# Markets Continue to Discount That the Fed Will Achieve a Soft Landing; Is That Likely?

Earnings are priced in to keep rising while inflation is priced in to fall.
It rarely works out that way.

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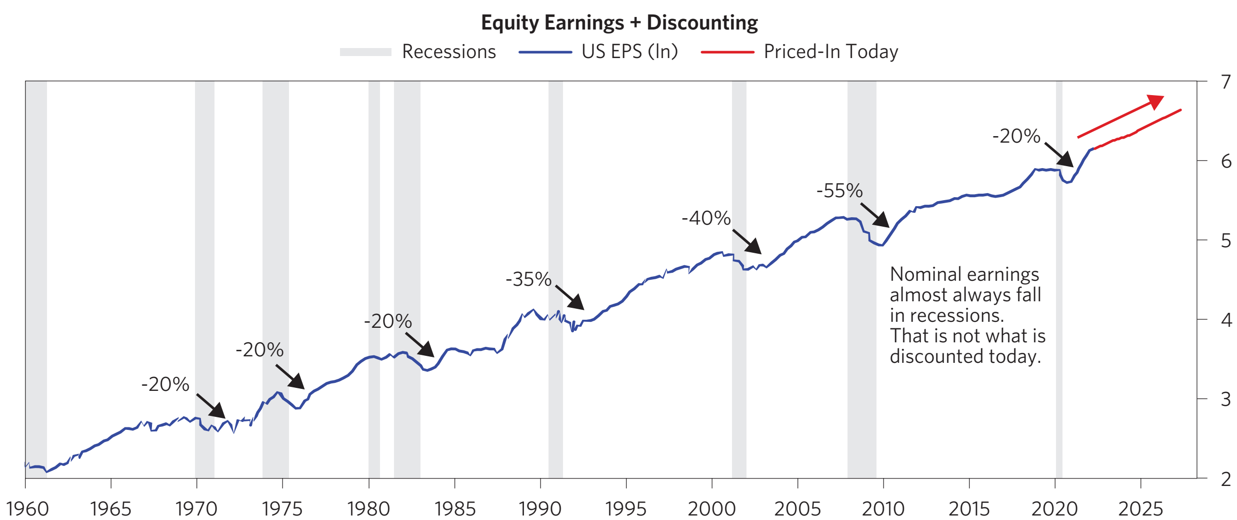
US equities are down about 10% so far this year, but until the last couple of days, this was driven by higher rates and not weaker discounted earnings. Even with recent market action, discounted earnings growth remains strong and has actually gotten stronger this year. The equity market is discounting economic resilience to higher rates and an ability to pass on price increases and sustain margins.

