Episode 28

First quarter check-in with Lara Rhame

Chief U.S. Economist Lara Rhame reflects on all that's happened in the market thus far in Q1, and what could lie ahead for the rest of the year.

Kara O'Halloran (00:06):

Welcome back to FireSide, a podcast from FS Investments. My name's Kara O'Halloran, and I am joined by our Chief U.S. Economist, Lara Rhame. Lara, welcome.

Lara Rhame (00:15):

Hi, thanks.

Kara O'Halloran (00:16):

So I have to break the fourth wall for a second. We recorded a version of this podcast a little over a week ago, and were all set to release and then the news broke of Russia invading Ukraine.

Lara Rhame (00:27):

Yeah.

Kara O'Halloran (00:28):

We did record an emergency podcast that day with some of our initial thoughts and reactions. We'll get into more of that during this episode, but I still want to talk about a lot of the things that we talked about on that episode, which was really a mid quarter check in all things markets and economy. But I think it's really important to rerecord it from our new paradigm. Right?

Lara Rhame (00:52):

Absolutely.

Kara O'Halloran (00:54):

So thank you to our producer, Erin, for bearing with us through all of this, but we're excited to dig into all of this. So Lara, let's start with the thing that has been top of mind for the last week, Russia-Ukraine. In our initial episode, the first thoughts were, "Okay, probably not a major direct U.S. impact." Have your views changed now that we've had a week or so to digest all of the news?

Lara Rhame (01:21):

Yeah. I don't think there's anything more difficult than looking at just the horrible humanitarian crisis that's developing there. I know you and I both are just thinking so much of people whose families are in danger, of people who are on the front lines there. I think to the extent that we just do want to focus on just the U.S. economy, what the direct impact is. The impact on growth right now is not expected to be significant. By that, I mean, Russia is not a significant trade partner for the U.S. and a lot of the big Ukrainian exports like wheat and corn are not going to be a disruption for us because those are things that we produce.

Lara Rhame (02:18):

Inflation is something that may really impact our economy or continue to impact our economy. We've seen in the wake of the invasion oil prices just skyrocket and they were already elevated. Grain, some of those other commodities across the board have also risen significantly. So just really tough timing given that households were already experiencing price pressure in energy and food. I know that's something we're going to talk about in depth, but from my perspective, the really direct impact on the economy is less obvious, and we may yet get some secondary impact, but that may take time to develop.

Kara O'Halloran (03:01):

Yeah. Unfortunately, the things that you listed that we're seeing elevated prices on are some of those household staples, right. Gas and food, and the things you don't want to hit.

Lara Rhame (03:14):

Yeah. The direct economic impact is much more likely to hit Western Europe. And that's where we're just seeing some really acute pressure on electricity prices, on natural gas prices. When you think about the global flywheel of growth, that's a potential loss of momentum. China's economy is not at a strong place right now. Those are the impacts that may well circle back to the U.S. economy, but that may take some time to be clear.

Kara O'Halloran (03:48):

Yeah. I think I should have said this from the get go, we're recording on March 2nd. So line in the sand, it feels like it's been a really long time, it's been less than a week since the invasion happened. So still sifting through all of the potential outcomes and it's a constantly evolving situation.

Lara Rhame (04:04):

Yes.

Kara O'Halloran (04:06):

Of course, I think this is something we will be talking about for quite a while.

Lara Rhame (04:09):

You're right.

Kara O'Halloran (04:11):

I want to zoom out now. Right. It's hard to think about what's gone on in the year before just this past week, but it's already been a really busy year, right. A lot has happened. We had a lot of market volatility before this. We had a lot of interest rate volatility. We had a lot of talk about the Fed. The Fed has made even more hawkish pivots, and we're going to get into all of that. But I think it'd be helpful if you could just set the stage for us with your growth forecast for the rest of the year.

Lara Rhame (04:44):

Absolutely. The U.S. economy right now is looking really strong. Already in the first quarter, we got January household spending rising 2.1% in real terms 1.5% gain in the month. Clearly the recovery from the Omicron wave has been really sturdy. We're just seeing this healthy growth in business investment, in business sentiment and really across the board in a variety of economic activity. So as we look ahead, the U.S. economy still has significant momentum. In the fourth quarter, we're looking for real GDP of another 6%, and for those strong numbers to continue in the first half of the year, the second half of the year, we are likely going to decelerate towards something that feels a little more pre pandemic. Your two to 3% range. I want to address the fact that inventory accumulation, it's a weird concept, right? We think about the fact that our economy, every quarter, we're really trying to measure how much we make. So if we make extra pens and we put half of them in a warehouse that's inventory accumulation, we don't count that the next quarter when somebody buys them to avoid double counting.

