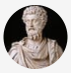
Fed Raises 75 bps, Goodbye Soft Landing, Hello Recession

June 16, 2022



Marcus Aurelius
Jun 16

Executive Summary

The Fed broke from it's prior guidance of a 50 bps hike to a 75 bps hike after the hot May inflation number.

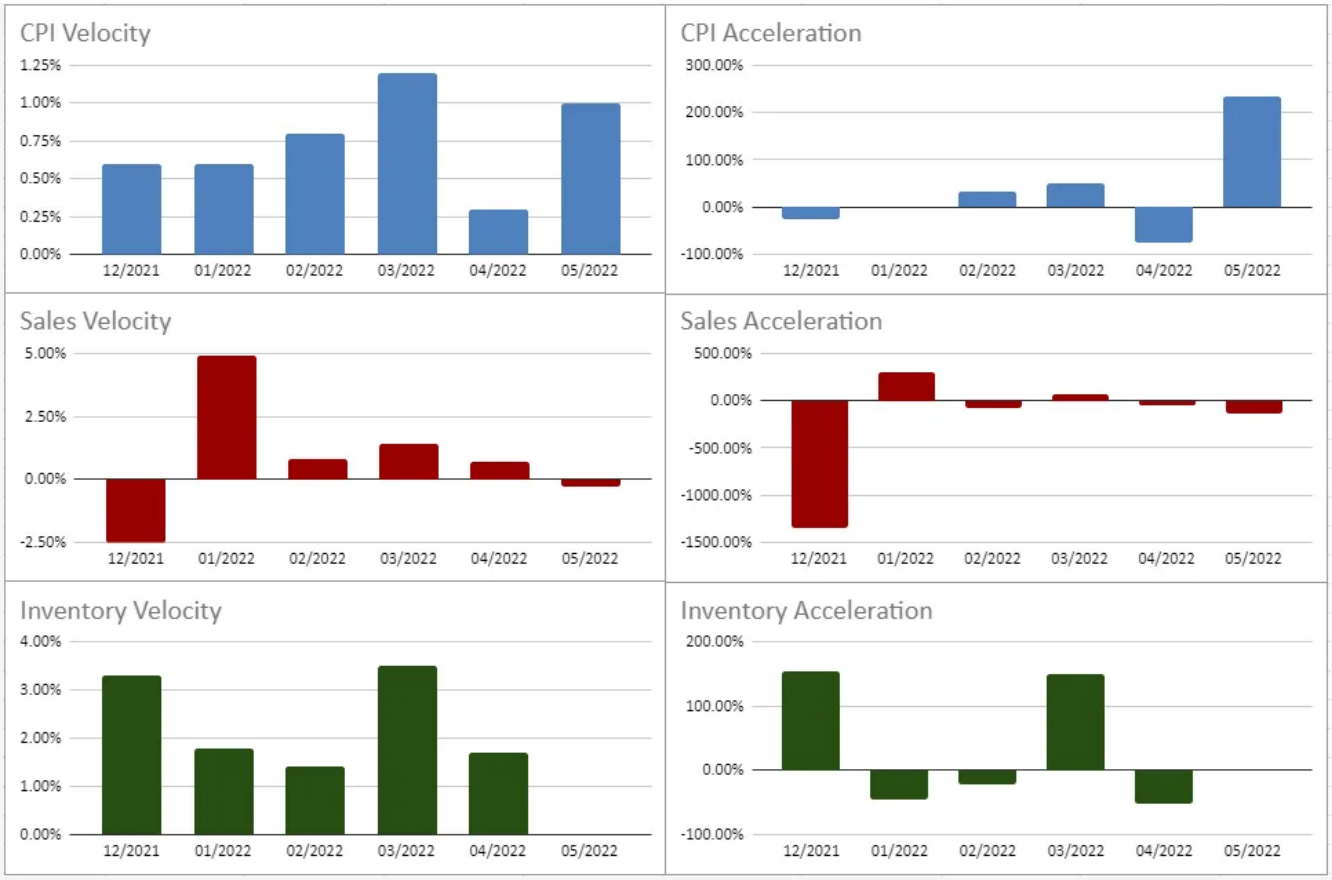
Economic metrics were already slowing down leading into May and large retailers (WMT, TGT) recently reported consumers being squeezed at the market and inventories building. So, what led to the inflation surprise? Energy.

