PRUDENT INVESTORS

THE PRUDENT PERSPECTIVE

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If you can walk away from a landing, it's a good landing. If you use the airplane the next day, it's an outstanding landing.
~ Brigadier General Chuck Yeager

Bracing for a Hard or Soft Landing?

Among the multitude of new buzzwords that proliferated in 2022, one that has been quoted with particular frequency in business parlance is the term, "hard landing." The metaphor seems appropriate as central bankers around the world adjust their monetary flight paths. Airspeed, pitch attitude, power, and drag, could just as easily refer to the pace of increases, policy expectations, level of rates, and inflation.

Over the last several months, investors have become increasingly fearful that the current economic climate could induce monetary officials to overcompensate in their efforts, which could lead to an unfavorable or even dangerous outcome.

While it is impossible to know whether we are headed for a hard landing, soft landing, or something in-between, one thing is certain: the economy is descending. There is abundant evidence of slowing activity in the form of lower consumer spending, reduced corporate earnings, stalled GDP growth, a decline in manufacturing, and even a dimming jobs outlook.

Entering 2023, market pundits will continue to opine on how we'll stick the landing. The landing will ultimately dictate how well we walk away and when we are ready to fly again.

A Determined Slowdown

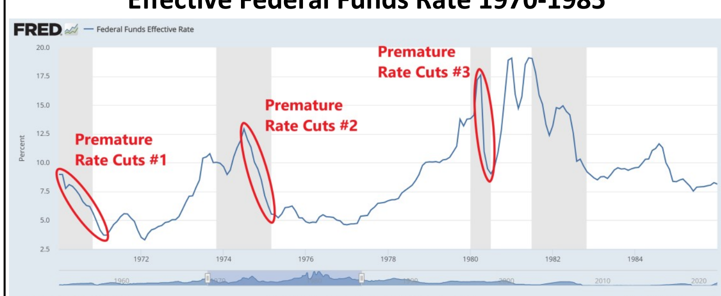
In 2022, the Federal Reserve increased its benchmark interest rate by 4.25% (from 0.25% to 4.50%), marking its largest increase in a single calendar year since 1973 when rates were increased by 5.25% (from 5.75% to 11%) under then Fed Chairman Arthur Burns. 2022's total size of rate increases even exceeded those calendar years of the late 1970s-early 1980s, when the Fed Funds rate eventually peaked at 20% in February 1981.

Following last year's historic monetary tightening, the market is pricing in two more small rate increases in February and March before cutting rates again in November or December of this year. While this is certainly a possibility, it doesn't appear to be the Fed's base case.

In August, Fed Chairman Jerome Powell expressed his reluctance to begin easing too soon, commenting, "History shows the… costs of bringing down inflation increase with delay… The disinflation of the early 1980s followed multiple failed attempts to lower inflation over the previous 15 years… Our aim is to avoid that outcome by acting with resolve now."

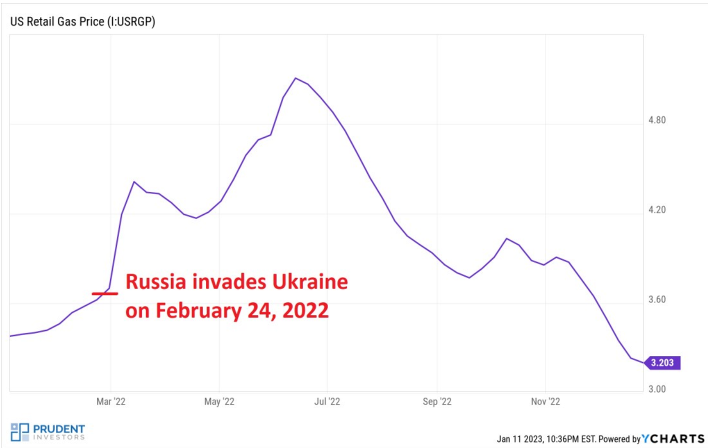
The Federal Reserve suffered three failed attempts to stabilize inflation during that period—in 1970-71, 1975-76, and 1981-82—before prices finally truly cooled in the mid-1980s. With the Fed outspokenly looking to history as a guide, the central bank is unlikely to begin reducing rates again until they are acutely certain that prices are back under control.

Effective Federal Funds Rate 1970-1985



Key Asset Prices Falling

Prices in some parts of the economy are already clearly slowing down. Gas prices, for instance, finished 5.5% below where they started in 2022 and are nearly 13% lower than when Russia invaded Ukraine last February.



Rents have fallen for three consecutive months through November, dropping at their fastest rate in 7 years, according to Zillow. The sharp reversal looks unlikely to change soon. Rents are dropping 0.2% a month in recent history and coincides with the highest level of US apartment construction in more than 50 years, according to *The Washington Post*.

It's no surprise that home prices are also turning lower in the US—Morgan Stanley predicts prices may fall 10% from their June 2022 peak. Other G-10 countries are in a more precarious position. According to Goldman Sachs, home prices in Canada and Sweden have already dropped 7% in the last six months and 11% in New Zealand in eight months. Britain is vulnerable as nearly all of their mortgages are due to reset within five years; 40% are due to reset by July 2023, according to the Bank of England. Furthermore, mortgage debt makes up a larger share of GDP in the UK than other developed economies.

Rather remarkably, lumber prices have fallen to even below pre-pandemic levels, after spiking as much as 313% from the start of 2020. Other key commodities such as aluminum and natural gas have seen prices pull back significantly in recent months.

