

Episode 32

# Research recap: Q2 2022

## Economic outlook

How will the economy evolve amid today's challenges? Chief U.S. Economist Lara Rhame shares her outlook on inflation, housing, the Fed and more.

Kara O'Halloran (00:00):

Welcome back to Fireside, a podcast from FS Investments. My name is Kara O'Halloran and today we are wrapping up our Q2 outlook content with an episode focused on macro. So, we have brought in the one and only Lara Rhame our Chief US Economist.

Lara Rhame (00:20):

Hi Kara.

Kara O'Halloran (00:21):

Hi Lara, so you're going to walk us through all things macro for Q2.

Lara Rhame (00:24):

Absolutely.

Kara O'Halloran (00:25):

So, I feel like it's been a while since we've podcasted together.

Lara Rhame (00:27):

Yeah.

Kara O'Halloran (00:28):

It's been, I feel like it's been a month. I think we haven't had you on since the market madness episode when you were crowned champion.

Lara Rhame (00:35):

Officially crowned.

Kara O'Halloran (00:35):

I hope you've been using those bragging rights that you've earned.

Lara Rhame (00:39):

Every day.

Kara O'Halloran (00:40):

I know, I know. I sit near you.

Lara Rhame (00:41):

Our team appreciates it.

Kara O'Halloran (00:42):

I sit near you. I know you are. Um, but I actually just have to laugh because we, in that episode, we had Elon Musk tweet as a dark horse and no one voted for it. And then lo and behold, he's over here trying to buy Twitter.

Lara Rhame (00:56):

It has been one of the biggest market movers over the last several weeks.

Kara O'Halloran (01:00):

I think we actually really all lost. Markets are wild, but anyway, let's get into the topic at hand here. So we have to start as always with inflation. CPI came in at 8.5% year over year in March. We really just continue to see these acute pricing pressures, especially in areas like energy and food. I loved how you put this in your outlook. You called it a peak without a descent. So, what does that mean? Where could we see inflation coming from going forward to keep us at these high levels?

Lara Rhame (01:36):

Yeah. I mean, I think really focusing in on the second quarter. Inflation, on a year-on-year basis - When we sort of talk about inflation at 8.5% percent on the consumer price index. That's what we're talking about today from a year ago today. And that has probably peaked because we just had such extraordinary base effects. Energy, oil prices, more than doubling, food prices used car prices. A lot of these measures that had hit rock bottom a year ago, just normalized, and then some. So, one of the hallmarks of inflation over the last several quarters has been that it is coming from virtually every sector of our economy. And going forward, it's going to become more muddled. Some things like used car prices, you know, keep in mind, this is a little piece of the index. It's only 4% of the index, right? But when it's up 50%, it adds a lot to the headline measure. And for example, last month used car prices fell and it shaved two tenths off of the core measures. So, this little index really is a tremendous swing factor. And as on a year-on-year basis, it comes down somewhat. It will cause overall the core index to decelerate.

Lara Rhame (03:04):

Now, what do we mean "a peak without dissent"? We may have hit the high watermark year over year, but that doesn't mean that we are on a straight shot back down to 2% inflation. That is the Fed's target. It's where we were for two and a half decades. It does not mean that we are sort of headed right back down to that outcome. More likely we are going to see inflation continue to be elevated because of food prices. Energy prices are still elevated. I have this blended sort of food and energy... like that's what every household in America has to buy those two things. And that's up over 15% year on year, and those prices are not expected to come down. So, the pain of inflation is going to, to be with us. And I think, you know, my expectation is that inflation ends 2020, between 4% and 4.5%.

Kara O'Halloran (04:03):

Well, you were all laughing at me last week because I had to, I had to work remotely one day because I had to stay home and I had to eat lunch at home because I had bought a pack of chicken that used to cost me \$6. And then it cost me \$10, and I refused to let it go bad because it's like, I spent so much more money on this chicken than I usually do. So, I was like, I can't come to work today. I have to stay home and eat this chicken.

Lara Rhame (04:26):

I tell you. I think, you know, we're creatures of habit. We're used to seeing that price volatility at the pump. But food prices. I mean, I know I sound like a mom right now. Right? But like I do the grocery shopping food prices are really high and we're seeing it everywhere.

