Risk market outlook

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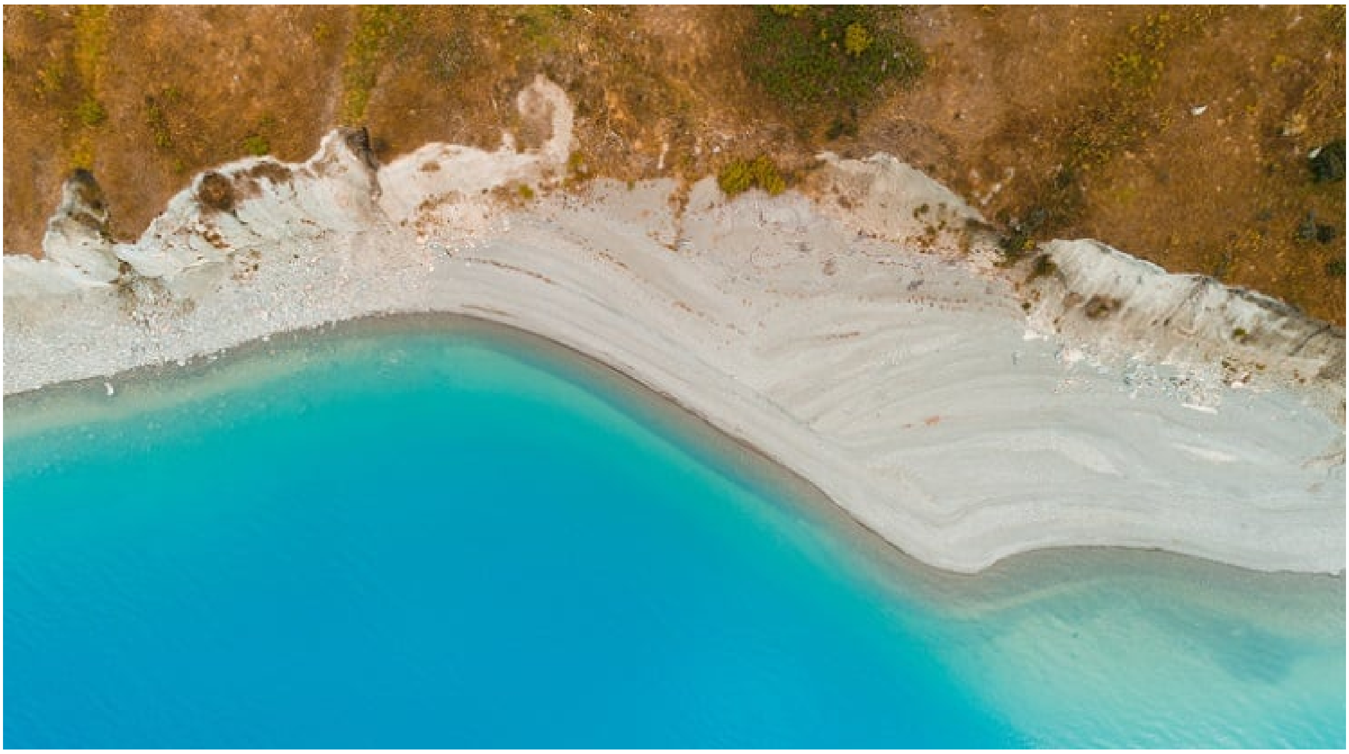

Over the past 25 years, global investors have become conditioned to the notion that central banks will bail out global asset markets amid the first sign of stress. Many of these occurrences have been when the economy has been firmly in expansion territory such as 1998 when the Russian default crisis and the collapse of LTCM saw the Fed cut rates during one of the biggest economic and speculative equity booms in recorded history. Twenty years (and a few months) later, the Fed was completing one of its slowest tightening cycles ever and decided to go on hold in early 2019 because the US equity market had declined -20% in Q4'18, and then they cut rates in September 2019 when US unemployment was at a fresh 50-yr low of 3.5%, which sparked a huge gain in the S&P 500, despite zero earnings growth.

Although there are numerous other examples of the Fed, in particular, bailing out markets in the past quarter century, all of these policy pivots were possible as their preferred inflation gauge, the core PCE, was close to the +2% target. In 2022, investors have once again formed an expectation that the Fed could pivot on policy and be easing rates as lower commodity prices means financial conditions may not need to tighten as much as previously thought to get core inflation back to 2%. This is a challenging notion as reducing inflation from 6% to 4% will be much easier, than from 4% to 2% without a recession.

In the below paper, we examine more closely, why the market may be over-estimating the Fed's optionality.

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