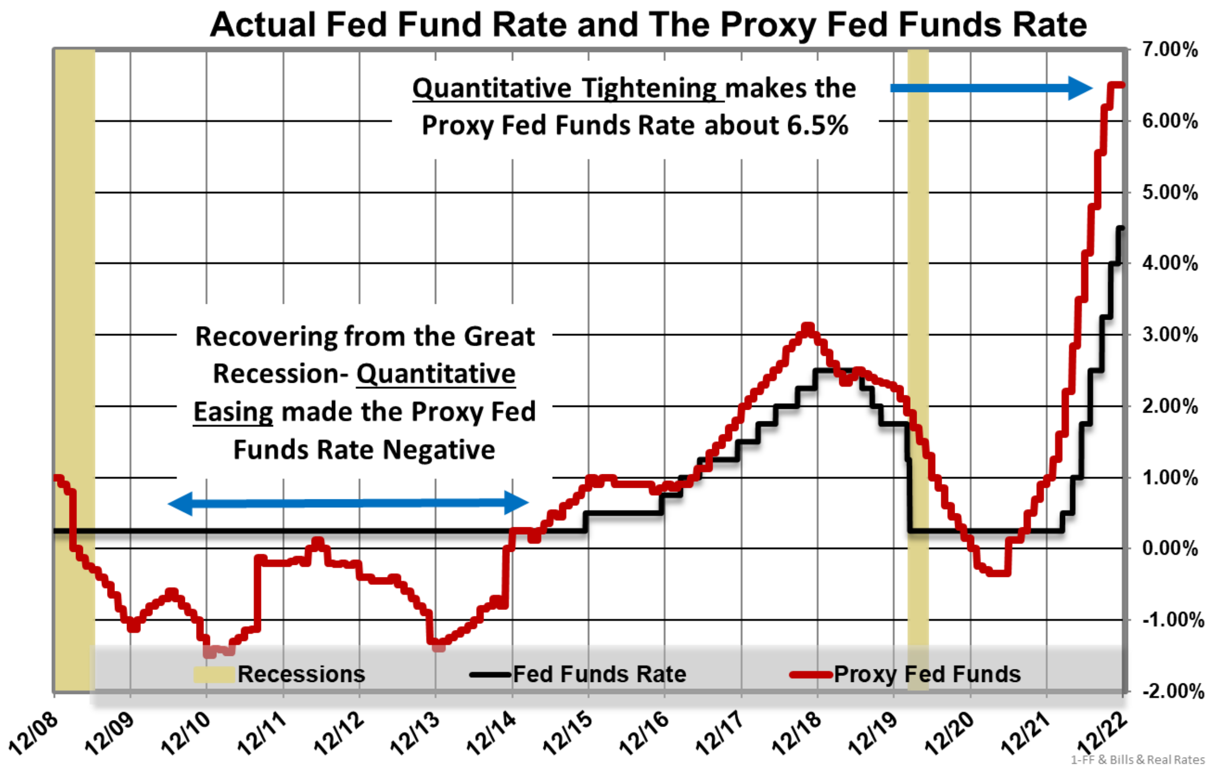
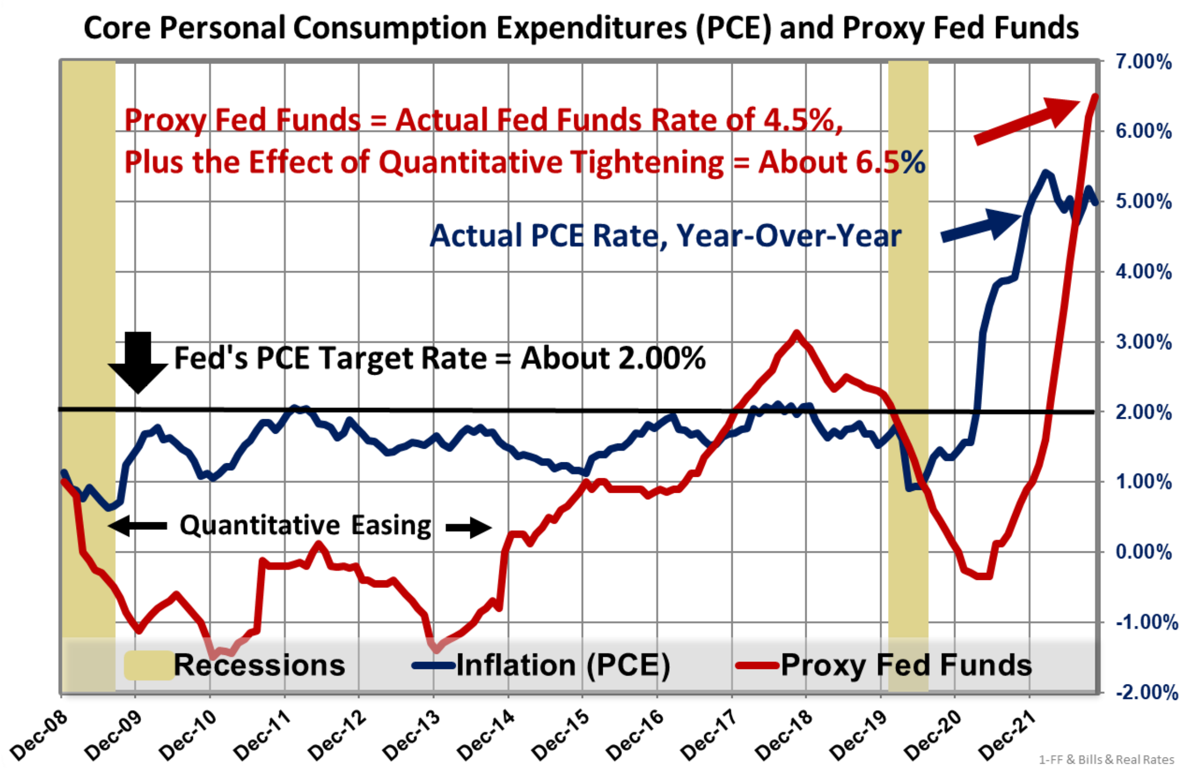
Will The Fed Over Tighten?

