Stocks are rallying on hopes that Jerome Powell and the Fed will stop increasing interest rates this fall, pivot, and start reducing them next year. For fear of missing out on the next great bull run, many investors are blindly buying into this new Powell pivot narrative.

What these investors fail to realize is the Fed has a problem. **Inflation is raging, the likes of which the Fed hasn't dealt with since Jerome Powell earned his law degree from Georgetown University in 1979.**

Despite inflation, markets seem to assume that today's Fed has the same mindset as the 1990-2021 Fed. The old Fed would have stopped raising rates when stocks fell 20% and certainly on the second consecutive negative GDP print. The current Fed seems to want to keep raising rates and reducing its balance sheet (QT).

The market-friendly Fed we grew accustomed to over the last few decades may not be driving the ship anymore. **Yesterday's investment strategies may prove flawed if a new inflation-minded Fed is at the wheel.**

Of course, you can ignore the realities of today's high inflation and take Jim Cramer's ever-bullish advice.

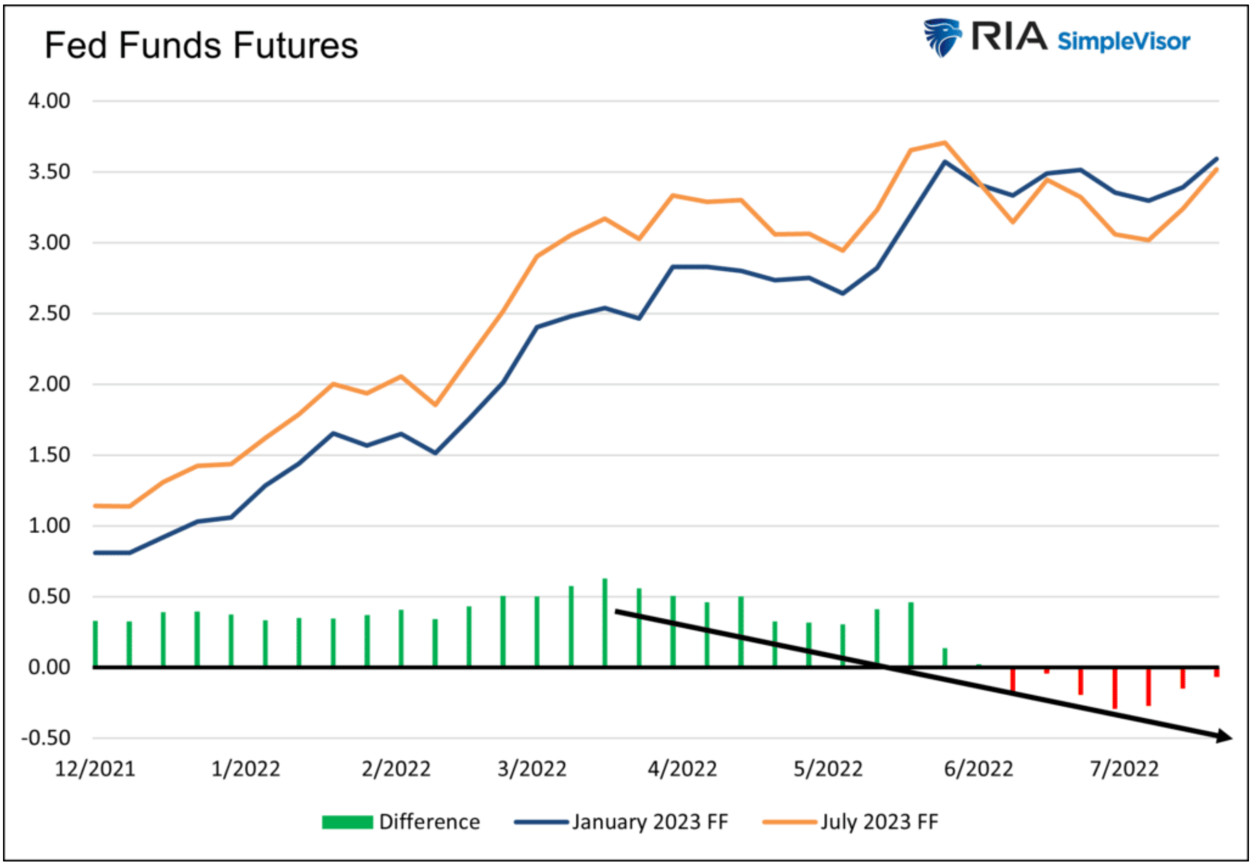
> ***When the Fed gets out of the way, you have a real window and you've got to jump through it. ? When a recession comes, the Fed has the good sense to stop raising rates," the "Mad Money" host said. "And that pause means you've got to buy stocks.***