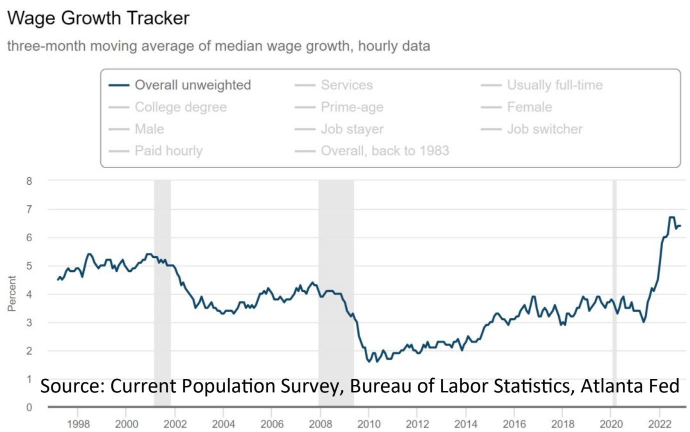
A Convoluted Picture

Nevertheless, other key segments of the economy have not gotten cheaper, and in some cases, have seen prices rebound again. Copper prices, for example, have rebounded significantly on increased demand from a reopened Chinese economy. Iron ore has rallied over 60% since the end of October, and many analysts are predicting oil prices could rebound back above $100/bbl before the end of this year.

While China's reopening is expected to drive increased demand, a weaker dollar is also contributing to higher commodity prices. After rallying as much as nearly 20% through September of last year, the dollar has weakened 10% from its highs. The selloff in the dollar may create some reluctance for the Fed to reduce interest rates as soon as market participants are hoping for.

Key Metric Taking Longer to Stabilize

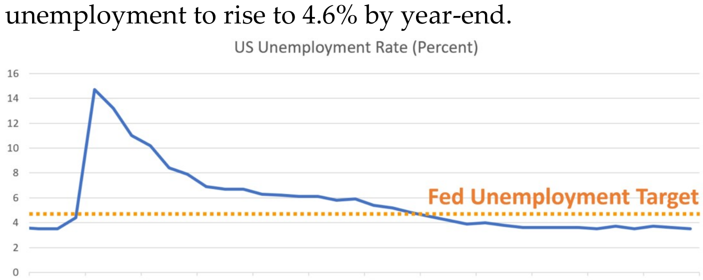
Perhaps the price metric that is of greatest focus is wages. With roughly 3/4 of the US economy tied to service industries, labor occupies a disproportionate share of expenses across overall commerce. High wage inflation puts significant upward pressure on the cost of goods and services, and also boosts demand from US consumers to drive up prices. These two fundamental dynamic factors must be stabilized for inflation to cool down long term. The difficulty is that until just very recently, wage inflation has remained stubbornly high. While risky asset prices have turned down more quickly, wage growth has been sticky despite the importance of bringing it under control.



Source: Current Population Survey, Bureau of Labor Statistics, Atlanta Fed

Fed Chair Jerome Powell expressed similar sentiments in his Brookings Institute speech at the end of November, remarking, "[core services]... may be the most important category for understanding the future evolution of core inflation. Because wages make up the largest cost in delivering these services, the labor market holds the key to understanding inflation."

The critical challenge facing monetary policy makers is the tight labor market. There are currently 10.5 million job openings in the US, significantly more than the 5.7 million people who are unemployed. Although the White House applauded the recent jobs report showing unemployment at a 50-year low of 3.5%, the central bank would likely prefer to see a healthier balance. In its December Summary of Economic Projections (SEP), the Fed expects unemployment to rise to 4.6% by year-end.



The Politics of Policy

There will likely be plenty of debate throughout the year of where rates are expected to peak and when is appropriate for the Fed to pivot on policy. Arguably of equal or even greater importance is the Fed's tone it adopts in communicating with the public. Their words and rhetoric will be carefully dissected and can dramatically impact inflation expectations.

Inflation expectations can be self-fulfilling because they largely affect consumer behavior, as consumers will make purchasing and financial decisions around the rate at which they believe prices will change in the future. For this reason, central banks around the world will be highly sensitive towards messaging. It is also why the Federal Reserve has been cautious about guiding towards a soft vs hard landing.

Ultimately, what would a soft landing look like? It would be a rapid reduction of price inflation while avoiding a dramatic rise in unemployment. Is this achievable? Recent data has been trending positively; prices have largely started coming down (albeit slowly) while labor remains intact. That said, with inflation still north of 7%, prices are miles away from the Fed's 2% target and plenty can change in the coming months.

Is a Soft Landing the Optimal Outcome?

While there has been plenty of discussion about hard and soft landings, one question that isn't asked is: should a soft landing be the ultimate objective? Pilots will tell you that amidst adverse weather conditions, when the runway is slick or slippery, a firm landing is often the safer approach as it lessens the chance of skidding or hydroplaning and also allows for greater distance on the runway after touching down.

A "soft landing" amidst current economic conditions, is only to be desired if price inflation can be stabilized long term. Prolonging the remediation process or seeing inflation flare up again will only serve to undermine confidence and reignite fear.

While we can hope for a relatively painless outcome, a firmer landing that we can walk away from and still be ready to fly the next day may be for the best in the long run.

Jeremy L. Lau serves as President and Chief Investment Officer. He teaches the Investment Management course for California State University, Fullerton's Trustee Certification Program and frequently speaks on fiduciary investing to attorneys and fiduciaries across various associations. Before joining Prudent Investors, he worked as an Executive Director in investment banking in Tokyo and Hong Kong for Deutsche Bank AG and UBS AG in structured credit and convertible bonds. He graduated in Accounting (with Honors distinction) from Brigham Young University and has earned the right to use the Chartered Financial Analyst (CFA®) and Certified Financial Planner (CFP®) designations.

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