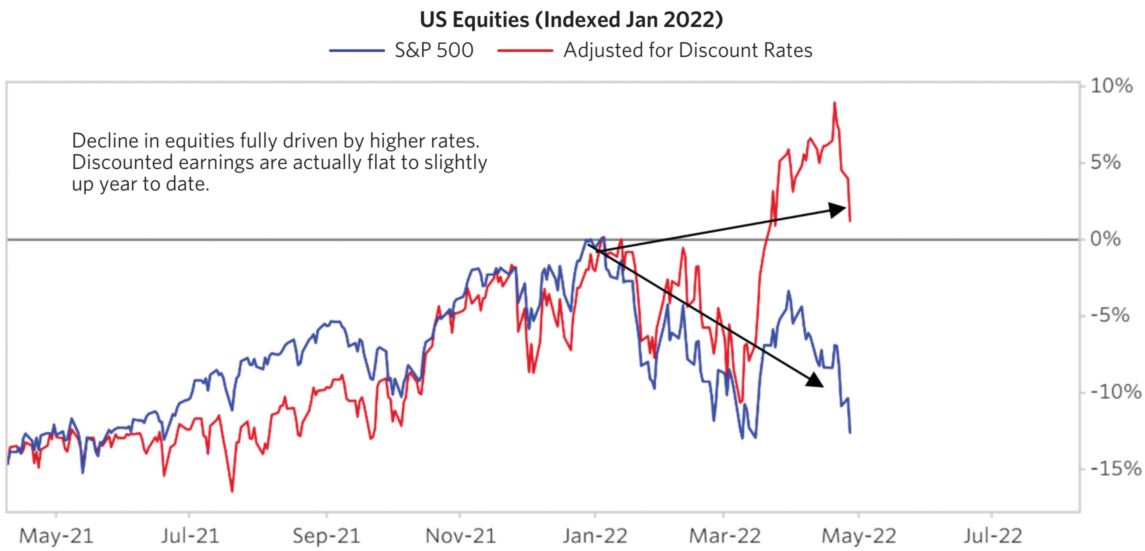
This equity market pricing stands in stark contrast to the discounting of inflation, which is pricing in large declines back toward the Fed's target. Material slowdowns in inflation from high levels have typically required recessions (and earning contractions), so what is priced in today is highly unusual. While we expect some inflation pressures to be transitory as we see reversions in categories like autos that have been most impacted by acute shortages, this will not be enough to get inflation anywhere close to the Fed target. At this stage, inflation is a self-reinforcing monetary process that is likely to need a greater tightening and a significant economic slowdown to cool off. The labor market remains historically tight, and rising wages and spending are fueling each other. Wages are also supporting rent inflation, which is running quite a bit hotter than official measures. On top of these pressures, the war in Ukraine and the risk of production and transportation shutdowns in China are causing additional supply constraints, tilting the balance of risks toward more inflation and less real growth.

Our view is less which of these pricings is wrong, and more that both are unlikely to be right. A lot will be up to the Fed, as they may have to choose between getting inflation down or avoiding a recession.

We start first with the pricing of the equity market, followed by a deeper dive on inflation pricing and pressures. Note that even in the recessions of the 1970s when inflation levels were higher than they are today, nominal earnings still experienced meaningful contractions. Today's pricing is inconsistent with expectations for any meaningful slowdown.

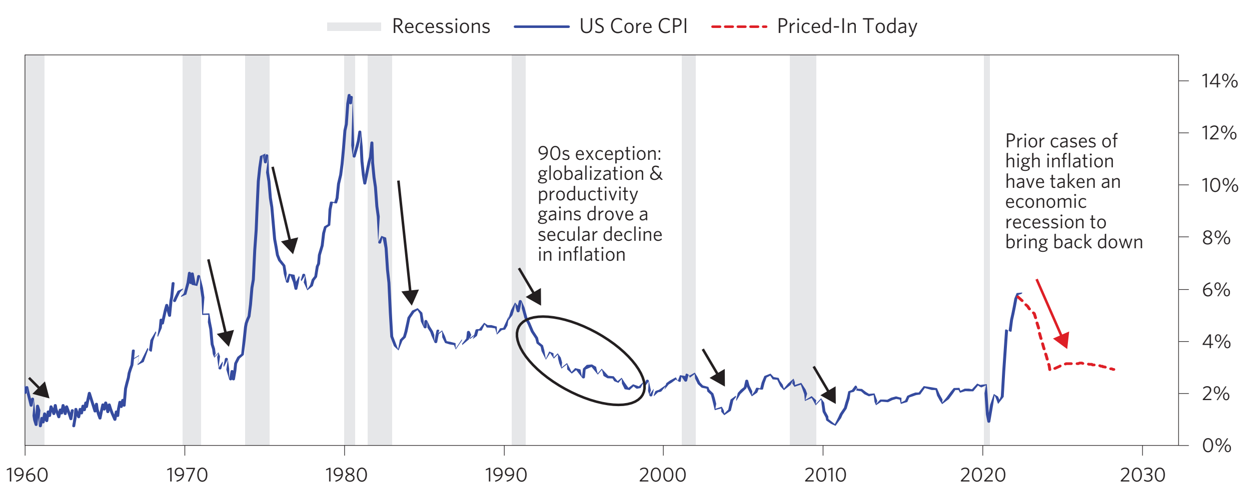


While we have seen a softening of equity prices so far this year, until the last few days this has been primarily driven by the rise in discount rates. Even incorporating the market action over the past few days, without the drag of rising rates, US equities would be flat to slightly up on net for the year.




