Episode 48

Our economist answers our top 3 questions for 2023

Chief U.S. Economist Lara Rhame shares answers to three top questions from her 10 for ’23 chartbook.

Kara O'Halloran: As we wrap up 2022, we want to thank all of you for listening this year. We wish you all a happy and healthy new year and are excited to bring you even more FireSide content in 2023.

Welcome back to FireSide, a podcast from FS Investments. My name is Kara O'Halloran. I'm a Director on the Investment Research team here. And on today's episode, we are answering the top three questions that we have for our Chief Economist as we enter 2023. Namely, are we going to have a recession? When will The Fed stop raising rates? And what does all of this mean for markets? So to answer all of those, a tall order, I have brought on Lara Rhame, the Chief U.S. Economist. Lara, thanks for joining.

[00:00:42] Lara Rhame: Hey, this is probably my favorite podcast of the year: the 10 for 23 look ahead.

[00:00:48] Kara O'Halloran: Well, it's funny you say that because we are mine too. Because we are talking about my favorite piece that you put out every year, which is your, your chart book. So it's your 10 big ideas for the upcoming year, so we hot off the presses have your 10 for ’23. And luckily for us, it kind of answers, or at least I should say, gives your views on those three big questions that I just asked.

[00:01:13] Lara Rhame: Yep.

[00:01:13] Kara O'Halloran: So let's dive in. I did list those questions that I want to address, but I think it's impossible or really difficult to answer those without first talking about your views on inflation. which really continues to just be the nexus for all things policy growth and markets. So let's talk inflation. Consensus is that we will see inflation fall in 2023. What exactly does that look like? Where do you think we end next year?

[00:01:40] Lara Rhame: Yeah. yes, so I it, and it's very appropriate that we're starting off today's discussion with inflation because we just got November CPI data this morning and it was a really soft report. By that I mean the consensus was expecting a 0.3% gain in the month. We got 0.1. The core also was lower than expected and a lot of the things that, we've really been expecting to kind of normalize that's happening. Energy prices are down. We see that in oil markets, used car prices. We've been really waiting for that to fall significantly, and they are, and goods prices have really normalized as well.

This is where we need to just remember that headline inflation is still 7.1%. That is very far away from the fed's, 2% target. And, to your point, it is consensus that inflation is going to come down next year. But the magnitude, the momentum and the persistence of that is going to be where it's at.

My year end inflation forecast is 3.5%. at the end of next year, I expect inflation, those year-on-year numbers to still look really high in the first quarter of next year. Our quantitative team, Brian Cho and that group, also, totally independent from me, quantitative analysis pegs, year-end inflation at 3.8% at the end of next year. And so this is the big question, Kara, that it raises because, inflation is more than just CPI, right? It's wages. And that is when we talk about the persistence, sort of the pervasiveness of inflation coming down, this is more than just gas and used car prices, right? This is a dynamic that has pushed its way through our economy in 2022, and as it works its way out, it is really important to understand and it's important for policy to see whether this is just sort of one off things or if it is really, coming out of the entire system.

[00:03:50] Lara Rhame: That's the big question and to me, I think that is very far from answered in 2023. I think inflation's going to continue to be a problem, and I [00:04:00] think wage pressure is going to remain far from the fed's, 2% target.

So let me go out of order then for my questions. Because this just brings up the natural question is fed policy.

[00:04:12] Kara O'Halloran: So we just said, okay, inflation, end of next year, three and a half percent is your forecast. What do you think the Fed does next year? When do you think that they, I think consensus is for them to stop hiking rates sometime at the end of the first quarter, early second quarter, something like that. We actually have some rate cuts priced in for next year, but if you're still forecasting inflation of 3.5%, do you think the Fed spikes the ball at that point and they're like, Hey, we got it down close. We're not going to get it to the 2%. That was a lot of questions in one question. So, maybe you could just walk through your, your thoughts on what the Fed is going to be doing next year.

[00:04:56] Lara Rhame: I think, the three questions you asked and you've framed out at the top of this, there's a reason for that. That's what every conversation that I am having. Is being distilled in to those three questions. so yeah, the question and the trajectory of the Fed next year is really important and you can break that down into a two-step process, because the Fed is widely expected to continue to raise the beginning of next year.