The following is from the San Francisco Federal Reserve's web site: "*The San Francisco Fed has launched a new data page that helps gauge the stance of monetary policy under various types of actions. The Proxy Funds Rate focuses on financial market indicators, which show the influence of the Fed's forward guidance and asset sheet actions beyond what can be seen through the level of the federal funds rate.*

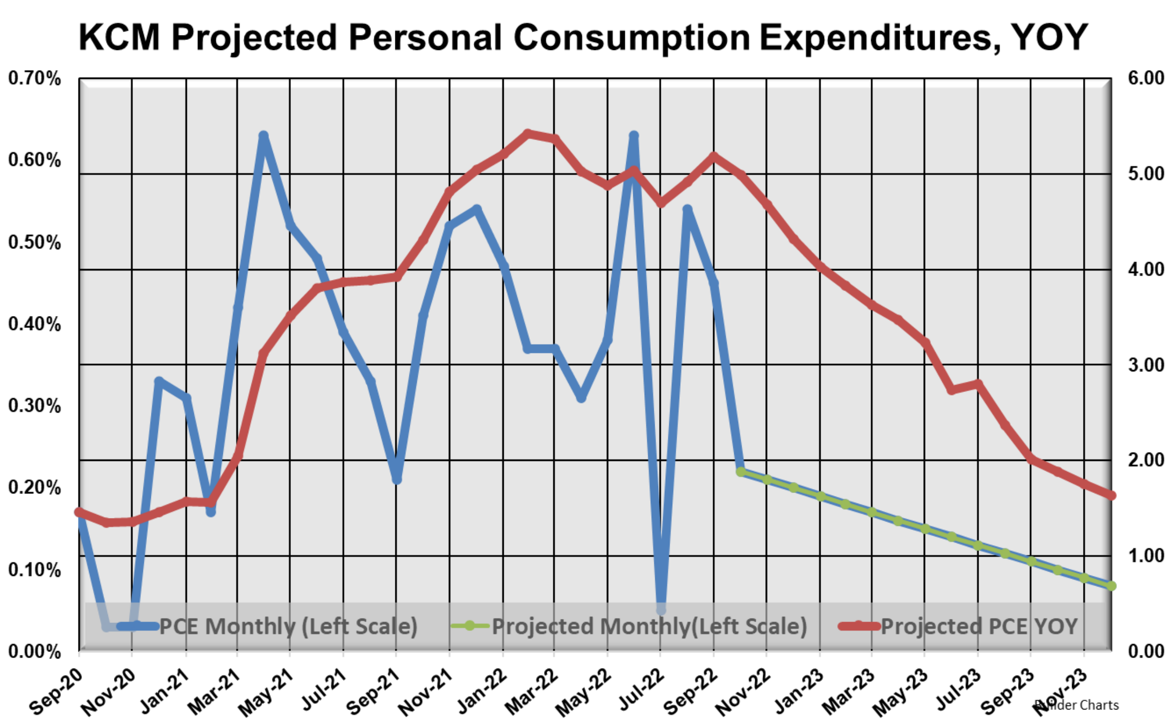
For many years, the Federal Open Market Committee (FOMC) conducted monetary policy solely through changes in the federal funds rate—the short-term interest rate that is the basis for other interest rates in the U.S. economy. However, to help the economy recover from the Great Recession, the FOMC needed to begin relying on additional ways of putting policy into action, specifically through forward guidance and the balance sheet.