# High Inflation Almost Always Requires a Recession to Normalize

The equity pricing stands in stark contrast to inflation expectations. The chart below shows that inflation is priced to fall meaningfully—something it has typically only done in recessions. The only major episode of declining inflation without one was the 1990s, when a lot of forces, including globalization and productivity increases, led to a steady decline in inflation. While increased automation will likely continue to be a deflationary pressure, other historically deflationary secular forces, such as globalization and the offshoring of supply chains, are more likely to reverse and be inflationary going forward. Given the entrenched nature of today's inflation, we don't see the currently priced-in path as a likely outcome without significant economic weakness.



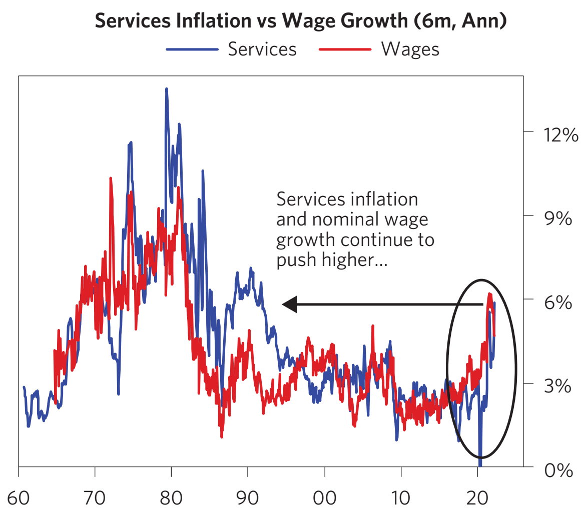

Next, we explore in more detail why we expect inflation to be sustained.