Now with the Fed accelerating the decline, the likelihood of a soft landing is nil and the odds of a deeper more destructive recession are growing.

> **"Treat with utmost respect your power of forming opinions, for this power alone guards you against making assumptions that are contrary to nature and judgments that overthrow the rule of reason."**
>
> **- Marcus Aurelius -**

Economic Metrics

The 3 key metrics that I watch on a month to month basis is CPI, Retail Sales, and Retail Inventories. Between these, we can see how goods are moving through the economy and whether pricing is slowing down the consumer or not.



Our focus is on the rate of change of that metric (velocity) and the rate of change of the rate of change of that metric (acceleration). As we can see in May, not only did CPI increase 1% MoM but it accelerated at a 200%+ rate MoM as well. Inflation is hot, there is no doubt about it and this is what has spooked the Fed so much.

But, we also see that Retail Sales look to have peaked in April and really lost momentum back in February. Correspondingly, inventories grew in March matching up with the February sales slowdown and continued to build in April. (May Inventories are to be released on June 28).

What does this tell us? Let's try to put the puzzle pieces together. Retail Sales slowed in February, Inventories spiked higher in March (Low Consumer Demand), and CPI slowed in April. What led to the May hot inflation number?

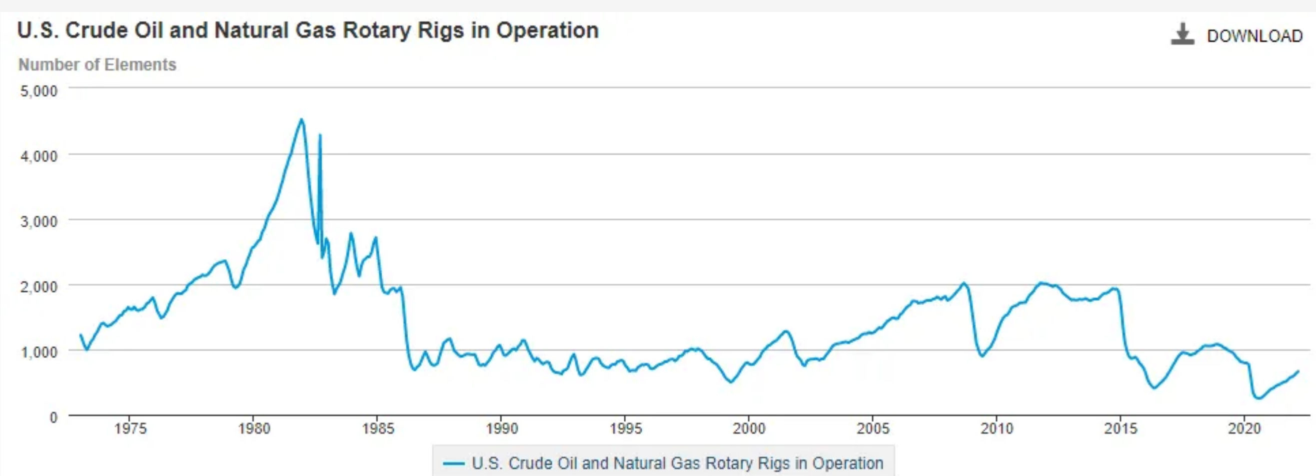
WTI Crude Oil Futures

RBOB Gasoline Futures

Henry Hub Natural Gas Futures

Energy Prices! Since April, we have seen a steady climb higher in Oil & Gasoline prices which is raising fuel costs for agriculture, transportation, and consumers. Meanwhile, Natural Gas has been on a bull run since March that is driving input costs higher for products such as fertilizers, plastics, pharma, fabrics, and utilities.

Can this be solved with demand destruction? Sure, but how much demand destruction will need to take place. Could this be solved with increasing Supply? Definitely, yet US Oil & Gas Rig counts are near 50 year lows.



With the current energy transition policy to renewables that will not allow for supplemental oil & gas production, the Fed looks to feel trapped in a corner with inflation, and demand destruction is the only way out.