Lara Rhame (06:11):

But inventory accumulation stands to really add to top line GDP throughout the course of this year. That is, to me just as solid as any other growth. I think that's something you may hear other pundits say that inventory accumulation isn't "real growth" it's still production, it's still jobs, it's still output. So from where I sit, the economy has strong momentum, the household still is looking very positive and is still spending actively. At every wave of the coronavirus that we meet, we become better at managing through it and I think the Omicron wave really proved that.

Kara O'Halloran (06:55):

Yeah. I just think about the resiliency that we've seen. It felt like the Omicron wave-

Lara Rhame (07:00):

That's the perfect word.

Kara O'Halloran (07:01):

Yeah. It has never ceased to amaze me over the last couple of years. I'm glad that we started where we did, because I think that inflation remains in the headlines. I don't think you can open a paper or go online and not see-

Lara Rhame (07:18):

Or have dinner with your family.

Kara O'Halloran (07:19):

Exactly. Literally-

Lara Rhame (07:20):

My 11 year old is talking about inflation.

Kara O'Halloran (07:23):

You're raising them well over there.

Lara Rhame (07:24):

Yeah.

Kara O'Halloran (07:27):

That clouds everything, right. We're talking so much about inflation and of course, we're going to talk about inflation in a minute, but I think it's just clouds that really strong economic growth that we've seen. So thank you for setting the stage there. Clearing that up first.

Lara Rhame (07:39):

Yeah.

Kara O'Halloran (07:41):

I want to pivot to central banks.

Lara Rhame (07:43):

Okay.

Kara O'Halloran (07:43):

This has been a big topic of conversation. The rate hike expectations, the moves that we've seen have been pretty crazy. So I want to just tick through them just to show how wild they've been. So August 1st we were expecting one federal rate hike. Markets are pricing in-

Lara Rhame (08:00):

In 2022.

Kara O'Halloran (08:00):

Thank you.

Lara Rhame (08:01):

Yes.

Kara O'Halloran (08:01):

Well, markets were pricing in one Fed rate hike in 2022, as of December 31st, we were pricing in three rate hikes. A week and a half ago, we were pricing in six to seven and a lot of people were talking about a 50 basis point rate hike in March. Even just yesterday, we saw hikes being priced out, we were at five hikes and now we're back between five and six. So it's just moving so, so quickly, the Fed is moving is meeting, I'm sorry, freudian slip maybe, the Fed is meeting in two weeks. We heard from chairman Powell today in congressional testimony. So walk us through, what do you see happening at that March 6th team meeting?

Lara Rhame (08:42):

I think Powell really made clear today that they were pretty set on raising rates at that meeting, 25 basis points. I think the name of the game for the Fed speakers is going to be trying to remind markets that they have long run flexibility. There's going to be no autopilot on this rate hike cycle. But that said, right, think back to the Fed's dual mandate, right? Full employment and controlled inflation, which they define as averaging 2%. Well, both of those are unemployment rates 4%, so well below where they would consider full employment and inflation's 7.5% right now. Both of those are strong green lights that they should be raising rates. Powell's message today, and it's been his message has been, the economy can take it. Our economy is looking solid, it's got positive momentum.

Lara Rhame (09:46):

This is the appropriate policy response to really just inflation that has arguably surprised them at every turn and being higher than they've expected. It's really come on like a freight train and I think it's going to get worse before it gets better. That's going to keep political pressure on the Fed to do something about it.

Kara O'Halloran (10:08):

I want to clear up, so do you think the events of the last week change anything when it comes to the meeting in a couple of weeks?

Lara Rhame (10:16):

No, I don't. We did have that testimony this morning and I actually really see the first half of the year still evolving as we expected. With the rate hike in March, in may, in June, unless we really get just such acute market volatility. But so far, this sort of what I view as a more rational level of uncertainty being reflected in markets, I think this really gives the Fed the ability to focus on underlying economic fundamentals, which are pointing to the need for higher interest rates.

