightening cycle and the transition to the next easing cycle, we are getting long duration and overweight high quality "spread sectors" while we wait for the end of cycle buy opportunity in lower quality credit. At the same time, we are reminded once more of the Monkey's Paw story as the Fed now wishes for lower inflation… they need to (again) be careful what they wish for. ■

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