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SKY HARBOR
CAPITAL MANAGEMENT

SKY Harbor Weekly Briefing

SKYView: The Pivot is On Pause

The US Federal Reserve raised rates by 75 bps this past Wednesday – the fourth such hike in a row – lifting their target range to a level not seen since late 2007. Though the hike was in-line with market expectations, a widely anticipated (though perhaps merely hoped for) Fed pivot did not take place. In fact, commentary from Chairman Powell's press conference was widely viewed as hawkish, leaving the door open for rates to rise beyond what was anticipated in the September dot plot. With the timing of peak interest rates a clear unknown, we decided to focus this *Weekly Briefing* on the historical drivers and cadence of inflation normalization in years past.

Dissecting Powell's Speech

With no new dot plot until the December FOMC meeting, market participants analyzed Chairman Powell's commentary this past Wednesday under a microscope. What they found, however, was not the dovish stance many were hoping for. Rather, with labor markets overheated and inflation still hovering only modestly below June '22 highs, **Powell opened the door for a terminal rate above the 4.6% median envisioned in September**, all while calling investor hopes for a pause in the Fed's quest to tighten monetary conditions "premature." As news was absorbed by the market, the futures-implied peak Fed Funds rate ratcheted up to 5.2% (vs. 5.0% at the end of October, and 4.5% at the end of September) while the risk asset selloff accelerated.

Post FOMC Press Conference More Hawkish Than Expected
November 2, 2022

"It would be premature to be thinking about or talking about pausing..."
(Markets were looking for a clear sign of a Fed pause or pivot in the near term)

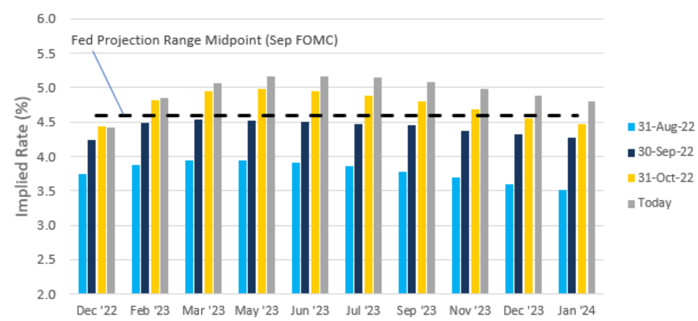
"as soon as the next meeting or the one after that. No decision has been made."
(Chmn. Powell on whether it was yet appropriate to slow the pace of increases)

"...you have households that have these significant amounts of savings and can keep spending..." and "it appears consumer spending is still positive...it is not shrinking"
(Chmn. Powell when asked about spending making it difficult to get inflation back to 2%)

"I'm pleased that we have moved as fast as we have. I don't think we've overtightened"
(Chmn. Powell in response to ~ 400bps of hiking since March '22)

"Has it narrowed? Yes. Is it Still Possible? Yes."
(Chairman Powell when asked about the window for a soft landing)

Terminal Rate Expectations Rising
November 2, 2022



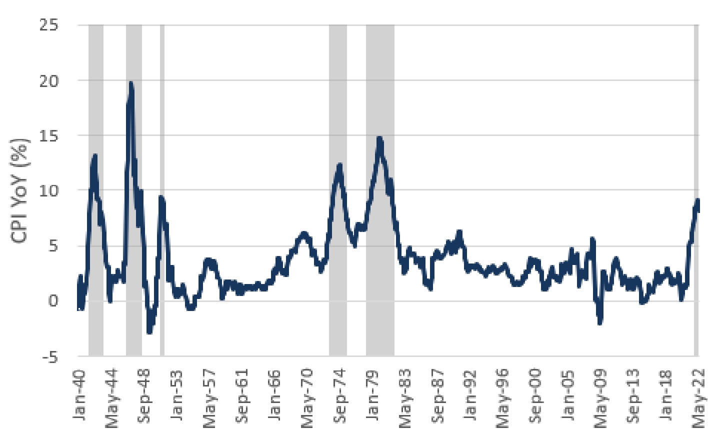
"The ultimate level of interest rates will be higher than previously expected"
(The Fed had previously guided to a terminal rate in the range of 4.5% to 4.75%)

Source: SKY Harbor, Federal Reserve, Bloomberg

Focused on Killing Inflation

The Fed seemingly doubled down on its quest to cool inflation, with Chairman Powell indicating that he would rather over-tighten than under-tighten, albeit cognizant of risks to the broader economy. Given a strong commitment to returning inflation to their 2% objective, the question of timing naturally arises. In the chart below, we present a US Consumer Price Index (YoY % growth) time series, with periods in which inflation exceeded a standard deviation over the long-run average highlighted in grey. At first glance, these peaks appear symmetrical, implying that inflation has historically declined at about the same pace as it initially increased. On a more granular basis, **we find 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**. Assuming peak inflation has already been reached (CPI has moderated from a high of 9.1% in June), a cadence consistent with historical outcomes would imply normalization around December '23. Importantly, this is nearly a year ahead of most economist projections.