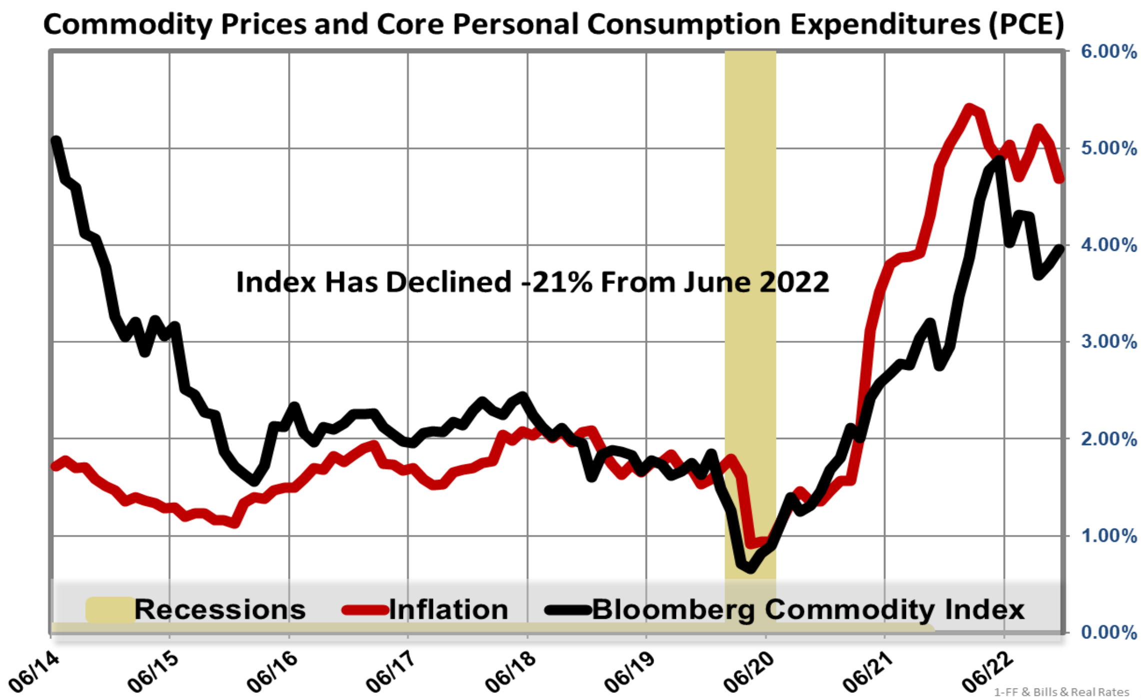
Using these new tools is an effective way of helping the Fed guide the economy toward its dual mandate goal of stable prices and maximum employment. But because the tools are different, it's challenging to find a single way to measure the broad stance of monetary policy. In other words, how do we know whether forward guidance and changes in the balance sheet are having an effect, and can we summarize the multiple tools into an easy-to-interpret indicator? The answer is the Proxy Funds Rate translates a set of financial variables into a rate that is comparable to the federal funds rate."