Shifting Market Expectations

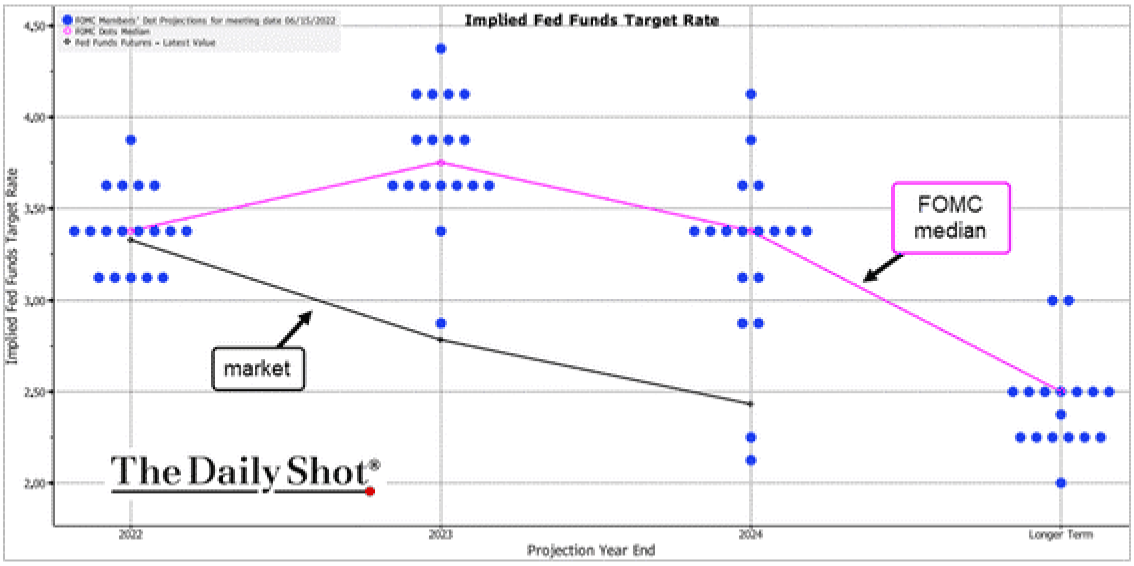
On June 10, 2022, the Fed Funds Futures markets implied the Fed would raise the Fed Funds rate to 3.20% in January 2023 and to 3.65% by July 2023. Such suggests the Fed would raise rates by almost 50bps between January and July.

Now the market implies Fed Funds will be 3.59% in January, up .40% in the last two months. However, the market implies July Fed Funds will be 3.52%, or .13% less than its January expectations. The market is pricing in a rate reduction between January and July.

The graph below highlights the recent shift in market expectations over the last two months.