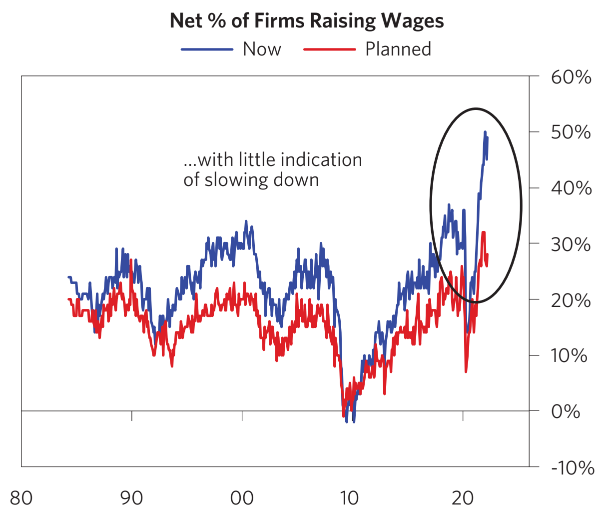
 

# Inflation Is Now in a Self-Reinforcing Dynamic

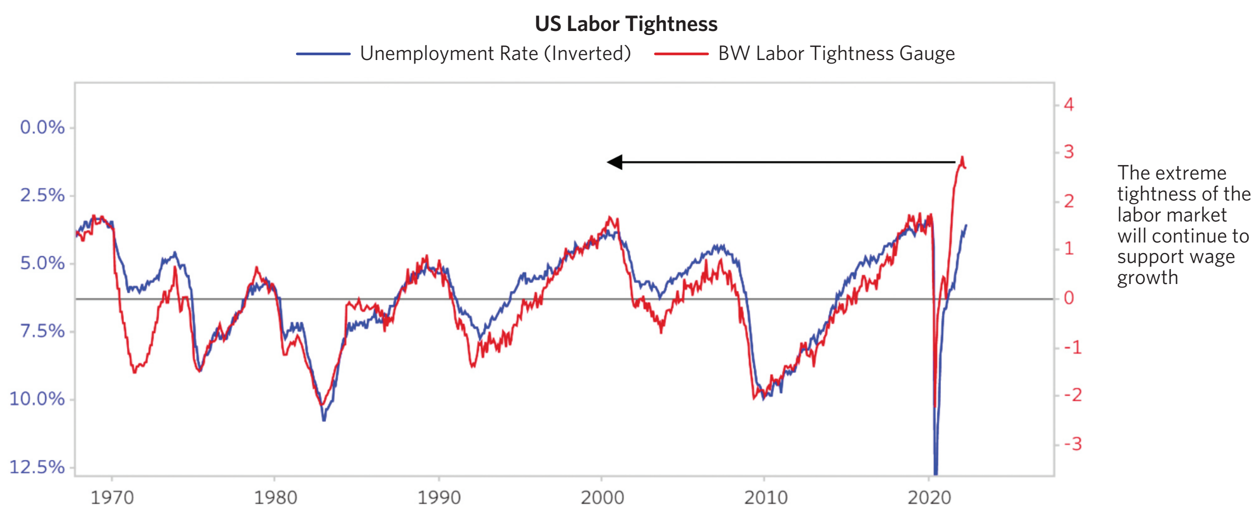
Because one person's spending is another person's income, nominal spending and wage growth create a self-sustaining inflationary process. This is where we are now.

An extremely tight labor market and continued rapid wage growth, as well as the shift from goods to services spending, have supported broad services inflation. With more companies than ever raising wages or planning to raise wages, we expect this dynamic to continue. Although we expect higher wages and the reduced impact of COVID will also coax some more people back into the labor force, we don't think there is close to enough additional supply of labor to match current levels of demand.

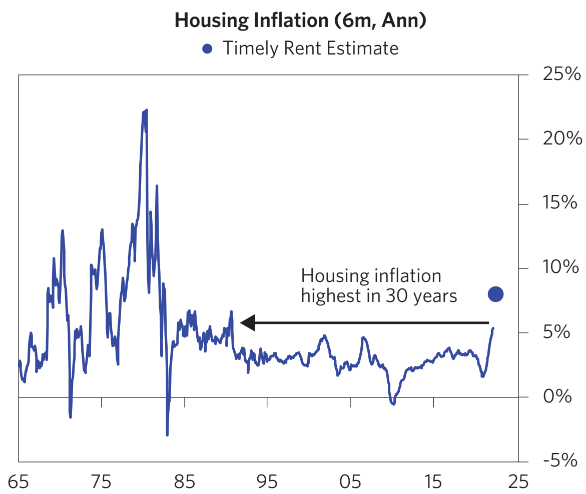


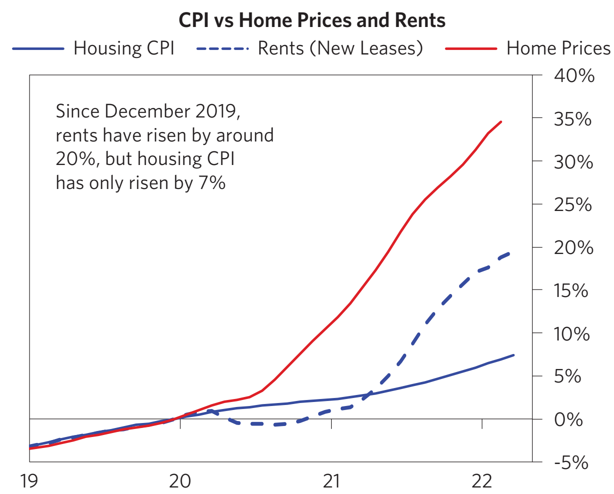




The strength in nominal wages is likely to be supported by the tightest labor market on record, whether we use our in-house gauges or the unemployment rate.