Kara O'Halloran (10:56):

So that brings up another question for me though, I think back to 2018, when we saw the Fed, that was the last Fed hiking cycle. The fourth quarter of 2018 ended up being the tail end of that cycle. We saw a lot of market volatility and then the Fed stopped hiking and then eventually cut rates, then I think three times the next year. We didn't have inflation then. Right. We had the luxury of possibly of being a little more flexible then. We're facing 7% inflation right now, so should we see more market volatility, does that change the Fed's calculus at all?

Lara Rhame (11:31):

So two separate answers to that question. First of all, the swing that we have seen in rate hike expectations in this cycle versus last cycle is very different. Of course, inflation just really erupting from really every major sector of our economy is a radically different situation that we've experienced in the last 40 years, right? This is the Fed's nightmare that we're seeing inflation circle back into wage gains. I think there's concern that it will kick off this inflation wage spiral that they want to try to take the wind out of, they want to try to decelerate that cycle. So very different situation from what we experienced in 2018. I think Kara, an important part of this is the discussion of quantitative tightening.

Kara O'Halloran (12:30):

You beat me to it.

Lara Rhame (12:30):

Yeah.

Kara O'Halloran (12:31):

It's where I was headed next.

Lara Rhame (12:39):

I think of the Fed rate hike cycle in three steps right now. The first step was to take their foot off of the gas, right? I'm going to use a car analogy, let's take their foot off the gas, and that was when they stopped quantitative easing. That was the emergency measure that they put in during the depths of the great lockdown that we had in 2020, and they've kept that in place. So take your foot off the gas, stop quantitative easing that winds down mid-March. The second step is putting your foot on the brake, right? Hitting the brake, those are the rate hikes. The third part of this removal of this rate hike cycle and this shift that the Fed is doing is what I would compare to steering towards an uphill. It's an additional way to slow us down and it's quantitative tightening, which is shrinking the balance sheet by allowing those excess accumulated assets to start running off by not repurchasing them.

Lara Rhame (13:44):

That is truly a black box. What do we mean by that? When we talk about Fed rate expectations, we have a futures curve that clearly show is what markets are expecting. We don't really know what markets are expecting for quantitative tightening. The Fed hasn't given us… They've talked about June. They haven't given us any framework for that, so it's very hard to know what markets are pricing in. And finally, the last time they tried this, you talk about 2018, was the last time they tried this, didn't end well. So I think when we look at volatility right now and we think about where it could come from throughout the year, to me, that is the glaring concern that I have.

Kara O'Halloran (14:33):

Yeah. I think reemphasizing the point that they've literally only tried to do quantitative tightening once before.

Lara Rhame (14:39):

Yeah.

Kara O'Halloran (14:39):

[inaudible 00:14:39] had to do it once. So really another unknown coming at us pretty quickly too.

Lara Rhame (14:47):

Yeah. Yeah.

Kara O'Halloran (14:48):

I think we'll all be watching those minutes out of the March 16 meeting to see if there's any indication there.

Lara Rhame (14:54):

Yeah.

Kara O'Halloran (14:55):

So Lara, we talked about the Fed, we're talking about the short end of the yield curve, right? The Fed funds rate is really the anchor of the yield curve. I want to talk about down the longer end. We've seen long term rates, extremely volatile this year. We saw the 10 year cross 2% for the first time, since 2019, a few weeks ago, after the Russia-Ukraine invasion, the 10 year's fallen, I think maybe 30 basis points, something like that in that flight to quality. Walk us through some of the dynamics if you will, starting back in January, what has been driving long term rates this year? Is it a Fed reaction? Is it not? All of that, walk us through some of that, if you will.

Lara Rhame (15:35):

Well, just remember back before the pandemic, we had real interest rates right around zero. You had the 10 year around 1.9%, you had inflation around 1.9%. Inflation expectations were 1.9%. All of it meant real rates were zero, it's low, it's too low for a healthy savings dynamic to develop in a country. But that's where we were and then since the pandemic we've really had deeply negative, real interest rates. And so I think there's a natural correction back towards zero that took place as the Fed, I think walked back a lot of these emergency liquidity measures and the markets looking at solid growth, looking at positive growth momentum, are moving back towards better health, better balance. That really caused long term interest rates to recover significantly. It was really a move in real interest rates.

Lara Rhame (16:46):

There's no doubt in my mind that were it not for this just exceptional geopolitical shock, the 10 year would be higher than it is right now, we would be above 2%, and I think as we start to see the Fed rate hike cycle take more on more traction, long term rates may yet recover. But right now you're seeing concerns about U.S. growth keeping 10 year interest rates down. You're seeing concerns about global growth impacting the U.S. 10 year, and flight to quality. They're all related to each other, but there're specific ways that the yield curve reflects the global financial conditions. This really this severe flattening that we're seeing right now, I think is really reflects global growth concerns and flight to quality, not just what we're seeing in the U.S.