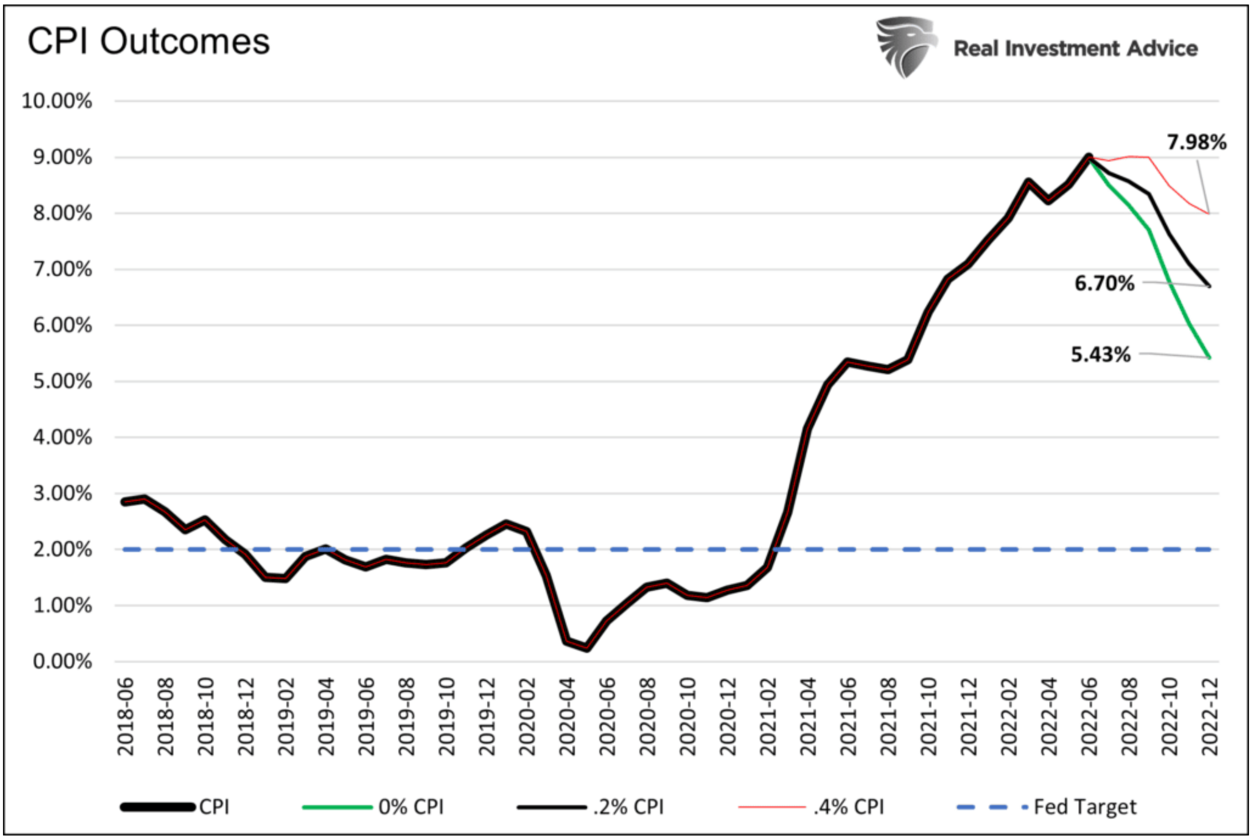
The graph below from the Daily Shot shows compares the market's implied expectations for Fed Funds (black) versus the Fed?s expectations. Each blue dot represents where each Fed member thinks Fed Funds will be at each year-end. **The market underestimates the Fed's resolve to increase interest rates by about 1%.**



Short Term Inflation Projections

The biggest flaw with pricing in predicting a stall and Powell pivot in the near term is the possible trajectory of inflation. The graph below shows annual CPI rates based on three conservative monthly inflation data assumptions.

If monthly inflation is zero for the remainder of 2022, which is highly unlikely, CPI will only fall to 5.43%. Yes, that is much better than today's 9.1%, but it is still well above the Fed's 2.0% target. The other more likely scenarios are too high to allow the Fed to halt its fight against inflation.

