SKY HARBOR
CAPITAL MANAGEMENT

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SKY Harbor Weekly Briefing

A Long Way to Go?

With little down time following the June FOMC meeting, Fed Chairman Powell testified before the House Financial Services Committee this past week, delivering his semiannual monetary policy report. As expected, Powell struck a hawkish tone, advising investors to expect more hikes in order to slow the pace of inflation. His commentary was, at times, at odds with other officials, as Atlanta and Chicago Fed Presidents Bostic and Goolsbee advocated for additional patience and data while speaking at other venues. In this *Weekly Briefing*, we focus on expectations for June CPI data – often cited as one of the more important economic releases ahead of the July FOMC meeting date – which may help explain the hesitance of markets to price in two additional hikes in 2023.

“A Pretty Good Guess”

Addressing lawmakers over the course of two days, Fed Chair Powell highlighted that the economy continues to grow at a modest pace, all while stressing that labor market strength and still elevated inflation would likely necessitate additional rate hikes in 2023. And, **though the July FOMC meeting remains “live,” Powell remarked that two more rate hikes this year represented “a pretty good guess” as to the course of monetary policy should the economy continue to move along as expected**. Not all Fed officials, however, are as convinced. Atlanta Fed President Bostic, in an interview with Yahoo Finance, said the Fed should hold rates steady for the balance of the year in order to allow prior actions more time to work their way through the system. Chicago Fed President Goolsbee, speaking from the WSJ Global Food Forum, echoed this sentiment, broadly advocating a “wait and see” approach.

Powell Remains Hawkish; Doves Emerge Among Other Officials

select commentary from week of June 18th

Powell's Semiannual Monetary Policy Report to Congress	Other Recent Commentary from Fed Officials
"The labor market remains very tight. Over the first five months of the year, job gains averaged a robust 314,000 jobs per month."	"If we simply press on with additional rate hikes, we could needlessly drain too much momentum from the economy." **- Atlanta Fed President Raphael Bostic**
"While the jobs-to-workers gap has narrowed, labor demand still substantially exceeds the supply of available workers."	"I continue to believe we can subdue inflation without severe economic dislocation." **- Atlanta Fed President Raphael Bostic**
"Inflation has moderated somewhat since the middle of last year. Nonetheless, inflation pressures continue to run high, and the process of getting inflation back down to 2 percent has **a long way to go**."	"I feel like the Fed's framework is wait-and-see...over the next couple of months, we will get some markers on inflation" **- Chicago Fed President Austan Goolsbee**
"Nearly all FOMC participants expect that it will be appropriate to raise interest rates somewhat further by the end of the year."	"If you don't see progress, that is an answer, if you do see progress, that is also an answer." **- Chicago Fed President Austan Goolsbee**
"We will continue to make our decisions meeting by meeting..."	

Source: SKY Harbor, Federal Reserve, The Wall Street Journal, Bloomberg

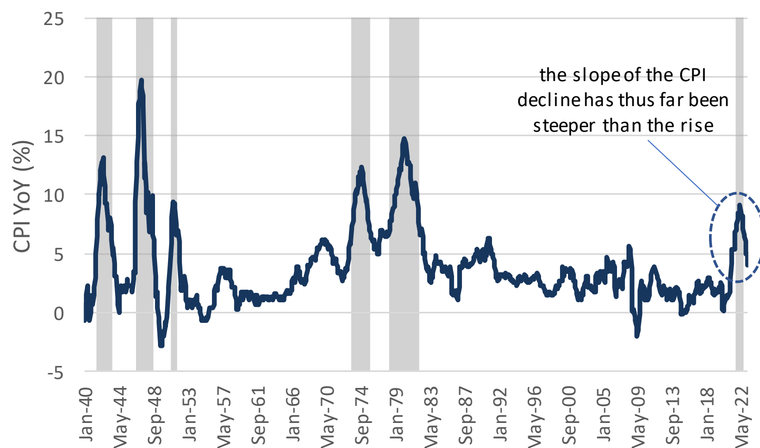
Waiting on Another Month of CPI

The Consumer Price Index (CPI) increased 0.1% sequentially in May (+4.0% on a YoY basis), reflecting deceleration vs. April (+0.4% MoM, +4.9% YoY). Though still elevated relative to the Fed's long-term target, **this gauge of inflation represented the smallest YoY increase since March 2021**, driven by decreases in the cost of energy and services, partially offset by stubbornly high rents and an uptick in used car prices. We highlight this data because the evolution of CPI may prove critical in the Fed decision-making process, as June data (released July 12) will be one of few prominent economic datapoints released ahead of the July FOMC meeting (July 26).