So the first question is, will they have room to hold. Like just, what will that look like? At what level will they be holding? and the answer is they have gone so far, so fast in 2022…

[00:05:32] Kara O'Halloran: Yeah. We were pricing in 75 basis points total of rate hikes this year. Just, I mean, I just need to step back and remember that sometimes.

[00:05:40] Lara Rhame: Yes, 2022 has been an important reminder of, you know, you sort of joke that everything's relative. we've had 4 75 basis point moves, per meeting. I think it's funny that at the beginning of the year, the idea that they would go 50 basis points in one meeting seemed, you know, really hawkish. And [00:06:00] outrageous. And now that they're downshifting, They're downshifting to 50 is considered very dovish.

[00:06:05] Kara O'Halloran: Right, exactly. It's all relative. but I apologize, I, I interrupted you.

no. because,the idea that they would downshift again in the beginning of next year to some 25 basis point rate moves, to level set, my expectation is still that they will raise rates to 5%.

[00:06:21] Lara Rhame: I still think that there is a risk, they go higher in 2023 than 5%. Their rate hikes impact the economy with a lag. And they've gone so far, so fast. It's important to, for them to just take a minute, and see what these impacts are on the economy. so a hold scenario is really critical. And the reason that markets have started pricing in rate cuts is because should we have a recession, the fed typically cuts rates at that time.

The rate cut trajectory is part of the market's, probability range that we will have some kind of recession next year, and that is where the inflation discussion becomes so tricky because we are far from the fed's. Two per even 3.8%, 3.5% is far enough from the fed's. 2% target. it's a scenario where conceivably they would deliver a few rate cuts should the economy weaken significantly.

But it's not a scenario where we would get the, you know, elevator down to zero interest rates that we've gotten in 2007 and in 2020.

I want to talk about your views on whether or not we will have a recession next year. and what that might look like. And I think this is another important time to bring up that those two recessions were so abnormal, right?

[00:07:53] Kara O'Halloran: They were financial crises. So we remember they were emergency rate cutson like Sunday night. I think I remember that Sunday in March where the [00:08:00] fed mat and cut rates to zero. really just trying to prevent another financial crisis, and liquidity issue. okay. So let's talk about your thoughts. We just said that the market is pricing in some, the likelihood of a recession at some point next year. What do you think?

[00:08:16] Lara Rhame: So, don't kill the messenger , I've tried. All right. My, I'm not rooting for a recession, but my job as a forecaster is to prepare, our clients and our partners in the investment universe for, the probable outcome and the probability that we will have a recession has risen significantly, for next year.

you know, when we talk about the markets pricing and recession, the most obvious example of that is yield curve inversion. my preferred sort of pairing there is looking at the spread between three month interest rates and 10 year interest rates in the treasury yield curve. And that is deeply negative now, and that has reliably predicted [00:09:00] recessions.

you can go back a hundred years and that's reliably predicted recessions. and it's deeply inverted now. So I think it's, one reason why. the timing of recession, I still put late next year. it is not a guarantee that we get a recession. If we don't get a recession. We are unlikely to get very strong growth next year.

[00:09:22] Lara Rhame: Remember this rate hike cycle. The entire goal of this policy response is to slow the economy down. to the Fed success looks like slower growth. that is full stop, whether it tips into recession or not. So we're unlikely to get very strong growth next year, and the probability that we get a recession to me is quite high.

[00:09:44] Kara O'Halloran: And so what are you going to be watching to tell what are we looking at?

[00:09:48] Lara Rhame: You know, I'm going to refer back to my handy 10 for '23. Point number two is yield curve inversion. But I think this is important because yield curve inversion is a good and reliable historically indicator of whether or not we're going to have a recession.

It doesn't give us much information about how bad that recession could be. We were, we had deeper yield curve inversion ahead of the 2001 recession than we did ahead of the financial crisis , which, or the Great recession. so, and to your point, recessions come in all shapes and sizes. 1991, 2001, these were shallow recessions. So my expectation, and I think point number three in my 10 for 23 is a pair of charts that I've gotten some of the best discussions going when I'm out on the, in the field. And it's this idea that higher interest rates are absolutely impacting interest rate sensitive sectors of our economy.