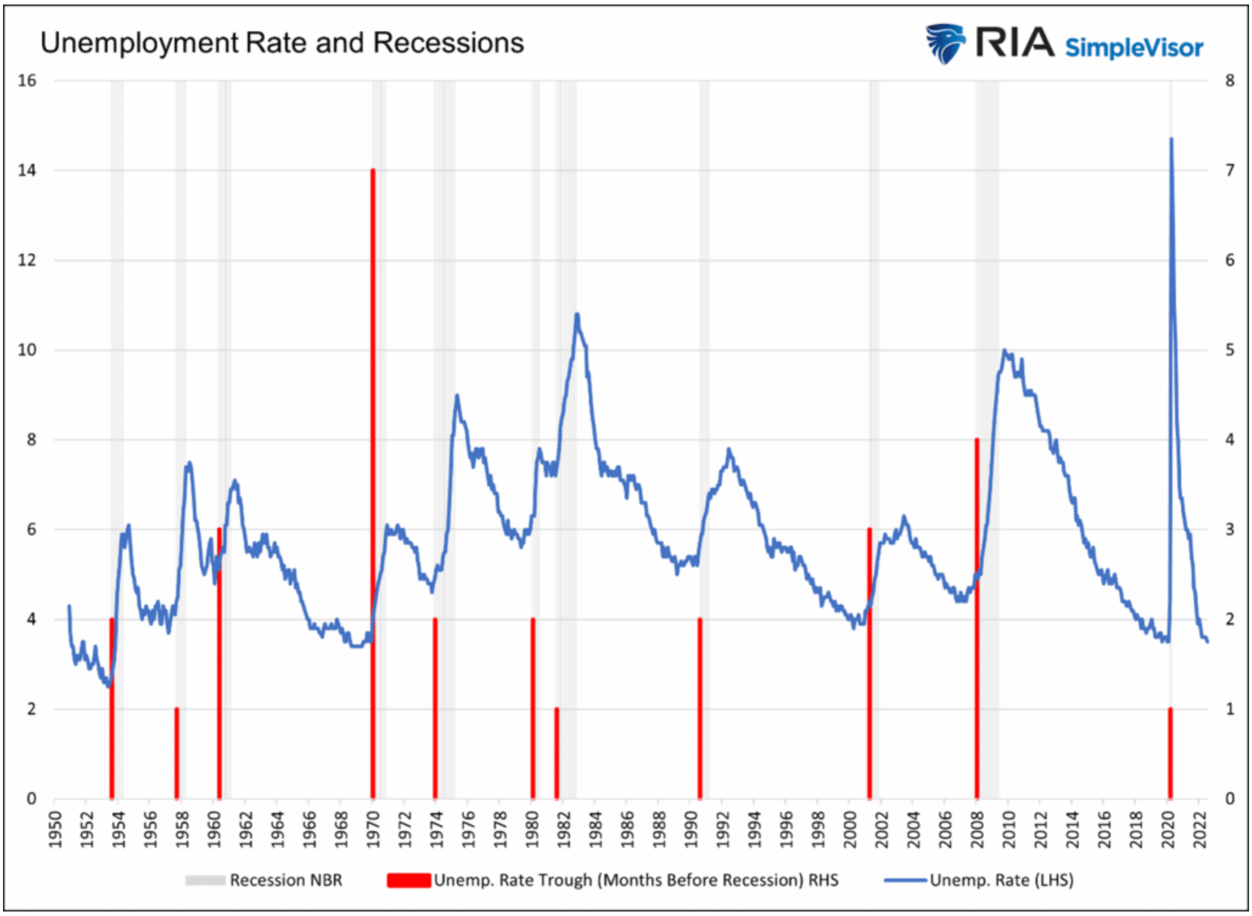


Inflation on its own, even in a rosy scenario, is not likely to get Powell to pivot. However, economic weakness, deteriorating labor markets, or financial instability could change his mind.

Recession, Labor, and Financial Instability

GDP just printed two negative quarters in a row. Some economists call that a recession. The NBER, the official determiner of recessions, also considers the health of the labor markets in their recession decision-making.