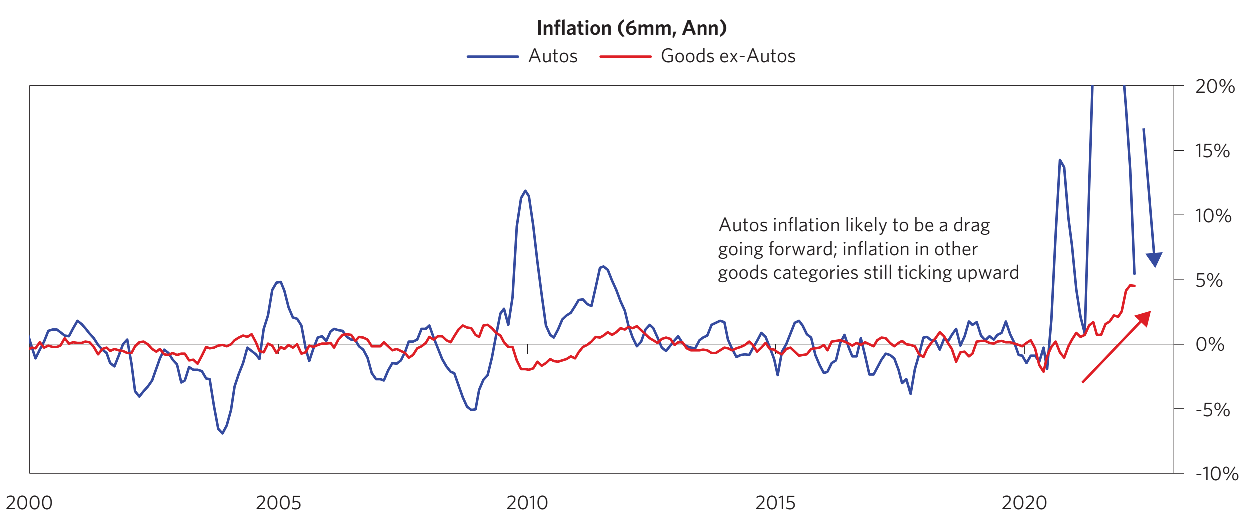
Housing adds to these pressures. Housing inflation is at 30-year highs but continues to lag the rise in house prices and rent. Higher mortgage rates are likely to slow home price inflation some, but it may actually help to push more people to rent, supporting rent increases. The chart below on the right shows how official measures have understated the actual rises in both home prices and rents on a backward-looking basis.



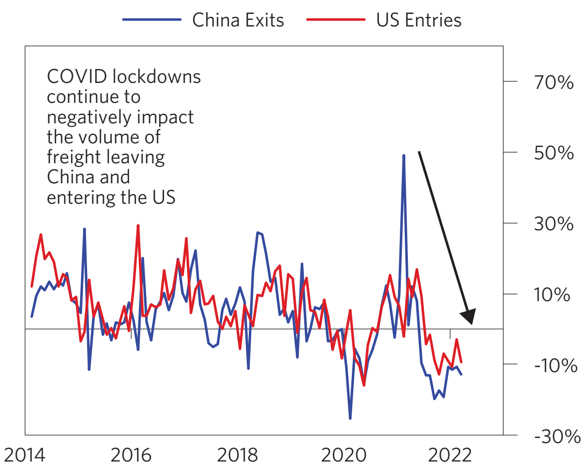

# Autos Inflation Shifting to a Drag, but Supply Chain Disruptions Will Continue to Be Inflationary for Other Goods

While there are some pressures that we expect to be transitory, goods inflation is still facing pressures from supply chain disruptions and rising commodity prices. The recent fall in goods inflation has been driven by a leveling off in auto prices, a dynamic that on its own we expect will be a ~2% drag to core CPI over the next year if prices were to stay flat from here. While we think autos inflation will eventually reverse, shortages are likely to last into 2023, so material price declines in the short term are unlikely. Outside of autos, however, goods inflation is still rising.