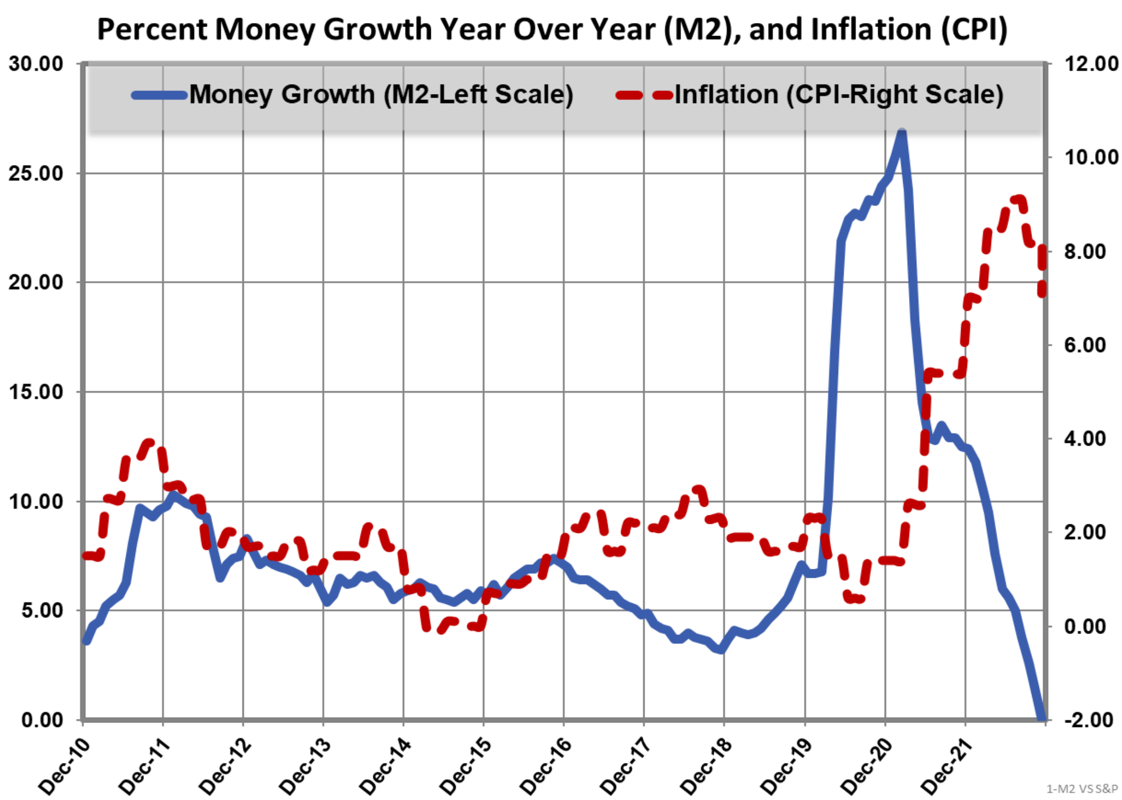


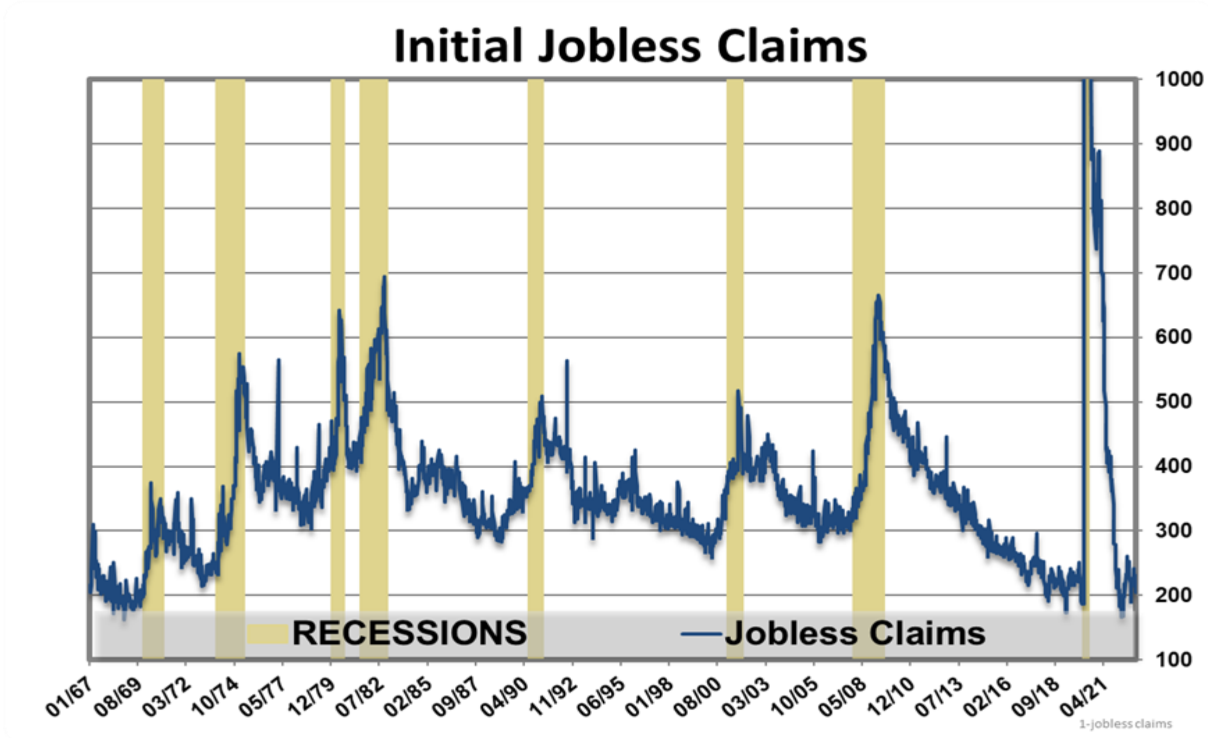
The Fed is aggressively raising the Fed Funds rate and shrinking its balance sheet, (i.e.,QT or quantitative tightening), this combination, according to a study by the San Francisco Federal Reserve Bank, makes the proxy Fed Funds rate about 6.5% (see above). <u>This will likely lead to a PCE level of 2% or lower by late 2023, a tail wind for the stock market (see below)</u>.