Kara O'Halloran (04:41):

I don't know if that was necessarily an excused absence. I have to, I have to work remotely to eat my chicken.

Lara Rhame (04:46):

I know you were still working. I can vouch for that in case the higher-ups are listening.

Kara O'Halloran (04:51):

Thank you. Thank you. I'm taking advantage of the flexibility that we've been offered.

Kara O'Halloran (04:51):

Alright, I want to dig into the housing component of CPI though. So, owner's equivalent rent the way that we really measure what is the biggest component of CPI, right? And the Fed has started hiking, which we're going to get to in a second. But we've also talked about, and we will talk about in, in another minute, the challenges that the Fed has in taming inflation because it's really coming from a lot of these supply chain disruptions. New areas that it's pretty hard to tame with an interest rate hike. But housing is one of the most interest rate sensitive sectors of the economy. So, is this an area that we could see moderate in the future and kind of contribute to some of that possible descent that we might see in inflation?

Lara Rhame (05:40):

Yeah, you know, housing is absolutely ground zero for the impact of rate hikes on the economy. And I think, what I expect to see... So first of all, owner's equivalent rent follows the housing market rents follow the broader housing market, so let's start and work our way backwards. Housing prices continue to be up very sharply year on year. We just got the existing home sales numbers for last month and prices were up 15% year on year. So strong price gains. But what you saw in last month's data is actually pretty typical. Obviously when interest rates go up. You know, your mortgage rates are higher. Mortgages were above 5% now for the first time in years and what you typically see is the number of houses sold falling because people are... it just takes time for people to admit just prices downward. So, the quantity of sales, dries up. Not dries up, but diminishes, falls. You know, if your neighbor has sold their home for \$500,000 last year, you're going to list your home at \$500,000 and it may take time for you to decide, "okay, maybe I'll drop that to \$475, you know, \$470" to make the sale more attractive. So, the value of the home, the prices are stickier.

Kara O'Halloran (07:05):

Such a mental hurdle.

Lara Rhame (07:06):

Yeah, of course. You get it.

Kara O'Halloran (07:07):

Right. The last year was, oh, you know, I saw my neighbors sell their house for \$500,000 a month later. I'm going to list mine for \$525, \$550. So maybe we don't see that necessarily.

Lara Rhame (07:16):

Definitely not. Now. I want to be very clear that I do not expect, and there's no reason to expect a replay of the real housing price decline that we saw during the last recession. And that's because we continue to have demographic headwinds. The millennials are still, you know, at the age and have the money to buy these homes. We have the decade of underbuilding, so we still have a very limited supply of homes and it takes a long time for that construction to catch up. And finally, we just, haven't seen the mortgage-backed security froth or any of the subprime lending froth that we saw elevate home prices the last cycle. So, this time around what I would expect is a moderation in house price gains. But generally, for the sector to remain fairly solid, I do want to explain one thing that often gets lost in the shuffle. When you're buying and selling the same homes, that doesn't actually add to GDP. New construction adds to GDP, or if you remodel a kitchen. That adds to GDP. So, when we think about rate hikes, affecting the economy, it could have some impact on wealth gains and as this discussion, I hope has made clear, we don't expect housing prices to plunge and you know, wealth and housing, to plunge, but there's a moderation that would be completely normal. And we don't really expect it to negatively impact GDP because there is a huge demand for housing construction, which is a small piece of GDP. It's only about 3% to 4% give or take, year over year. That's the story, right? Housing prices still on an upward trajectory, maybe a likely a more moderate, upward trajectory. We would expect rents to continue to climb. We see vacancy rates are low and so that I think is what we expect to keep core inflation elevated going into the year.