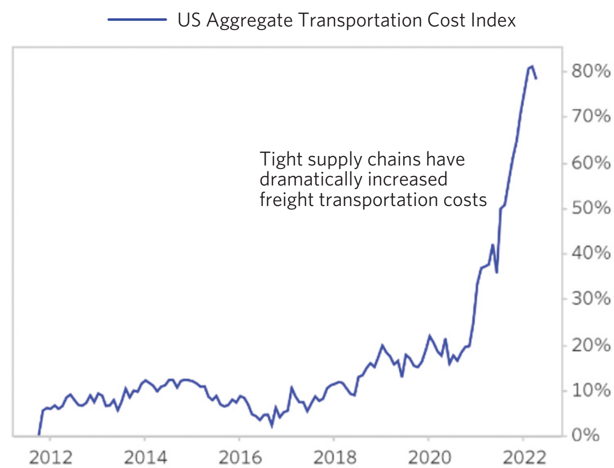
While the shift from goods to services spending may ease some pressure on goods inflation going forward, ongoing supply chain constraints, coupled with high levels of overall demand, will likely support higher prices from here. China's COVID situation has the potential to be a large inflationary supply shock for finished goods. Lockdowns in Shanghai and elsewhere continue to disrupt global supply chains and impact production capacity for the world's largest supplier of goods. These disruptions are coming at a time when global supply chains are already stressed, reflected in the still extremely elevated levels of freight transportation costs.

**Container Freight Tonnage (Y/Y Growth)**




*Source: UBS Evidence Lab*

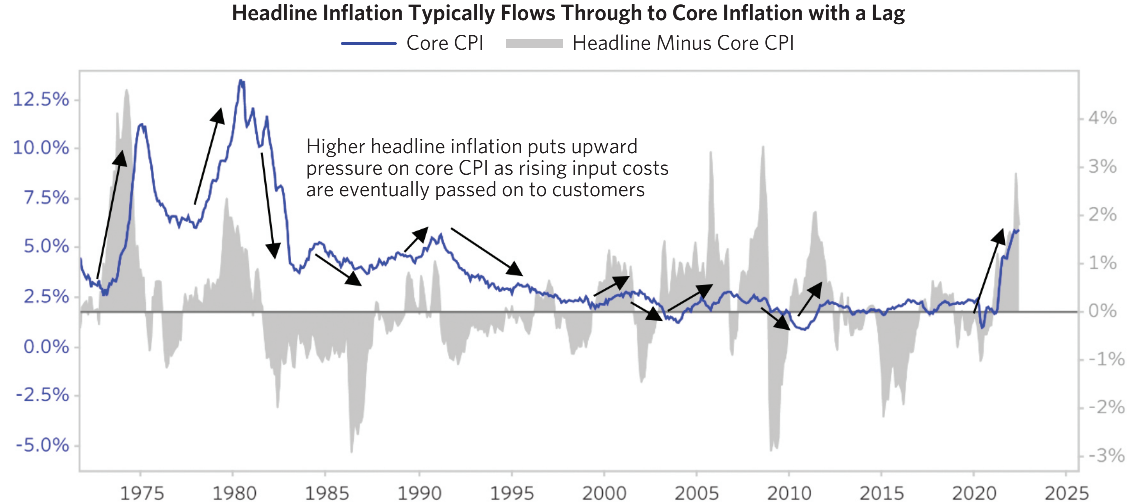
**Supply Chains Remain Heavily Constrained**




# High Commodity Prices Will Flow Through to Higher Core Inflation with a Lag

Commodity prices have risen dramatically in recent months, exacerbated by the supply disruptions from the Russia-Ukraine war. While commodity price increases will eventually flatten out, we expect that the increase in prices that has already happened will continue to flow through to higher core inflation with a lag. This is because gasoline and energy prices are inputs for almost everything else, and it takes time for the pressures from higher input costs for producers to flow through to higher prices for consumers. The chart below shows how high levels of headline inflation relative to core often lead to upward pressure on core inflation.

**Headline Inflation Typically Flows Through to Core Inflation with a Lag**



Our systematic process is netting out to both higher inflation and more real economic weakness than markets appear to be discounting. But more than either view, we have more confidence that both elements of market pricing are unlikely to be right at the same time. If the Fed actually wants inflation to fall as much as they hope, they will ultimately need to engineer more economic weakness than what is currently discounted.

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