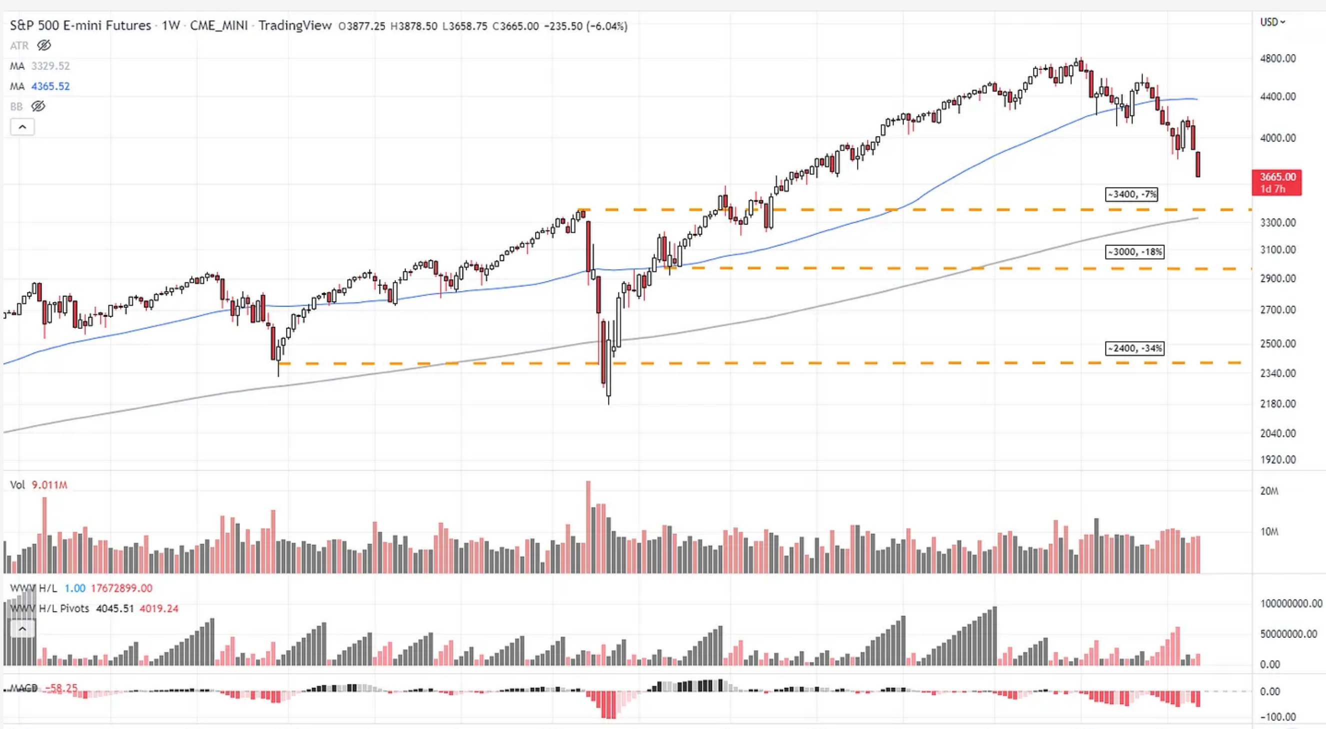
Market Price Action

The immediate reaction of the Fed's 75 bps hike was mixed yesterday, until Fed Chair Powell said the following:

> "Clearly today's 75 bps increase is an unusually large one, and I do not expect moves of this size to be common."

This was enough for the market to rally like the Fed will be back to 50 bps or less hikes going forward. Prior to June 10, the Fed had confidently said the June hike would be 50 bps and then the June 10 inflation number came out, and 6 days later, the Fed raised 75 bps. Does anyone have any confidence with Powell's expectations right now? The Fed is at the mercy of the data now, behind the curve, and trying to play catch up.

This larger rate increase combined with the lack of credibility of what the Fed expects for upcoming meetings has set the market on a path for very rough times ahead.



S&P 500 Futures Weekly Chart

S&P 500 Futures Daily Chart

We have significant levels lower at -7%, -18%, and -34% from current prices. With a recession nearly guaranteed now, all of these levels can be in play. In the short term, we have measured move targets to ~$3000-$3400 that is the likely first stopping area where we could see some consolidation and bear market rallies take place.

Comments

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