[00:10:50] Lara Rhame: They are a cyclical, emergency break, and that we see that housing is clearly ground zero for that. But there are structural tailwinds [00:11:00] that, mean that this recession may very well be shallow. You can take that to housing. We've underbuilt housing, so there's less supply. You can take that to autos.

we haven't had a big auto spending cycle to crash down from. Right. There's still a tailwind of demand for autos. We could take that to investment. We've had 15 years where we've underinvested in our economy. So it's this cyclical versus structural story that, really I think is a reason to be optimistic that we may very well see a more shallow recession.

[00:11:38] Lara Rhame: And then finally, at the risk of going too long. it's important to recognize the difference between a leading indicator of recession and a coincident indicator of recession. And what I mean by that is, yield curve inversion is a leading indicator of recession. Job losses are the recession. Job losses, I like to say when we start seeing job losses, that is the equivalent of the weatherman standing in the rain saying, I think it's going to rain. You know, so yeah, when we see job losses, that is the recession.

[00:12:14] Kara O'Halloran: And I think that's why earlier this year when we had those two negative quarters of GDP growth, we didn't see those job losses. We still at a very strong labor market and that's why officially we were. In a recession by all accounts or most accounts.

[00:12:29] Lara Rhame: That is why for me, when I got asked at the beginning of this year, are we in recession? you point to, millions of jobs added this year. you point to an unemployment rate that's still right on top of a multi-decade low, and you say no. So, that to me is a really important point. point number four of my 10. When we see job losses, that is when you start the clock on the recession. And that is something I still do not expect until later this year.

[00:12:55] Kara O'Halloran: Yeah. So I know you come in, every payroll Friday, very excited just to see what the data's going to be. So, you get our team all excited about what that data's going to look like, so, I'm sure we're going to be watching it even more closely next year.

[00:13:06] Lara Rhame: Yeah. I think that you hit the nail on the head, Kara. We've had such volatile market moves on the back of inflation data. We may start having that volatility shift to the payroll report instead.

[00:13:18] Kara O'Halloran: That's so interesting. We've had, I think, the best and worst days in the market this year on CPI day. And we're starting to see that good news, bad news, whatever, like markets reacting on payroll days. But yeah, just even more important next year. So, speaking of markets, let's talk more broadly. it's clear that there is still uncertainty next year, right? we're all turning the calendar page. It's not like we can just ignore all of the challenges that we're facing, right? and I think my favorite part of your 10 for 23 is your last one, and you wrote a breakup letter to the 60/40, which I just thought was phenomenal. So what does all of this mean for markets next year?

Lara Rhame: I think when you said that uncertainty is going to be with us, that is one of my overarching themes. Economic uncertainty is not going to resolve. We are still going to be thinking about recession, talking about inflation. All of the things which have really hit the 60/40 very hard, I think are going to continue to give us an environment.

I think folks who've been riding this 60/40 wave for years are expecting to be able to dive back in, and that's why I am breaking up with the 60/40 . I think that is something that, I really had fun writing and when you kind of break down both pieces of that,Point number seven in my 10 for 23 talks about the fact that for interest rates we have broken out of the multi-decade downward channel that we have seen.

[00:14:56] Lara Rhame: We are decisively out of that. And while I still see interest rates remaining low enough, I mean, the yield that you get off fixed income, especially traditional fixed income is far below inflation and it may not recapture. right now 10 year treasuries at 3.5%, my year end inflation expectation is 3.5%.

if it's 3.8% as our quad team expects, that is zero. Real interest rates. So this to me just reinforces the challenge that traditional fixed income's going to have.

[00:15:32] Kara O'Halloran: Fixed income has become so volatile this year, so it's not even serving that ballast purpose anymore.

[00:15:39] Lara Rhame: That is critical because when you look at the equity side of this, this is where, to me, so many of the mean reverting economists are getting it wrong. Margins have stayed incredibly generous even while we've had price prices and equities come down so much. this is the big question, right? our earnings expectations really reflecting the possibility of a slowdown. And I would argue they're not and then you get into what do you do about it? And this is where I think the conversation gets the most interesting, because if we're breaking up with a 60/40, where are we filling that huge gap in our portfolio? And I think you and I co-authored point number eight about credit markets and the opportunity for outperformance there.

