Philequity Corner (August 1, 2022)
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Slowing down the pace

After falling 20.6% in the first half of the year, the S&P 500 rose 9.1% in July, posting its best monthly return since November 2020. Last week, US stocks moved higher for three straight days despite the Federal Reserve's (Fed) 75 bps interest rate hike and the contraction of US GDP in 2Q22.

Another 75

After a 75 bps rate increase in June, the Fed hiked its policy rate by another 75 bps last week, with the federal funds rate now at 2.25-2.5%. The unusually large rate hike is meant to tame US inflation which rose to a four-decade high of 9.1% in June. Powell maintained that the Fed seeks to "bring demand into better balance with supply in order to bring inflation back down to our 2% goal and keep longer-term expectations well-anchored."

Another ominous bottom?

The move of the stock market last week reinforces our thesis that the market may have bottomed at 3,666 on June 16. We enumerated signs of a possible market bottom in our previous article (see *Market Bottom?*, July 25, 2022). We explained how uncanny it is that we are looking at another ominous bottom 13 years after the S&P bottomed at the devilish 666 on March 6, 2009. Since hitting an intraday low of 3,636 and a closing low of 3,666, the S&P is up 12.6%. The Dow and Nasdaq gained 9.9% and 16.4% from their recent lows.

Markets fell because of the steep rate hikes and accelerated Fed tightening that were meant to address soaring inflation. However, these gave rise to concerns that tighter financial conditions would choke the economy and cause a recession. Powell's statement regarding a slower pace of tightening reassured investors and triggered a surge in stocks, a decline in bond yields, a narrowing of the 2y-10y yield inversion, and a pullback in the US dollar (DXY).

Pause and pivot

In his speech, Powell did not provide any specific guidance for the next meeting. Instead, he stressed that the Fed will make policy decisions on a meeting-by-meeting basis based on incoming data and the economic outlook. Powell explained, "As the stance of monetary policy tightens further, it will likely become appropriate to slow the pace of increases while we assess how the cumulative policy adjustments are affecting the economy and inflation." With Powell's announcement, the Fed would probably pause from hiking rates and eventually pivot from its monetary tightening.

No longer behind the curve

Renowned bear, famed bond investor, and Fed critic Jeffrey Gundlach of DoubleLine Capital changed his tune right after Powell's speech. Gundlach now believes that the Fed is no longer behind the curve. He pointed that the federal funds rate has caught up with the 2-year US Treasury yield. Powell explained that the policy rate is right in the range of what the Fed views as neutral. This is a level of interest rates that is neither contractionary nor expansionary. According to Mohamed El Erian, chief economic adviser at Allianz, "the Fed now believes that it has already done the bulk of what is needed to tighten monetary policy" to deal with inflation. Goldman Sachs noted that getting to the Fed's end-2022 terminal rate of 3.4% would be consistent with smaller rate increases for the rest of the year. Popular CNBC host Jim Cramer urged investors to capitalize on the buying window for stocks as the Fed nears the end of its tightening cycle.

Not in recession

Last week, news came out that the US economy shrank by 0.9% in 2Q22. This was preceded by a 1.6% contraction in 1Q22. This fits the 'rule of thumb' definition of a recession which is characterized by two negative quarters of GDP growth. However, the National Bureau of Economic Research (NBER), has not called a recession in 1H22. NBER analyzes different factors to determine if the economy is in recession. These are: 1) real personal income minus transfer payments; 2) nonfarm payrolls; 3) employment; 4) real personal consumption expenditures; 5) sales adjusted for price fluctuations; and 6) industrial production.

In his speech, Powell explained that he does not see a recession because many areas of the US economy are doing well. He specifically mentioned the strong labor market and the current unemployment rate of 3.6% which is near a 50-year low. He also noted that 2.7 million people were hired in 1H22. Powell expounded, "It doesn't make sense that the economy would be in a recession with this kind of thing happening. Overall, the continued strength of the labor market suggests that underlying aggregate demand remains solid."

Taking cues from the Fed

In a recent article, we highlighted the importance of taking cues from major policymakers. We explained that comprehending their mindset can help us determine the direction of the economy, interest rates, stocks, and currencies (see *Taking a cue*, July 11, 2022). In the current case, we are closely monitoring the Fed to see how it will steer monetary policy in these challenging times. While a deeper recession that may bring down the market is still possible, the Fed's recent pronouncements strengthen our view that the market is in a bottoming-out process. Their words and actions will help us navigate this tricky and volatile phase.

We have written many articles that highlight the importance of reading through the words of central bankers and policymakers. Listed below are some articles that show how we utilize the pronouncements of central bankers as guideposts for our investment decisions.

- *The power of words,* June 29, 2015
- *Every move you make*, November 9, 2015
- *I'll be watching you*, June 13, 2016
- *More than words*, September 19, 2016
- *Every word you say*, July 24, 2017

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