Kara O'Halloran (17:44):

So you just brought up the flattening yield curve, and this is an indicator that we watch very closely, right? It's really remarkably reliable that the yield curve has inverted about a year before each recession. We talk often about what happened in 2019, the yield curve inverted, and then the pandemic happened and just how crazy of a coincidence that was.

Lara Rhame (18:07):

Or was it, Kara?

Kara O'Halloran (18:08):

At least I hope it was a coincidence. Who knows. But that one is just crazy to me. So what are you seeing in the yield curve right now? It has flattened significantly. Is it sending you any signals right now?

Lara Rhame (18:19):

It's flattened significantly. It sends me the signal that markets are very nervous about growth and global growth prospects. Again, more so global than the U.S., but until the yield curve inverts, I view this as more of a broad sentiment indicator, that really an indicator of an imminent recession. Just a reminder when the yield curve inverts, it means that 10 year rates are lower than say two year interest rates or the Fed funds rate. That has reliably occurred about a year to 18 months before we get a recession. So right now the yield curve is still positively sloped. I think at last check, it was 35 basis points. It's flat, don't get me wrong, but it can stay flat like this for years at a time, we recently saw that mid 2017 to 2018, it was flat right around where we are right now. So all that's to say until it really goes negative, I'm not hitting the panic button about a recession at all.

Kara O'Halloran (19:32):

Okay. Good.

Lara Rhame (19:33):

Yeah.

Kara O'Halloran (19:33):

One less thing to worry about.

Lara Rhame (19:35):

Definitely.

Kara O'Halloran (19:37):

So I want to know where you see the 10 year going for the rest of the year. I think coming into the year, your forecast was four, 2%, maybe towards the end of the year, we hit that a little sooner than you expected. The moves of the last week have been put you back in line with your forecast coming to the year. Not for a good reason obviously, but where do you see things going from here?

Lara Rhame (19:56):

Yeah. Let me just also say that so much of what I had expected to happen in 2022, seemed to have been front loaded in the first six weeks of 2022.

Kara O'Halloran (20:07):

It's been a long year.

Lara Rhame (20:09):

It's really been.

Kara O'Halloran (20:10):

It's been a long two months-

Lara Rhame (20:11):

Hard to believe it's only March 2nd.

Kara O'Halloran (20:13):

Yeah.

Lara Rhame (20:16):

Yes. I have been very cautious at expecting long-term rates to rise. I think something that is so critical to remember is that when the Fed raises rates, long-term interest rates tend to rise somewhat, but do not match Fed funds rate hikes one for one. Back in the 2000s, we had a 525 basis point rate hike cycle. The 10 year rose a hundred basis points over that time. In 2016, '17, '18, the Fed raised rates a total of 225 basis points. Once again, the 10 year only rose a 100 basis points. So I do expect the 10 year to push higher, but it will lag the increase that we see in the Fed funds rate and the 10 year typically peaks early in the rate hike cycle.

Lara Rhame (21:23):

So that's another thing to, I think, keep in the back of our minds when we look for some renormalization long term yields. The biggest question I get is inflation's at 7.5%, the last time inflation was this high, the 10 year was at 8.5%. What's changed right now? It's all of the same factors we've been seeing, demographics, low global growth, low potential U.S. growth, and negative long run interest rates around the world, and add to that this additional geopolitical uncertainty, all of that is just keeping U.S. interest rates low. Boy, that is just crushing the real returns of every investor out there. It's awful.

Kara O'Halloran (22:13):

It's really has been the driving force of markets this year. I'm talking prior to the geopolitical tensions, we saw cascading effects throughout markets because of these interest rate increases.

Lara Rhame (22:27):

High yield spreads have risen.

Kara O'Halloran (22:30):

Absolutely. Yep. Yeah.

Lara Rhame (22:32):

Another thing talk about something that everybody's watching is a bell weather for market function. I think high yield spreads are top of the watch to stare.

Kara O'Halloran (22:42):

Absolutely. Yeah. High yields had one of its worst, I think it's worst start to the year ever. But if you actually decompose that move, we're seeing that the highest rated bonds have underperformed significantly. Again, I'm talking pre the last week and we can go into the last week as well, but atypical of a typical risk off environment. So in that environment, you expect those triple-C bonds, the riskiest, the lowest rated assets to underperform. We're seeing them outperform pretty significantly. So that really tells us that credit is really moving because of this rate story, because of these. But over the long term, we also have done a lot of analysis on this, you can tell this is where I spend a lot of my time.