[00:16:27] Kara O'Halloran: Yeah. Actually, so I published, we took a page out of your book and we published mini versions of our chartbooks. So I published a 5 for '23 for credit markets next year. And it's funny, when I was writing, the calls don't seem that bold. They're kind of like run-of-the-mill calls, but almost making any sort of directional call next year feels bold at this point. And one of the calls that we made was for credit to outperform equities and exactly to that point, I think that equities probably have not priced in the earning, the earnings slowdown that we expect, whereas credit markets actually look pretty well positioned to weather some sort of slowdown in corporate earnings.

[00:17:07] Kara O'Halloran: mean, we've talked ad nauseum this year about the credit markets have had a lot of declines at the headline level, but their fundamentals remain really strong, really supportive. they can probably withstand that earnings slow down. And I think if you just look at the risk return profile of credit versus equities, I prefer credit right now. So equities, theoretically you can lose a hundred percent of your investment. Credit markets have an effective floor set by recovery rates. So even if we do see defaults rise next year, and we're not naive, we do think defaults will rise slightly. investors... from incredibly low levels.

I mean, that's a great point. Thank you. Yeah. Investors are recovering nearly 70% of their investment in the event of a default. So you have this effective floor. Prices have fallen a lot this year, so you have a lot of upside. The convexity in the market looks really nice. So I think the risk return profile in credit looks really good going forward and you're also, you're getting the market's yielding over 9% right now, the high yield market. so you're getting that income that can offset some of that possible spread widening that we'll see. But yeah, I mean, I think credit's an interesting place to be, especially, to get a little more of that downside while still if we do see periods of positive sentiment, you're still going to participate in that as well.

[00:18:24] Lara Rhame: Yeah, and I think it's important cause when you talk about credit outperforming equity, as we're talking about sort of that traditional big equity basket. I think something that you know, you and I have discussed is how there is opportunity within equities. You just have to really drill down past that, that headline measure, which is so concentrated in the global growth tech, names. And, we talked about opportunities in Europe, opportunities within metals and mining energy. these are some of the sectors that we highlighted at the beginning of last year that could, really outperform. Europe, obviously we didn't get the, we didn't get the Russia, Ukraine war. We didn't guess that one last year. But I think, the point is, even investing, actively in equities requires the alternative, right? It requires not just jumping into the S&P 500, it requires that active management approach. I think that to me, There's tons of opportunity out there. you just can't rely on the 60/40 anymore.

[00:19:25] Kara O'Halloran: Yeah, I think that's exactly right. And then just to wrap it up, I think if 2022 has taught us one thing, it's that alternatives are required reading and, I don't think that's going away anytime soon. I mean, I think anybody who was in any sort of well-structured, and when I say well-structured, I mean an investment that is doing what it says it's going to do. So if it says it's going to have low correlation or beta to traditional markets, it's actually delivering that. I think anyone in an investment like that this year was very well served, is very happy. And I think those are going to be very important parts of portfolios going forward.

[00:20:01] Lara Rhame: Yeah. Thank you. Thank you. I think one of the, one of the points you made about correlation, I mean, I think at the end of the day we shouldn't blame ourselves for getting complacent. You know, it's had a great run. Yeah. So these are areas well, and these are areas that we've really underinvested in. And I think that to me is what we need to be really tearing our portfolios apart and. thinking about next year.

[00:20:25] Kara O'Halloran: Yeah, I think that's right. All right, Lara let's, we'll wrap it up there. I could go on and on. There's so much to talk about and we'll just, we'll run it back next year. We'll do it all again. but thank you as always for joining and your 10 for 23. As long as the 5 for ’23 for credit, commercial real estate and equities are all available on FSinvestments.com.

[00:20:44] Lara Rhame: Thank you.

[00:20:48] Kara O'Halloran: This episode was recorded at the FS Investments headquarters in Philadelphia's historic Navy Yard. It was produced by Kara o' Halloran. It was edited and engineered by Aaron Sherman. Special thanks to show [00:21:00] coordinator Ellie Zhang and guested Lara Rhame. If you enjoyed this episode, be sure to like and subscribe wherever you get your podcasts.

Thanks for listening.