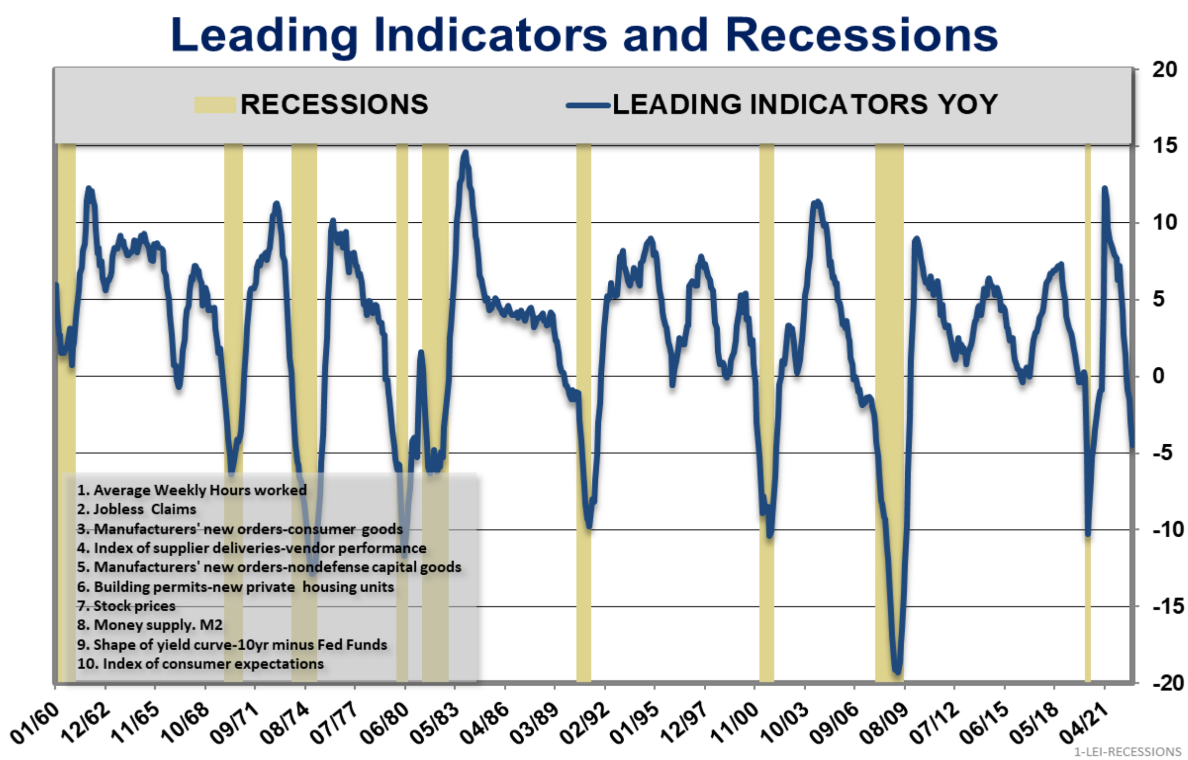


Inflation is cooling. The Bloomberg Commodity Index is off 21% from June (see above). Money supply growth has turned negative which will, with a lagging effect, <u>put downward pressure on inflation over the next year or more (see below).</u>