Lara Rhame (23:32):

You're getting very excited. I like it.

Kara O'Halloran (23:33):

I just perked up in my seat. But over the long term, it's really credit fundamentals that went out. We just talked about how the economy is on really solid footing.

Lara Rhame (23:43):

Yeah.

Kara O'Halloran (23:44):

Revenue, earnings growth, really solid, default rates are below 1%. Fundamentally credit has a very solid backdrop and we do expect that rate impact to be near term and that over the long term, high yield has been extremely resilient.

Lara Rhame (24:01):

Earnings too. When you look at equities, I think that's something to keep in mind as well.

Kara O'Halloran (24:05):

Absolutely.

Lara Rhame (24:06):

Andrew Korz just wrote his piece on equity markets during rate hike cycles and I loved one of his subheadings was earnings can take a hike.

Kara O'Halloran (24:14):

Yeah.

Lara Rhame (24:16):

Looking at earnings three years out after a rate hike cycle starts, every rate hike cycle of the last seven, there's been a positive trajectory there. I think the Fed raises rates when the economy is doing well and we are back in that situation.

Kara O'Halloran (24:31):

Yes.

Lara Rhame (24:34):

We're in this part of the cycle where the economy's doing well, but because of policy, financial markets are feeling the volatility.

Kara O'Halloran (24:42):

Yeah. I think that volatility is something we expect unfortunately, to remain for a lot of the year and things are changing really quickly. So you'll be a constant presence on this podcast this year.

Lara Rhame (24:57):

Fasten your seat belt. It's going to be a difficult [crosstalk 00:25:01].

Kara O'Halloran (25:00):

Oh, seat belts.

Lara Rhame (25:01):

Again with the cars.

Kara O'Halloran (25:03):

Well, yeah. Now we have to bring up the really big thing that's changed in this year.

Lara Rhame (25:08):

Oh yeah.

Kara O'Halloran (25:10):

If you've listened to any of our podcast episodes over the last year, you know that Lara has been watching inflation numbers very closely for a very personal reason. She had needed to buy a car. Very unfortunate timing, but you did it.

Lara Rhame (25:23):

I did it. February retail sales should also be significantly higher because that is my personal contribution.

Kara O'Halloran (25:28):

Yeah. Well, congratulations.

Lara Rhame (25:29):

I forgot I was so grumpy about it in past podcast episodes, Kara, I'm in a better mood now. I bought American, I have a great car.

Kara O'Halloran (25:35):

Inflation it impacts us all. Well, very exciting. As much as I will miss our rides to work, I used to pick you up sometimes, but you know I can't drive in your neighborhood, it confuses me, one way is my close streets. So I'll miss those car rides, but I'm very excited for you.

Lara Rhame (25:51):

Well, Kara, I hope we'll still get to carpool occasionally.

Kara O'Halloran (25:54):

I think we can make that happen. We do have a lot of events coming up in the next month.

Lara Rhame (25:58):

March is right around the corner. Isn't it? International Women's Month.

Kara O'Halloran (26:01):

It sure is. I think we have a lot of women and wine events and I'll ask for a ride for those.

Lara Rhame (26:07):

We have webinars. We have the women and wine events, which have been so successful. I'm really excited. I feel like this is the first year anniversary of your podcast.

Kara O'Halloran (26:19):

Exactly.

Lara Rhame (26:19):

I think our first ever, and it wasn't even a FireSide branded show, our first ever show I think was on International Women's Day. I don't I could even go back and listen to that, but how far we've come.

Kara O'Halloran (26:32):

More importantly, we need to celebrate that too.

Lara Rhame (26:34):

Absolutely. There's going to be a lot to celebrate in March.

Kara O'Halloran (26:37):

A 100%. It's going to be great. I'm excited.

Lara Rhame (26:39):

Yeah. Great events.

Kara O'Halloran (26:40):

All right. Well, thanks so much, Lara, as always for joining us. We will have you back on, there's going to be plenty to talk about for the rest of the year. So really excited to have you along for the ride.

Lara Rhame (26:49):

Absolutely. Thanks again, Kara.

Kara O'Halloran (26:51):

Thanks so much.

Kara O'Halloran (26:59):

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