The graph below shows the unemployment rate (blue), recessions (gray), and the number of months the unemployment rate troughed (red) before each recession. Since 1950 there have been eleven recessions. On average, the unemployment rate bottoms 2.5 months before an official recession declaration by the NBER. **In seven of the eleven instances, the unemployment rate started rising one or two months before a recession.**



The unemployment rate may start ticking up shortly, but consider it is presently at a historically low level. At 3.5%, it is well below the 6.2% average of the last 50 years. **Of the 630 monthly jobs reports since 1970, there are only three other instances where the unemployment rate dipped to 3.5%. There are zero instances since 1970 below 3.5%!**

Despite some recent signs of weakness, the labor market is historically tight. For example, job openings slipped from 11.85 million in March to 10.70 in June. However, as we show below, it remains well above historical norms.

A tight labor market that can lead to higher inflation via a price-wage spiral is of concern for the Fed. Such fear gives the Fed ample reason to keep tightening rates even if the labor markets weaken. For more on price-wage spirals, please read our article [Persistent Inflation Scares the Fed](#)
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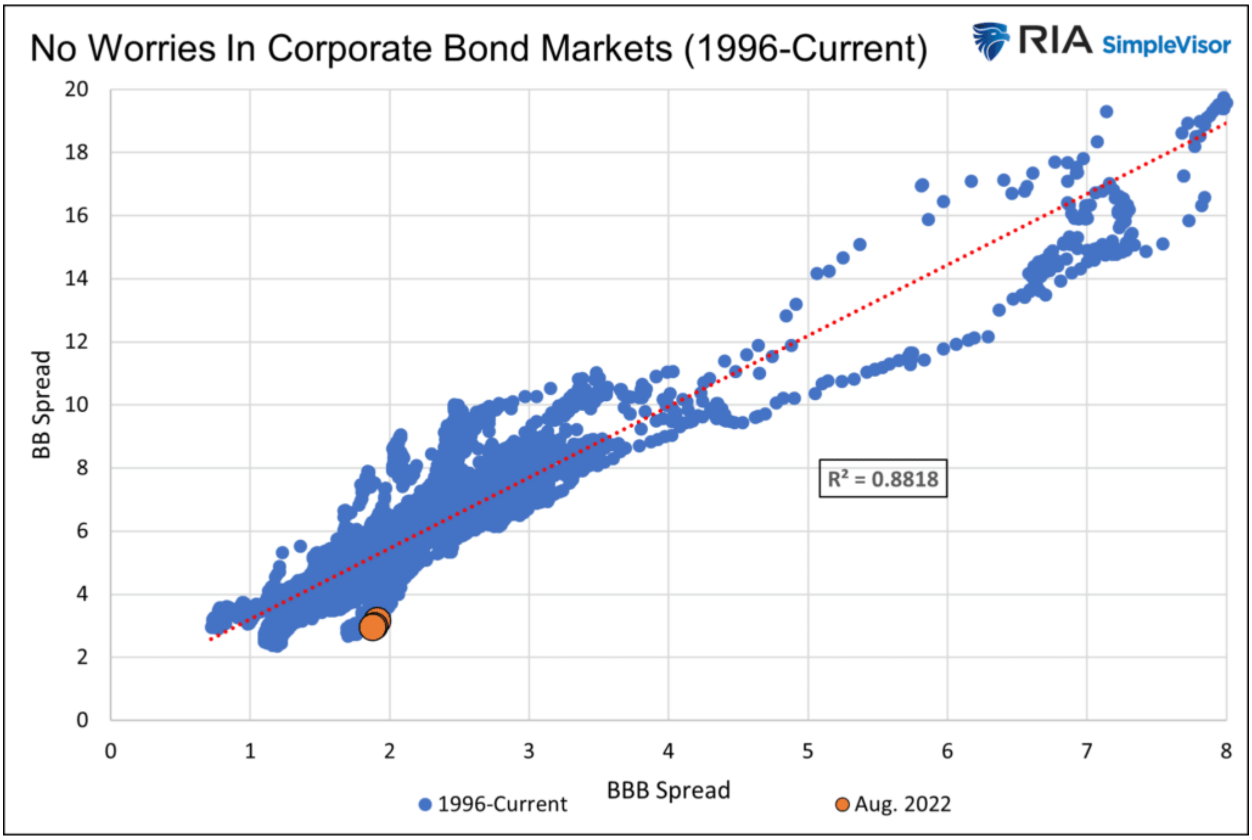
Financial Stability