Kara O'Halloran (09:27):

Alright, let's talk about the Fed, we started talking about them a little bit. They have embarked on what we really expect to be the most aggressive hiking cycles since the early 1990s. They've already hiked rates once 25 basis points. There are nine more 25 basis point hikes priced in for the remainder of the year. We pretty much assume a 50-basis point rate hike and markets have fully priced in a 50 basis point rate hike in May and another one in June, which means in Q2 alone, we are likely facing 100 basis points of rate hikes. That's a lot. Pretty extreme. Plus, quantitative tightening is likely to start also in May. And we're starting to get more details out about that. So, we're going to talk in a minute about some of the near-term market impacts of navigating this hiking cycle, but I want to, I want to skip to the end of the cycle now. If you look at a longer dated measure of Fed funds rate expectations, we're actually starting to see rate cuts priced in. We saw the yield curve, the spread between the two-year treasury and the ten-year treasury invert very briefly, a few weeks ago. Um, that's a common recession sign. So, these are essentially, markets are pricing in the idea of a hard landing or a policy mistake. Are we past the idea or the possibility of a soft landing? You know, what do you see for the conclusion of this hiking cycle?

Lara Rhame (10:54):

You know the Fed, when they decide to hike rates... and I think it's really important to appreciate that the last rate hike cycle that we went through was really a very slow, gradual rate hike cycle that was in theory meant to be preemptive. Now the Fed is behind the curve on inflation and for these Fed officials who really, I think came through doing their PhD work, and many of them have been at the Fed for decades... they really came up during the time when Volcker, was really the lead, took the lead in squashing inflation by very aggressive rate hikes. And that is, I feel like the playbook that they are really imposing right now. And to some degree it makes sense. They are on their watch seeing inflation the highest since the early 1980s. And I think they feel like they really need to be very reactive to this, that they're very behind the curve. So, it's caused even the most dovish Fed governors to come out as very hawkish. They're going to be, I think, very aggressive and they've signaled these two 50 basis point rate hikes as you indicate. And so, for investors, this one, two punch of inflation and Fed rate hike cycle, these are the two big challenges. You know, the inflation just erodes your gains and the rate hike cycle

injects this massive policy uncertainty into markets. So, you're just getting this double whammy and it's causing markets to experience a lot of volatility. We've seen that throughout the first quarter of the year.

Lara Rhame (13:00):

And I really think that it is specifically because markets are now worried about a recession and you know your point exactly about yield curve inversion, Fed funds futures curves... we have all these little warning lights going off all over as we look at our dashboard and what do we make of it all? So, the Fed Chair, Powell, has been very optimistic that the Fed is going to be able to execute a soft landing. That means they're going to be able to slow the economy down and bring inflation back towards their target without causing a recession. And you know, I hope is not a strategy. I think that's what I've been communicating to investors. Because it would be irresponsible to go into this Fed rate hike cycle, without your eyes wide open that Fed rate hike cycles usually, or historically have preceded recessions by about one to two years. So normally the Fed, you know, they start cutting rates, they start raising rates, they did that in March. They raise all the way up to wherever they end and then about a year to 18 months later, guess what? They're cutting again, because the economy's in a recession. That's historically been the pattern. Yes. We've had a few episodes where that hasn't happened, but very few. So, a lot of people point to the pandemic and they say, "well, if we hadn't had a pandemic, we wouldn't have had a recession." Sure. I'm not saying that it necessarily works in theory, but it works in practice. You can, you know, the history kind of speaks for itself. So that is my core message that a recession is not in my forecast because I'm smart enough to not forecast three years out. But, the probability of a recession has greatly increased.

Kara O'Halloran (14:52):

Yeah, and I know there's other things that you're watching as well. I mean, we talk about the 2s/10s curve. That's the one that kind of gets all the airtime. Right? As soon as it inverts, everyone's like oh recession, recession. There's no reason that an inverted yield curve causes a recession, but I know that there are other things that you're watching. So, I think it'd be helpful if you could just walk through a few of those and what those signs are telling you right now.

Lara Rhame (15:15):

You know, I called the article in the quarterly "Reading the tea leaves", because it is more art than science. But again, if you believe history repeats itself, it's really important to pay attention to it. One of them is a ratio of consumer confidence. Looking at how households feel about their present situation versus their future expectations. And when that ratio gets very wide, meaning that people are really positive about how things are going now, but they're really negative about the future. If that ratio gets very wide, that often precedes recession and it's wide right now. Another one is the unemployment rate being very far below the Fed's estimate of full employment. So that's the Fed's estimate at 4%, we're at 3.6%. That is statistically significant in models, which predict recession over the next three years.

