The Sphere in Las Vegas can at least serve as a metaphor for how to think about the economy and markets. (UBS)

Is the Sphere actually a crystal ball?

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I've seen the future, and it's in Las Vegas. More precisely, the future of entertainment seems to be with the Sphere, which I experienced first-hand this past weekend.

Even if you haven't been inside, you've very likely seen the stunning hyper-realistic visuals displayed on the enormous exterior shell, whether a basketball, an eyeball, or something else. I was hoping for a crystal ball, one with perfect foresight on the economy. That's the future I really want to see. The technology isn't there yet, but the Sphere can at least serve as a metaphor for how to think about the economy and markets.

There is a circularity, or reflexivity, between GDP growth, interest rates, and the Fed right now. Much stronger-than-expected growth is one reason why 10- and 30-year Treasury yields have risen over 110bps in three months, with the market pricing out future Fed rate cuts. The resulting tighter financial conditions index (FCI) is why it's now very unlikely that the Fed hikes at the 1 November Federal Open Market Committee (FOMC) meeting. The assumption that the Fed seems to be making, with justification, is that the tighter FCI will slow the economy, helping to achieve its goal of bringing inflation down, eventually bring rates down as well.

That's a nice story, but the extent of circularity depends on one's assumptions. Most important is whether the rate rise is largely a consequence of the better growth data—i.e., it's an endogenous outcome—or if it's more due to other non-growth exogenous factors (e.g., supply-demand imbalance, worries about large fiscal deficits, among others). Fed Chair Jay Powell said last Thursday that he thought it was the latter, so as growth slows, rates are unlikely to come down much. This logic implies that the rate shock will slow growth, and therefore the case for another Fed hike is low. But if the rate rise is mostly endogenous instead, then assuming slower growth may be mistaken.

This creates a dilemma for investors. If Powell's assumption is wrong and the economy doesn't slow, then the Fed may have to resume hiking, and likely more than once. That raises the probability of a hard landing later in 2024. There isn't much relief if Powell's interpretation is correct, because the odds of something breaking in the financial system go up if rates stay elevated while growth slows. The best scenario is if the rate rise was mostly but not entirely endogenous. Then growth should slow, beyond what was already in the pipeline, because of the exogenous rate move. But then rates should decline at least modestly along with growth, thereby reducing the potential breakage risks.

Aside from the Fed potentially not hiking in November, which would confirm what's widely expected, there may not be much clarity soon on which scenario will play out. All of them assume growth slows, but there's not much evidence of that happening yet. For example, the weekly initial jobless claims on 19 October were the lowest in nine months. As that occurred during the survey week for October payrolls, another strong result could be in the offing. Inflation data may not help either, with seasonal adjustment factors expected to slow the disinflation progress in 4Q.

As a result, investors are skittish. The VIX—at 21.7—is the highest it's been since Silicon Valley Bank went under in March. The same is true for VVIX— the volatility of volatility index—implying bigger tail risks looking further out. The 2-year Treasury yield has risen only 25bps in the past three months, a fraction of the long-end rise. This is consistent with the Fed relying on tighter FCI to slow the economy, not more rate hikes. This Fed policy has effectively pushed volatility further out on the yield curve, and for the economy as well.

The bottom line: Exactly how the inter-relationships between growth, interest rates, and the Fed are working right now is uncertain. Markets are likely to stay choppy until there's more clarity on how these feedback loops are flowing. We favor the more optimistic of the three scenarios—both growth and rates decline without too much breakage, for the economy and financial markets—as the most likely outcome. That's good for high quality bonds, and ultimately equities too, especially laggards. I didn't see the Sphere reveal that future, but then again—what happens in Vegas stays in Vegas.

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