Besides economic deterioration or labor market troubles, financial instability might cause Jerome Powell to pivot. While there were some growing signs of financial instability in the spring, those warnings have dissipated.

For example, the Fed pays close attention to the yield spread between corporate bonds and Treasury bonds (OAS) for signs of instability. They pay particular attention to yield spreads of junk-rated corporate debt as they are more volatile than investment-grade paper and often are the first assets to show signs of problems.

The graph below plots the daily intersections of investment grade (BBB) OAS and junk (BB) OAS since 1996. **As shown, the OAS on junk-rated debt is almost 3% below what should be expected based on the robust correlation between the two yield spreads.** Corporate debt markets are showing no signs of instability!



Stocks, on the other hand, are lower this year. The S&P 500 is down about 15% year to date. However, it is still up about 25% since the pandemic started. More importantly, valuations have fallen but are still well above historical averages. So, while stock prices are down, there are few signs of equity market instability. In fact, the recent rally is starting to elicit FOMO behaviors so often seen in speculative bullish runs.

Declining yields, tightening yield spreads, and rising asset prices are inflationary. If anything, recent market stability gives the Fed a reason to keep raising rates. **Ex-New York Fed President Bill Dudley recently commented that market speculation about a Fed pivot is overdone and**

counterproductive to the Fed's efforts to bring down inflation.

What Does the Fed Think?

The following quotes and headlines have all come out since the late July 2022 Fed meeting. They all point to a Fed with no intent to stall or pivot despite its effect on jobs and the economy.

- **KASHKARI: 2023 RATE CUTS SEEM LIKE `VERY UNLIKELY SCENARIO'*
- *Fed's Kashkari: concerning inflation is spreading; we need to act with urgency*
- **BOWMAN: SEES RISK FOMC ACTIONS TO SLOW JOB GAINS, EVEN CUT JOBS*
- **DALY: MARKETS ARE AHEAD OF THEMSELVES ON FED CUTTING RATES*
- *St. Louis Fed President James Bullard says he favors a strategy of "front-loading" big interest-rate hikes, repeating that he wants to end the year at 3.75% to 4% ? Bloomberg*
- *FED'S BULLARD: TO GET INFLATION COMING DOWN IN A CONVINCING WAY, WE'LL HAVE TO BE HIGHER FOR LONGER.*
- *"If you have to cut off the tail of a dog, don't do it one inch at a time."- Fed President Bullard*
- *"There is a path to getting inflation under control," Barkin said, "but a recession could happen in the process" ? MarketWatch*
- *The Fed is "nowhere near" being done in its fight against inflation, said Mary Daly, the San Francisco Federal Reserve Bank president, in a CNBC interview Tuesday. ?MarketWatch*
- *"We think it's necessary to have growth slow down," Powell said last week. "We actually think we need a period of growth below potential, to create some slack so that the supply side can catch up. We also think that there will be, in all likelihood, some softening in labor market conditions. And those are things that we expect...to get inflation back down on the path to 2 percent."*

Summary

We are highly doubtful that Powell will pivot anytime soon. Supporting our view is the recent action of the Bank of England. On August 4th they raised interest rates by 50bps despite forecasting a recession starting this year and lasting through 2023. Central bankers understand this inflation outbreak is unique and are caught off guard by its persistence.

The economy and markets may test their resolve, but the threat of a long-lasting price-wage spiral will keep the Fed and other banks from taking their foot off the brakes too soon.

We close by reminding you that inflation will start falling in the months ahead, but it hasn't even officially peaked yet.