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There's a disconnect between the macro scenarios currently priced into equities and Treasuries. (ddp)

Entering the final stretch of 2022

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There are four weeks left in 2022, though the last two should (hopefully) be quiet in financial markets. Less clear are the number of weeks left until the Federal Reserve is done with its rate hiking cycle, although to even think in terms of weeks rather than months or quarters means the end is near.

This is one interpretation of Chair Jay Powell's comments last Wednesday, though the stronger-than-expected November payrolls report threw a spanner in the works. Overall, policy news and economic data last week provided plenty for investors to chew on, though the 3-to-6 month investment outlook didn't really change.

The focal point was Powell's speech, which may have signaled (or not) a policy tweak. Fears that the speech would be hawkish a la Jackson Hole proved overdone. Instead, Powell was relatively dovish by acknowledging that a step down in the pace of rate hikes is warranted and that the FOMC doesn't want to over tighten, while also sounding more optimistic on a soft-landing than at the November FOMC. Also noteworthy is that he didn't push back against the easing of financial conditions (FCI) since mid-October—they've retraced over a quarter of their tightening to that point. Instead, Powell commented that "markets are working … we're now in a place where we can bring inflation down."

These could be innocuous statements and viewed simply as a repeat of what Powell said a month ago. But they could also indicate a subtle shift in Fed policy in two ways. First, concern about over tightening suggests that the Fed is no longer solely fixated on bringing down inflation, and the slowing economy is factoring into their risk management approach. Second, the Fed appears to believe that the "long and variable lags" of monetary policy are more impactful on growth than the impulse of tighter, or looser, financial conditions. Knowing that he intends to hike rates at least another 100bps and keep them in restrictive territory for a while, which should further slow growth, is why Powell can seem comfortable with financial conditions easing.

Regardless of whether Powell's comments reflect any actual policy tweak, the data from last week and today don't make the Fed's job easier. Housing and manufacturing data have slowed to outright recession levels, but at least the PCE and ISM prices paid inflation data continued to fall faster than expected. It is the upside surprises to job and wage growth in the November payrolls report and the ISM services data that complicates matters. Average hourly earnings have risen at an annualized rate of 5.3% since July, and at 5.8% over the last three months. While we shouldn't put too much stock

in any one data point, there's little cumulative evidence of moderating wage inflation, which is consistent with the ISM services prices paid component still at a very elevated level of 68.1.

The net takeaway from the data is that both inflation and growth may grind lower more slowly than investors have being anticipating, with sticky wage inflation being a major reason why. Relative to the aforementioned wage growth, headline CPI has annualized to 2.8% since July and 5% the last two months. That means real income growth is turning positive and that should support consumer spending for a while longer. This matters for the market debate as to which of inflation and growth will fall faster. Over the past month investors have become hopeful that inflation could fall faster than growth in a race to the bottom, leading to a soft landing.

This leads to three comments about the investment outlook.

First, it's too soon to say that there's been a change to the basic market set-up for this year, which is a Fed focused on tightening financial conditions in order to slow growth and cool the economy. Powell may be more comfortable with conditions easing thus far, but that's unlikely to persist if wage growth stays elevated. He spoke of the risk that tight labor markets pose to non-shelter services inflation, and the jobs data on Friday highlighted that risk. The FOMC meeting on 14 December provides Powell with an opportunity to walk some of his comments back. But even if it's premature to say that the market setup has changed, the days when the Fed is a source of market volatility are also nearing an end.

Second, the latest data increases uncertainty about the timing of the 2023 inflection points for growth and inflation, and that's likely to prolong market swings until those points are reached. The US is a two-track economy right now, with the manufacturing and housing sectors in recession territory experiencing disinflation, while the labor-intensive services sector has slowed very little and has had no inflation moderation. The implications are growth resiliency and inflation stickiness, with trajectories for both that are hard to predict.

Third, there's a disconnect between the macro scenarios currently priced into equities and Treasuries. The S&P 500 forward P/E multiple is around 18 and\ the VIX fell to 19 on Friday, which are both levels consistent with a soft-landing. Meanwhile, a deeply inverted yield curve (the 10-year minus 2-year yield is about 80bps) is signaling that a recession is coming. Convergence to the same implied scenario is more likely to be led equities pricing in a deteriorating earnings outlook, which is why we view the risk-reward for US equities over the next 3-to-6 months as skewed to the downside.

The bottom line: A year-end rally may still be in the offing, though investors are likely to remain skittish until November CPI is released on the 13th and the FOMC meeting concludes on the 14th. If there are no surprises with these events, momentum could continue. But the fundamental challenges of rates going higher and growth continuing to slow will still be there when the calendar year changes.

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