With that in mind, we reflect back on an analysis presented in our early November '22 *Weekly Briefing* entitled “The Pivot is On Pause,” in which we found that **periods in which inflation exceeds a standard deviation over the long-run average tended to normalize at about the same pace as the initial spike** (more specifically, we found that the timing from inflation peak to levels consistent with a pre-peak trough is on average 1.2x longer than the duration of the initial inflation run-up). With CPI hitting a high in June '22, implied normalization (2% to 3%) pointed toward late 2023 or early 2024. As demonstrated in the chart below and updated since our original publication, the trend has largely followed a path consistent with historical norms.

Inflation Tends to Decline Nearly as Quickly as it Increased

monthly data; periods a standard deviation over average highlighted grey



Current Trend Implies Normalization in Early '24

trough to peak / peak to trough timing of standard deviation spikes

Peak CPI (YoY) Growth Month	Local Trough to Peak (months)	Peak to Subsequent Trough (months)	Correction vs. Rise Ratio
31-May-42	18	24	1.3
31-Mar-47	13	22	1.7
28-Feb-51	10	13	1.3
31-Dec-74	17	19	1.1
31-Mar-80	25	25	1.0
30-Jun-22	15	?	
Set Average			**1.2**

Implies ~ 18 months for inflation to "normalize" to mid 2% range following June '22 peak, or approximately **end of '23 / start of '24**

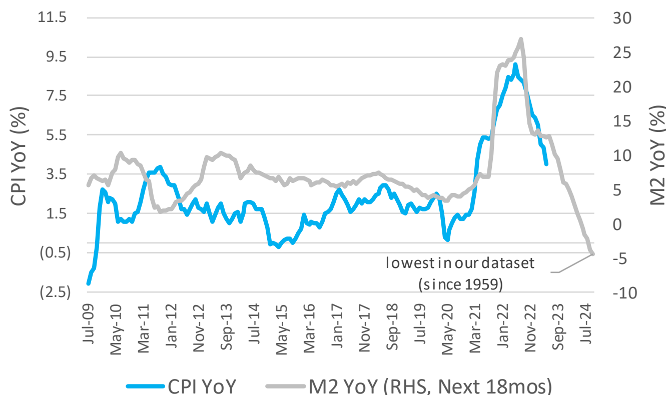
Source: SKY Harbor, Bureau of Labor Statistics

M2 Money Supply Continues to Shrink

Recall, as well, that rate hikes aren't the only weapon in the Fed's arsenal. From the onset of the pandemic until the end of 2021, the M2 money supply grew at an annualized rate of approximately 18%, including an all-time record of nearly 27% in February '21 as the US government delivered trillions of dollars in stimulus payments. M2 has contracted significantly since December '22, an unprecedented trend in our dataset that dates to 1959. **Using CPI and M2 YoY growth rates over the last two decades, we find the strongest correlation between factors (.70) occurs when the latter leads by 18 months**. As such, and as demonstrated below, a significant decline in the money supply should continue to exert downward pressure on CPI. Furthermore, both our slope- and M2-implied CPI output models fall below consensus expectations over the next three quarters, perhaps reducing the need for the Fed to act as aggressively as the most recent dot plot might infer (and more in-line with a market-implied probability of one additional hike).

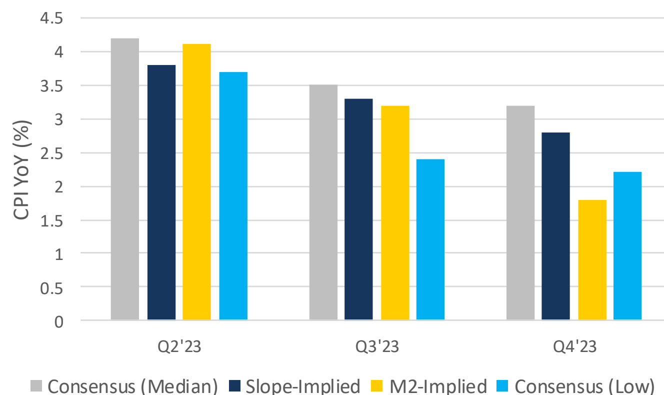
Decline in M2 Growth Implies Sizeable Reduction in CPI

monthly data, trailing 20 years



Consensus Looks High If M2 and Slope Relationships Hold

monthly data, trailing 20 years



Source: SKY Harbor, Bureau of Labor Statistics, Bloomberg, Morgan Stanley

Getting Closer to the Destination

As our work is solely dedicated to the analysis of leveraged credit issuers, the correlations presented above should not be taken as explicit projections for CPI and other gauges of inflation in the coming quarters – we leave that analysis to the professional economists. Rather, we present this work simply to express the view that we cannot rule out a reduction in inflation consistent with historical trends that could soften the hawkish outlook put forth by the most recent dot plot. Consistent with this notion, we have moderated our long-standing underweight to the better quality / longer duration subset of the market within our broad strategies, and are moving toward reducing a similar underweight within short duration portfolios.

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