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Recession or Soft Landing
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Despite the fact that there are many clear signs that US inflation is peaking, Chairman Powell of the Federal Reserve wanted no part of a possible Central Bank pivot back to a more accommodative stance. The US Central Bank was obviously far too late in initially reacting to higher inflation by keeping interest rates down for much too long. Their only response was that inflation was totally transitional based on supply constraint issues.

Unfortunately, Chairman Powell and the Federal Reserve were totally wrong in their assessment of inflationary pressures. In fact, inflationary pressures continued to escalate in the midst of supply constraints starting to ease. Over the last month, with the exception of the last week, equity markets staged a sharp rebound with numerous signs of inflation falling off sharply. Lower prices for commodities, used cars, airfares and home prices are just a few examples. Year over year percentage increases in both US CPI and PPI came in below expectations, although still high historically. US core CPI for July came in at 5.91% year over year, the same as June but lower than May's rate of 6.01%. In addition, July 's year over year core PPI backed off considerably from June's level of 8.36% to the current level of 7.56%. Based on these recent trends of inflation easing off, many equity strategists believed that a new bull market may have already begun and that the recent rally in equity prices was not a bear market rally.

Last week at Jackson Hole, Wyoming, Chairman Powell delivered a short but to the point speech to global money managers and economists. The gist of his message was that the fight against inflation was only beginning and that the Central Bank was far more concerned with breaking the back of inflation than worrying about a possible recession. Taking into consideration the current Federal Funds rate of 2.33% combined with nominal CPI still growing at 8.5% in July, interest rates need to rise substantially from current levels, according to Chairman Powell. Since Powell's short speech, equity markets have totally reversed their recent uptrend by falling sharply.

Most equity strategists have stopped talking about rampant inflation and have changed their rhetoric to focusing on a hard landing and an economic recession. Based on the energy crisis in Europe, the EU is most likely already in a recession. China continues to experience economic weakness based on the continuation of lockdowns for COVID-19. The domestic economies of both Canada and the US remain stronger than most other countries, with Canada's heavily weighted focus on natural resources having a positive effect, especially in the case of oil and natural gas.

I have spent a considerable amount of time analyzing the current outlook for inflation and most definitely feel that inflation has peaked in North America. The combination of restrictive monetary and fiscal policy, high inventory levels, falling commodity prices and a global economy that is weakening dramatically, all lead to falling prices. The supply chain problems are also beginning to ease off and this will help lower inflationary pressures. The two most stubborn areas of inflation, namely wages and rents, will take a little longer to ease off. Historically there is a close correlation between house prices and rents and there is no reason for this to change. However, in the very short term, higher mortgage rates have prevented many potential house buyers from entering the real estate market. This group has been forced to continue renting until home prices fall or their incomes and savings rise accordingly.

It is only a matter of time before an equilibrium is reached between the demand and supply of jobs. At the moment, employees still have the upper hand and this is resulting in the percentage increase in wages to be much higher than the Federal Reserve wants to see. However, the number of job posting ads on Indeed.com has started to back off from a high of 89.4% in February to the July level of 53.8%. If this trend continues, job seekers will see their current advantage diminish accordingly. As we all know, job hoppers have historically seen their wages rise the fastest. At some point in a weaker economy, job hoppers will not have as many opportunities to switch positions for higher wages and this will gradually help to reduce overall wage inflation. This process just takes time.

Recommendation

Based on the improving outlook for US domestic inflation, I posted a mid month blog advising a reduction in cash of 5% with the proceeds being redirected back into equities for both portfolios. My rationale was that the visibly weaker inflationary stats would encourage the Federal Reserve to back off their very restrictive monetary policy. After listening to Chairman Powell's speech last week, I have changed my mind about any immediate change to monetary policy until inflation is visibly in a downtrend once again. It is important to keep in mind that the Federal Reserve fully realizes how late they were in increasing interest rates and that they have to ensure that inflation is clearly under control before they back off their current very restrictive policies. Saving face is important to them to avoid total humiliation.

However, I still think there is a small chance the Federal Reserve may back off should the rate of growth in both regular and core CPI and PPI really start to decline sharply. The next report for US CPI is September 13th and all eyes will be focused on any material slowdown in the rate of growth. The Federal Reserve did mention that they remain data dependent implying that there is some flexibility in their degree of hawkishness.

In my opinion the key factor will be if the domestic economy can avoid a hard landing and have a mild or no recession. The reason this is so important is that investors need to manage their portfolios very differently under either scenario.

Under a soft landing or no recession outlook, cyclical, value sectors should perform well. Under a hard landing, cyclical sectors will not perform as well as defensive and growth sectors will.

The probability is about 50/50 in regards to a soft or hard landing for the economy. For the next several months, economic growth and corporate profits will continue to weaken. In this environment, it pays to remain defensive both in asset mix and equity sector weights favouring defensive sectors over cyclicals. The Energy sector is the only cyclical sector I would continue to overweight under either a soft or hard landing.

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