Kara O'Halloran (16:09):

And that's just because that kind of gives the Fed license to, to hike, you know, the economy is doing well and whatnot.

Lara Rhame (16:16):

Yeah, you're completely right. That is the connective tissue of the Phillips curve analysis and these big macro models that really give the Fed the green light to hike and to hike aggressively. So again, it kind of all comes back to this Fed rate hike cycle and I continue to believe that ever since the pandemic, we've had our finger on the fast forward button of this cycle. Fastest bear

market, fastest market recovery. You know, deep, fast recession, fast recovery. We've hiked, we're hiking now two years into the recovery. Normally it's three to six years into a recovery. It's all still on fast forward. So, to me, it's not a surprise that some of these signals are calling for a recession kind of in record time, for a record showing. And Kara, not every recession, I mean the last two recessions we had, have been very scary.

Kara O'Halloran (17:11):

Yeah. It's such a good point. I mean, the COVID one was short, but it was deep. And obviously, like, I think we can all think back to March of 2020, and just how uncertain and scary the world felt. And the one before that was the great financial crisis. I mean, the Great Recession, you know, these are... not every recession accompanies a financial crisis. But our recency bias right now is working against us.

Lara Rhame (17:35):

You know, I think back to, you know, we've had more mild or shallow recessions in the early nineties for example, where you had two quarters of negative growth, but for the year, growth was still positive. I do not have a recession in my forecast. I certainly would never predict what type of recession it would be, but I think we all need to be clear that markets are signaling this for a reason. They're looking at history. And if this cycle stays on fast forward, as it has been, it is absolutely not a wild idea that we would experience some contraction in 2024.

Kara O'Halloran (18:10):

Alright. I want to quickly talk about China. We've really seen China... that was a really quick pivot there, but we got to keep it moving. Yeah. Let's dig in. So, we're seeing China's policy, you know, in COVID and monetary policy really completely diverge from where we're at. Right? You know, we just had the mask mandate on transportation lifted, who knows if that'll stick, but we're basically kind of living through COVID. China, most of China's under lockdown right now. I think 40% of their GDP is under lockdown, which is draconian. We're tightening policy. They are loosening policy, monetary policy, I should say. Um, what are you watching in China right now?

Lara Rhame (18:51):

Okay. I mean, I think in the second quarter it is all about watching their COVID response. There's zero tolerance policy for COVID, is in direct contradiction to their common prosperity goals. And they've really just begun to try to lock down this very, you know, highly transmissible outbreak of the Omicron variant. So how that goes in the second quarter, if they're able to lock it down, at what costs, I think it's clear to the rest of the world that it's not a sustainable policy. But it's unclear when and how Chinese leadership will accept that. Until then, it really doesn't matter how stimulative their monetary policy is. If people are physically locked in their homes and cannot consume, you're just not going to get the growth. So, I think you're correct that there is this important divergence, but when I look at China over the year ahead, you know, you look at 2022 growth expectations in China and Europe and the U.S., they all just keep getting revised down. And it could be the fact that I bought a Peloton during the pandemic...

Kara O'Halloran (19:57):

You and I both.

Lara Rhame (19:59):

And, but you know, this global flywheel of growth is slowing, and I think that's what we're seeing with China.

Kara O'Halloran (20:07):

And I think another important point to make there is the supply chain disruption. So, we've already seen and just, they can be exacerbated.

Lara Rhame (20:14):

I think that's, you know, not that all roads lead back to the Fed, but I do want to make the point, which is that as the Fed raises rates, the idea is to slow down U.S. domestic demand and bring it back into balance with supply to lessen inflationary pressures. But I think the problem the Fed may face pretty soon is that U.S. demand may not be so much more robust and then sort of trend growth. The Fed rate cuts don't help supply chain disruptions. And I think that's where these Chinese lockdowns in the second quarter, to me, it's all about how they're able to manage through this. And if they can get their economy back on track, or if they're just in, for a year of lockdowns like this because they can't get it under control, which is obviously the worst-case scenario.