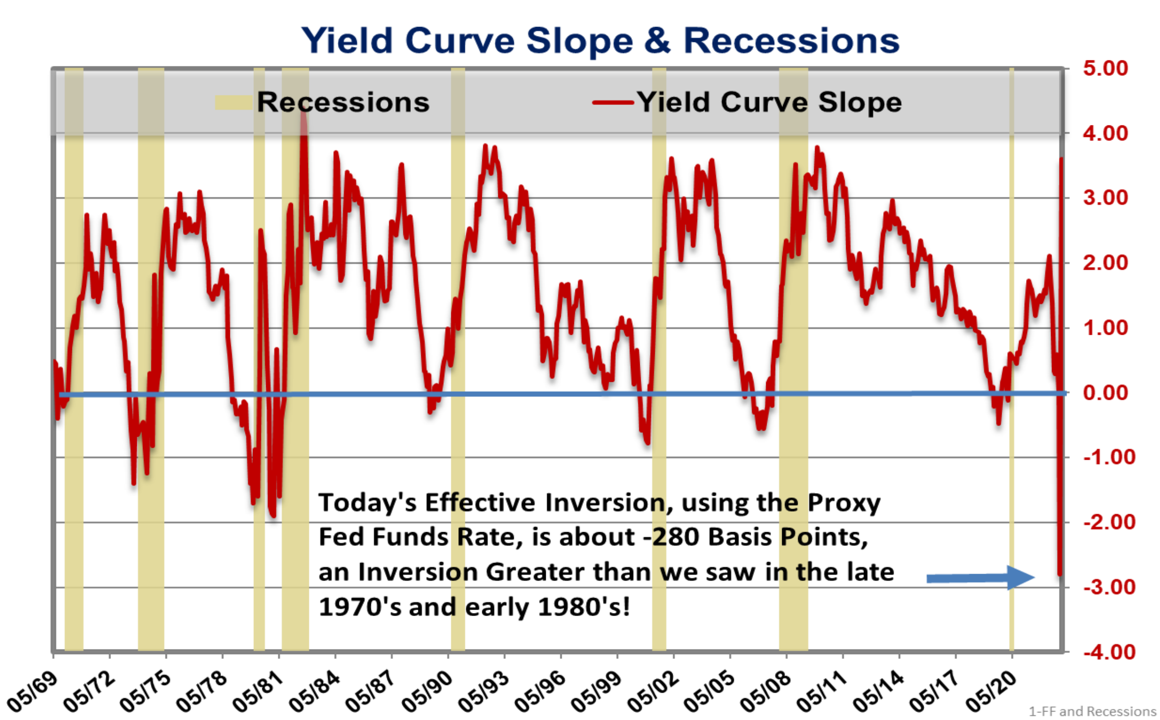


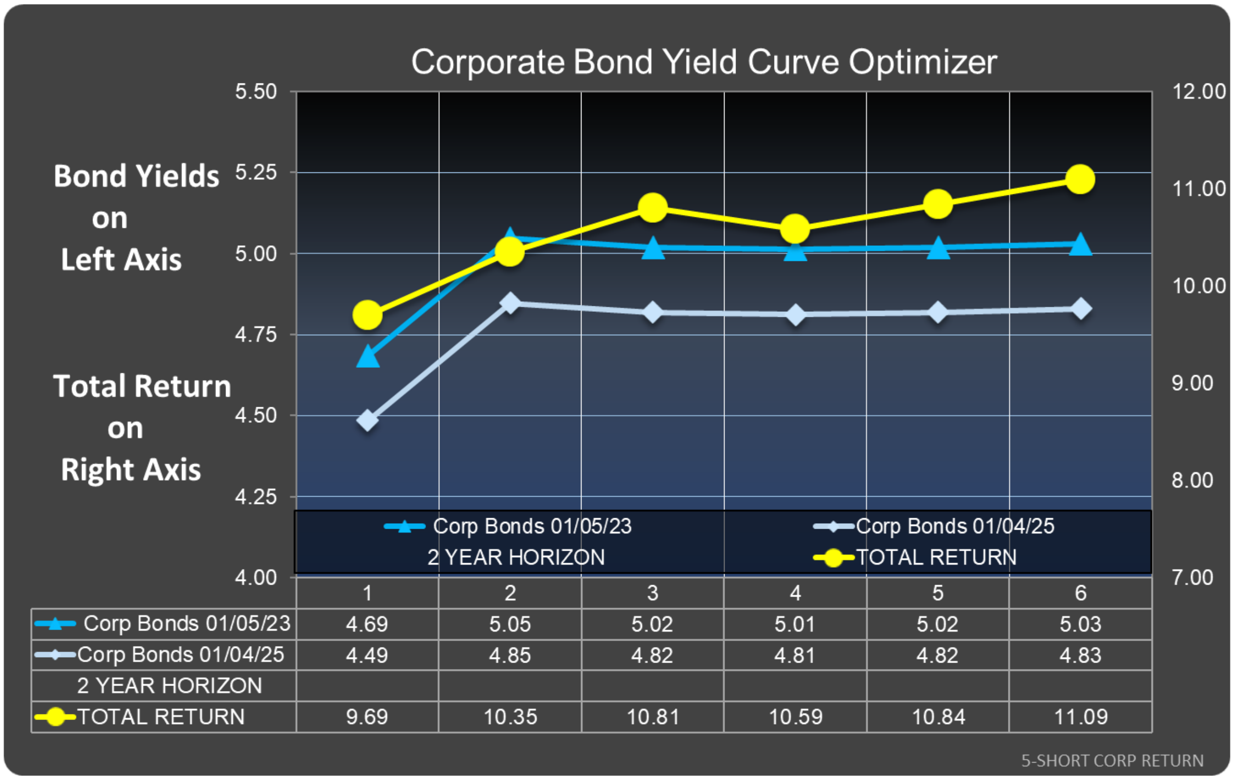


Jobless claims remain at a historically low level (see above) and wage growth is still catching up with inflation (see below). We need to have upward wage pressure continue to abate. That will happen as more layoffs are announced, and if the economy rolls over into a recession.