US Consumer Price Index (CPI) Y/Y Growth Near 40-Year Highs
monthly data; periods a standard deviation over average highlighted grey



Source: SKY Harbor, Bureau of Labor Statistics

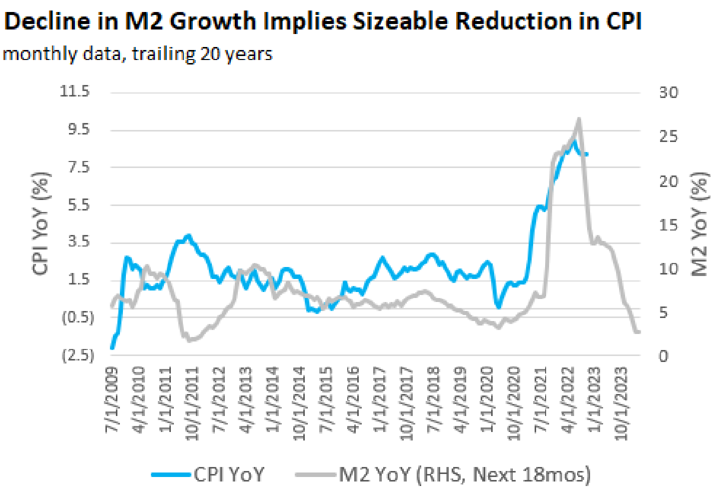
Inflation Tends to Decline Nearly as Quickly as it Increased
trough to peak / peak to trough timing of standard deviation spikes

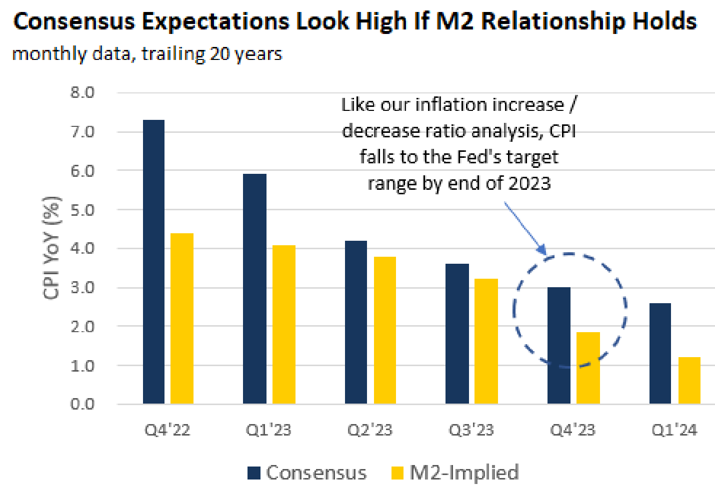
Peak CPI (YoY) Growth Month	Local Trough to Peak (months)	Peak to Subsequent Trough (months)	Correction vs. Rise Ratio
31-May-42	18	24	1.3
31-Mar-47	13	22	1.7
28-Feb-51	10	13	1.3
31-Dec-74	17	19	1.1
31-Mar-80	25	25	1.0
30-Jun-22	15	?	
Set Average			1.2

Implies ~ 18 months for inflation to "normalize" to mid 2% range following June '22 peak, or approximately **December 2023**

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. As highlighted in a recent note from Morgan Stanley[1], it's no wonder that inflation picked up rapidly, as the money supply was growing at over 2x the pace of the previous record high. They also highlight the significant correlation between inflation and money supply over time. **Using a dataset of CPI and M2 YoY growth rates over the last two decades, we find the strongest correlation between factors (.74) occurs when the latter leads by 18 months**. As demonstrated below, a significant decline in the money supply over the last several months should put downward pressure on CPI, with the Fed's 2% target for inflation seemingly achievable by the end of 2023 (again, more quickly than consensus expectations) should the historical M2 relationship hold.





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

Remaining Data-Dependent

Indications of a potential downshift in future rate hikes aside (the market is still expecting 50 bps in December), the Fed remains steadfast in their commitment to curb inflation. And, with no progress being made in cooling the jobs market (unemployment stands at its lowest level since the 1960s) or associated wage inflation, **Powell appears unwilling to change course ahead of November 8 midterm elections despite calls from prominent lawmakers to demonstrate some restraint**. The outlook, however, can change rapidly. Powell has consistently noted the "long and variable lags" associated with monetary policy, and we cannot rule out a reduction in inflation consistent with historical trends highlighted earlier in this briefing from showing up in the two CPI releases that will occur before the December FOMC meeting. In the meantime, we continue to believe an up-in-quality approach to high yield markets is in order, with any indication that inflation is levelling off likely the catalyst to get more aggressive on credit risk.

[1] https://ny.matrix.ms.com/eqr/article/webapp/dca5fcdc-53a2-11ed-91d4-5ef6e9fad808?t=1667109879:7164:10424:acba1c0882e9&m=1&ch=CDF%20Research%20ISG%20Autoblast#

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