Kara O'Halloran (21:05):

Okay. Let's wrap this up and take it back to markets and make this a little more actionable. So, you already said, volatility has been the name of the game in markets for the entirety of this year. Really just markets having to continually contend with these growing risks, these uncertainties, this hiking cycle, all of that... I think there's sometimes this narrative of things being priced in, right? We've been rapidly repricing expectations all year, but what are your thoughts on, you know, have we fully priced all of this stuff in, or are equities in for more pain ahead? I know you're our Economist, but you know, at a macro level.

Lara Rhame (21:43):

Oh yeah. It's important to, you know, that's what I think we all care about too. How the economies are, how our market's going to look. Our colleague, Andrew Korz has done great work on this. Historically in the first year of a tightening cycle, we've never seen multiple expansion. You know, we get the multiple compression before and after the Fed starts raising rates. If you sort of bracket the first rate hike, right? And you take the year before and the year after. It depends on how aggressive markets have been going into the rate hike cycle. How much compression we've seen. We get, you know, we get before or after the Fed starts raising rates. That's a complicated way of saying that Fed rate hike cycles equal multiple compression. And we can often see more of that before the rate hike cycle starts.

Kara O'Halloran (22:34):

We've seen that.

Lara Rhame (22:35):

We may have experienced sort of like maximum multiple compression. But multiples historically have not expanded in the first year of a rate hike cycle. So, we may still be in for more, top line discomfort and volatility. I do think this is where it gets complicated because earnings as we've seen so far in the second quarter are not looking bad. You know, the economy is on solid footing. That's why the Fed is comfortable raising rates because the economy does look good. Um, we know that free cashflow margins are at record highs, you know they're year long, multi-year highs. We know that earnings are going to be solid. Nominal GDP growth is strong. There are inflation winners and losers, but companies, it's definitely sector by sector, are able to pass along these higher input costs to consumers Right? Hence our inflation. So, all that together means that there's growth, there are earnings, but it just gets harder to access it through the top line sort of traditional investment vehicles when you're in the earliest stages of a Fed rate hike cycle. I look to you for the credit story. You know, when I look at fixed income, which is

getting crushed by rising long-term yields, there's value to be had now as you get deeper into the credit stack, right?

Kara O'Halloran (24:01):

A hundred percent. I mean, I think that it's this idea. We call it our... I called my Q2 credit outlook "A balancing act". Right? And it's kind of this, the same idea of this really strong, fundamental backdrop, you know? We're seeing rock-bottom default rates; EBITDA levels are I think 31% above pre-pandemic peaks. It usually takes two years just to get back to pre-recession levels.

Lara Rhame (24:25):

Faster cycle. Fast forward.

Kara O'Halloran (24:26):

Exactly. Exactly. We're seeing that throughout markets completely. So, we really still have this really strong, fundamental backdrop, but it's similar to what we're facing in the economy and in the rest of markets. It's facing these risks. Right? And we have kind of this growing storm of uncertainties or cloud of uncertainties that it's just going to be a balancing act, balancing those risks and those uncertainties, but volatility creates opportunity.

Lara Rhame (24:50):

Yeah. So that's, that's the second quarter, right? I mean, it's going to be. Like, we're obviously going to be watching the inflation data really, really closely. Used car prices may cause, you know, it's going to let some of the air out of the year-on-year base effects, but it's still going to be high because of food, because of energy, because of owner's equivalent rent. So, the inflation numbers are still going to be past a peak most likely but are not going to look friendly to investors. And you've got the Fed, you've got a hundred basis points of rate hikes. You've got quantitative tightening and that is going to be a lot, lots priced in, but it's still going to be interesting to see how markets handle it.

Kara O'Halloran (25:32):

It a lot to contend with.

Lara Rhame (25:33):

Yeah.

Kara O'Halloran (25:33):

Well, we'll have to have you back on to talk about it.

Lara Rhame (25:36):

Yea, it's going to be, it's going to be an interesting quarter.

Kara O'Halloran (25:39):

A hundred percent. All right, Lara. Well, thank you so much as always for joining us and going through all of that.

Lara Rhame (25:45):

Yeah. Thank you, Kara.

Kara O'Halloran (27:25):

This podcast is brought to you by FS Investments. If you found this helpful subscribe to get new episodes as soon as they're available.