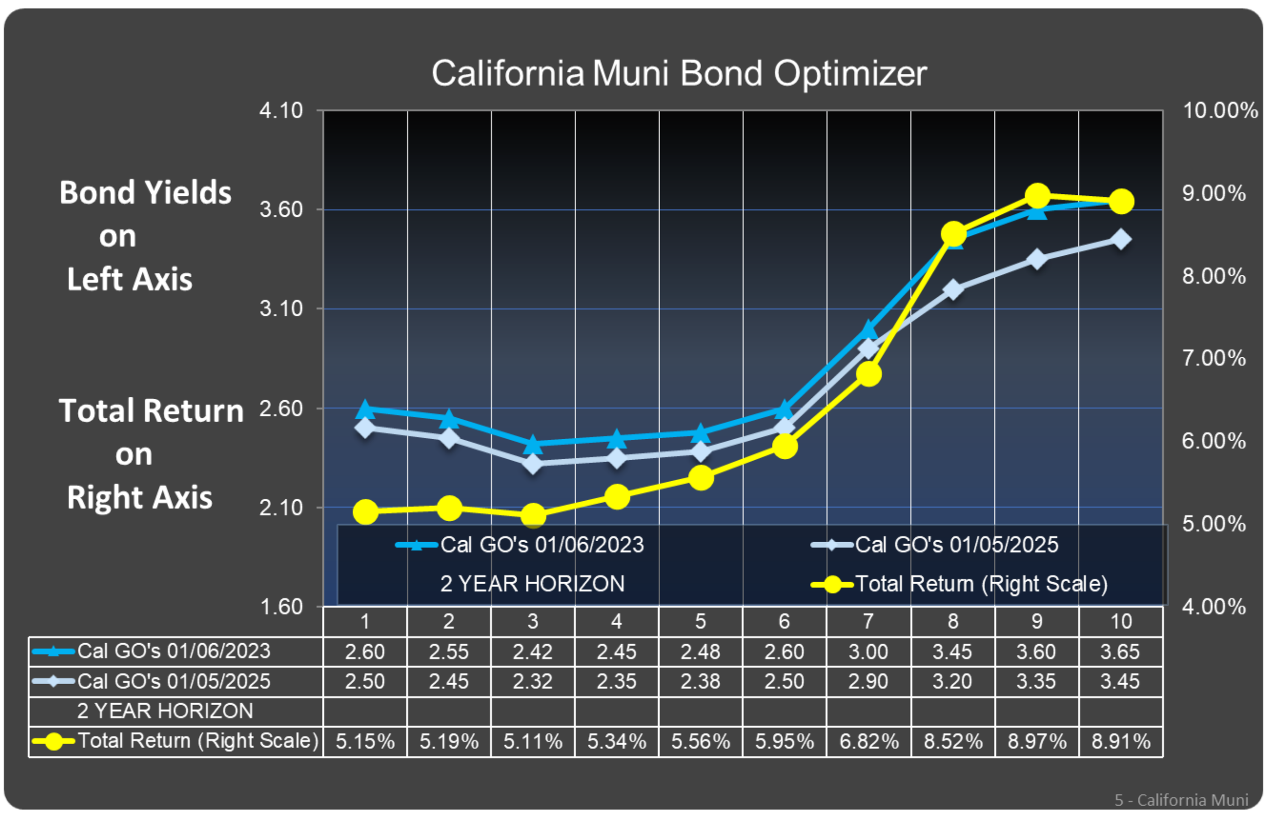
Leading Indicators predict a recession in 2023 (see above) and every time the Fed Funds to ten-year Treasury bond yield curve has inverted, our economy has entered a recession. Using the Proxy Funds rate, the yield curve is the most inverted ever (see below)!



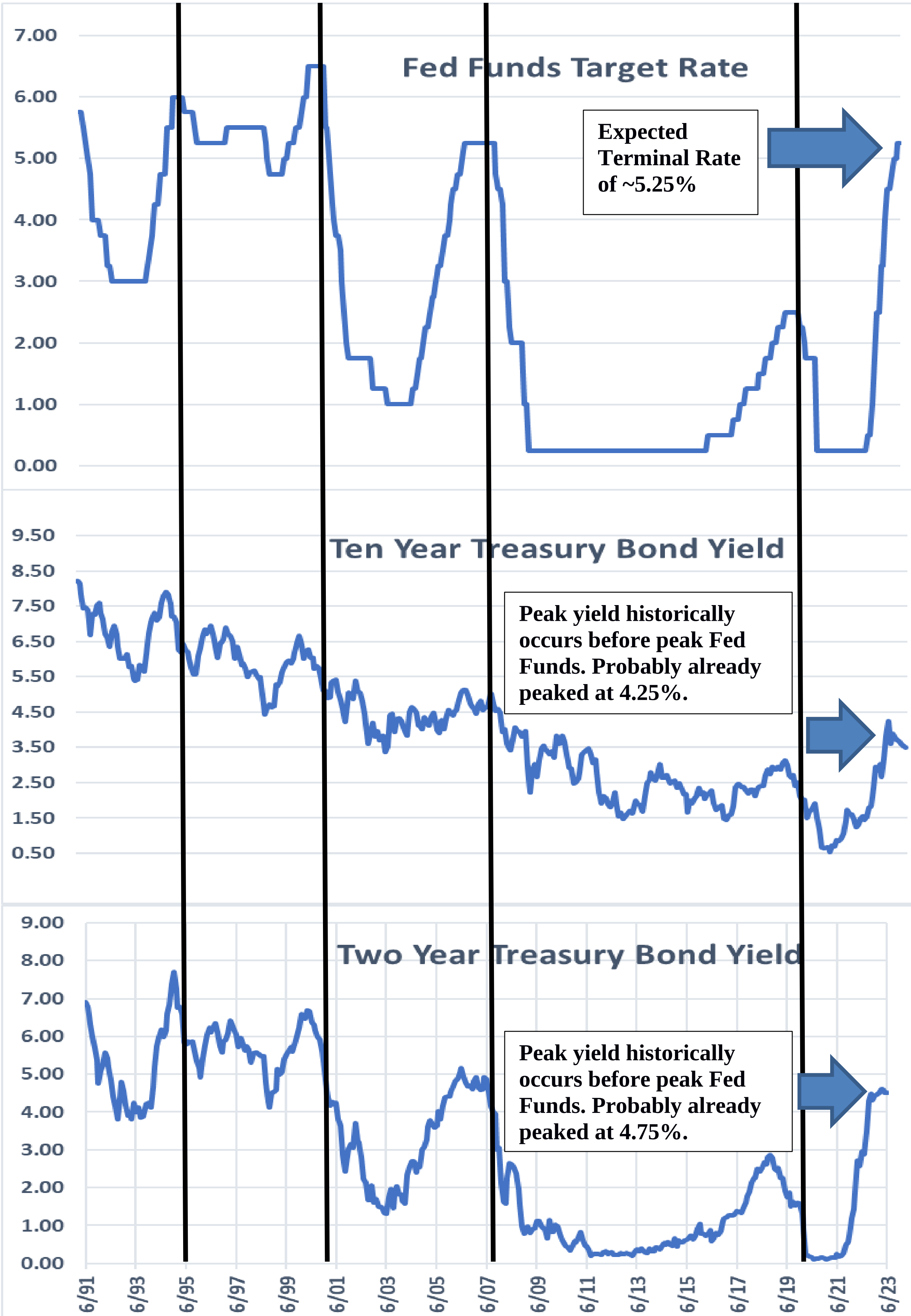


	1	2	3	4	5	6
Corp Bonds 01/05/23	4.69	5.05	5.02	5.01	5.02	5.03
Corp Bonds 01/04/25	4.49	4.85	4.82	4.81	4.82	4.83
2 YEAR HORIZON						
TOTAL RETURN	9.69	10.35	10.81	10.59	10.84	11.09

Both tax-free municipal bonds and taxable corporate bonds still offer a competitive alternative to stocks. A guaranteed 3.6% tax-free yield on an 8-10-year municipal bond equates to a 6% annual return on stocks, for a California resident, at current capital gains rates.



	1	2	3	4	5	6	7	8	9	10
Cal GO's 01/06/2023	2.60	2.55	2.42	2.45	2.48	2.60	3.00	3.45	3.60	3.65
Cal GO's 01/05/2025	2.50	2.45	2.32	2.35	2.38	2.50	2.90	3.20	3.35	3.45
2 YEAR HORIZON										
Total Return (Right Scale)	5.15%	5.19%	5.11%	5.34%	5.56%	5.95%	6.82%	8.52%	8.97%	8.91%


Fed Funds Target Rate
7.00
6.00
5.00
4.00
3.00
2.00
1.00
0.00
Expected Terminal Rate of ~5.25%
Ten Year Treasury Bond Yield
9.50
8.50
7.50
6.50
5.50
4.50
3.50
2.50
1.50
0.50
Peak yield historically occurs before peak Fed Funds. Probably already peaked at 4.25%.
Two Year Treasury Bond Yield
9.00
8.00
7.00
6.00
5.00
4.00
3.00
2.00
1.00
0.00
Peak yield historically occurs before peak Fed Funds. Probably already peaked at 4.75%.
6/91
6/93
6/95
6/97
6/99
6/01
6/03
6/05
6/07
6/09
6/11
6/13
6/15
6/17
6/19
6/21
6/23

Wrapping up:

- The Proxy Funds Rate, calculated by the San Francisco Federal Reserve Bank, is about 6.5% versus the actual Fed Funds rate of 4.5%, reflecting the additional tightening influence of the Fed's forward guidance and quantitative tightening.
- The Fed's favorite inflation indicator is the Core Personal Consumption Expenditures number (PCE), is currently at 4.7% year-over-year. The Proxy Funds rate of 6.5% is 180 basis points higher, high enough to put downward pressure on inflation and bring the PCE and other inflation measures into an acceptable 2%-3% range in the second half of 2023.
- Inflation is clearly abating; the Bloomberg Commodity Index is down 21% from its June high. Oil is off about 30%, natural gas is off about 65%, freight rates are off about 65%, and home prices are off sharply, all from their recent highs.
- Money growth (M2) has turned negative year-over-year, putting downward pressure on inflation.
- Historically low jobless claims, an unemployment rate of only 3.5%, and a high level of wage growth, about 6% year-over-year, kept upward pressure on inflation. (The last reported Average Hourly Earnings, month-over-month, was only 0.3%, giving us hope that wage growth is slowing.)
- We have likely seen the peak in Treasury bond yields (see the charts on page 7).
- Leading indicators and a historically inverted yield curve are strong indications that we will have a recession, probably in the second half of 2023, which would cause inflation to further slow, and push bond rates lower.
- The market has predicted, and hopefully discounted, a recession, as witnessed the 30%-plus drop in the Nasdaq from its high and about 20% decline in the S&P 500.
- Higher than expected inflation is what got us into this mess and what underpins our positive outlook is our prediction for faster-falling and lower inflation than the current consensus. Please see our PCE prediction chart on page 2.
- We believe the "long and variable lag" to central bank policy moves has probably shortened, inflation will move to an acceptable level sooner than the consensus believes and the markets have largely discounted a likely moderate recession.
- **We believe the Fed's current Fed Funds rate, forward guidance, and quantitative tightening path, are sufficient to get inflation to an acceptable level. A good job so far. Additional tightening would risk a severe recession and an unfavorable market reaction. We encourage the Fed to not over tighten.**

Our advice has not changed. Stay the course, do not sell your equities during a bottoming market, and take solid comfort locking in some of today's attractive bond yields. We particularly encourage investors to add to sensible risk assets like KCM's Dividend BlueBloods, companies we identify as smart long-term investments that make up a portfolio characterized by a healthy balance between growth and value.

Jay Kellett, Founder and CEO, and your KCM Team