PALLAS
CAPITAL ADVISORS

Week in Review

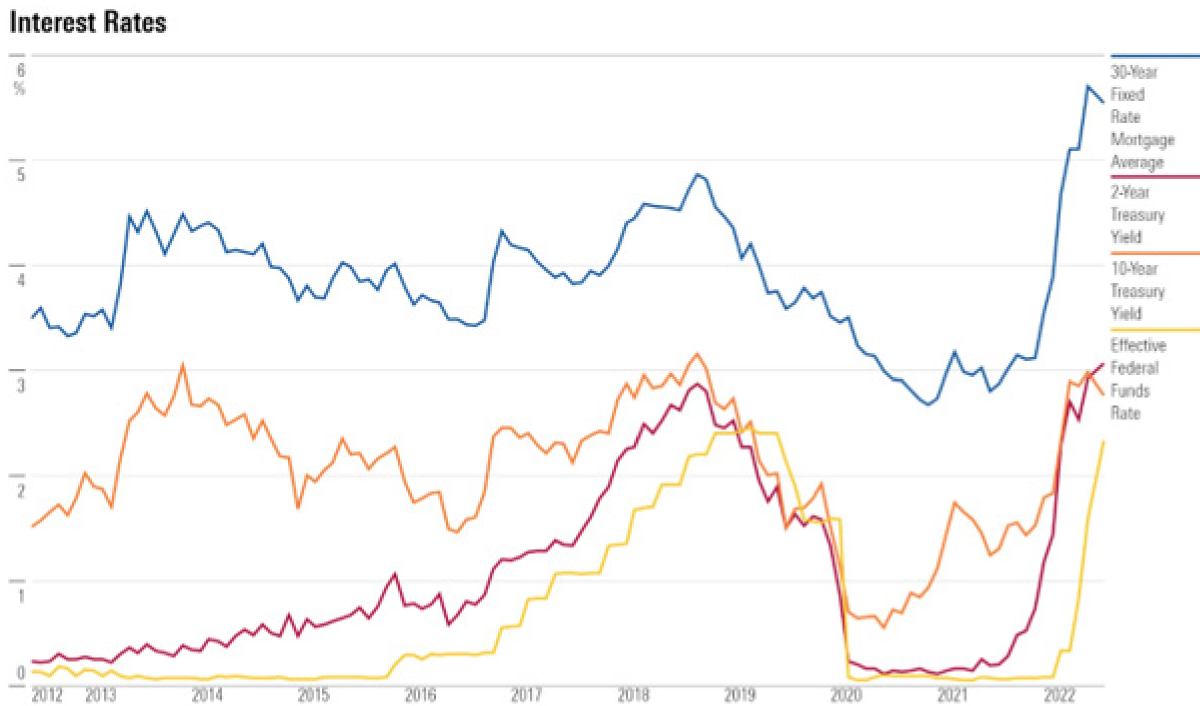
Friday, July 29th, 2022

1. Federal Reserve Tightens as Expected

As expected, the Fed announced Wednesday that it was lifting the federal-funds rate by 0.75 percentage points. The move had been widely telegraphed, reflecting the Fed's ongoing campaign against high inflation. The June Consumer Price Index report saw inflation reaching a new peak of 9.1% year over year, the highest since 1981.

This week's hike repeats the 0.75-percentage-point increase issued in last month's meeting, which was the largest since 1994. This brings the federal-funds target rate to 2.25% to 2.5%, up from near zero at the start of the year.

Expectations of a rising federal-funds rate have been incorporated in bond markets for several months with bond yields moving up in-line with the expected federal-funds rate. Therefore, bond yields have jumped compared to a year ago. This has translated into higher borrowing costs throughout the economy, such as new mortgage borrowers.



Conversely, higher interest rates have been a drag on financial asset valuation with both the equity and bond markets pulling back. The perceived dovish comment accompanying the announcement of the federal-funds rate and subsequent discussion by Federal Reserve Chairman Jerome Powell was met positively by the markets as expectations were raised that the most aggressive of the Fed's action to raise interest rates may now be behind us.

The Fed Chair veered in his comments from providing a specific trajectory for coming federal-funds rate increases, although a year-end target of 3.25% to 3.5% was still maintained and the potential for 3.75 to 4.0% for 2023 was left in place.

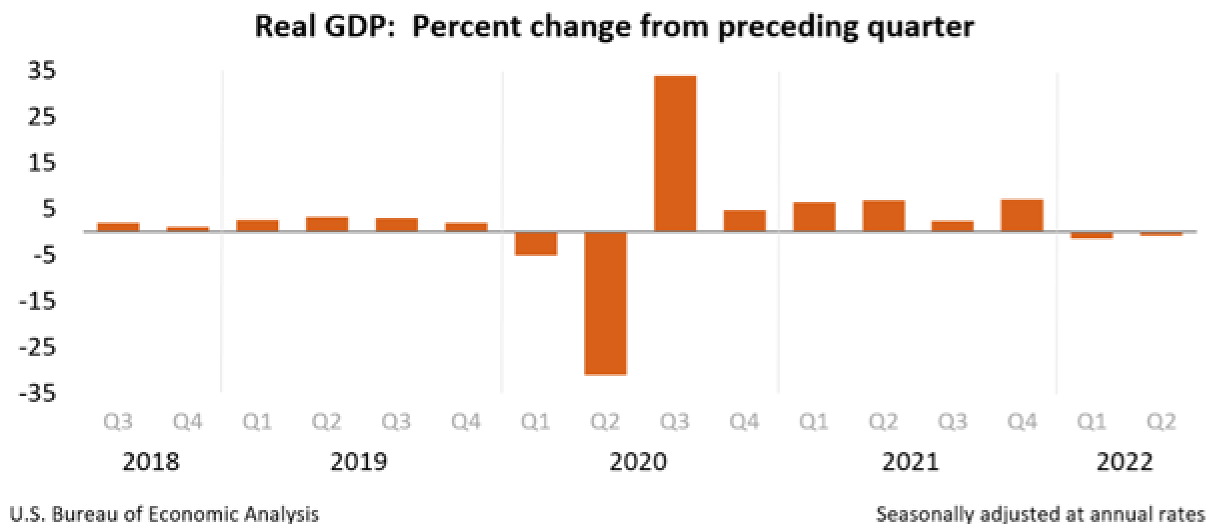
Commentary though was more balanced with the release stating that "recent indicators of spending and production have softened. Nonetheless, job gains have been robust in recent months, and the unemployment rate has remained low."

While the financial markets responded positively short term to the perceived more dovish comments, the pace of inflation will remain a key determinant of further monetary policy by the Fed. While recent inflation prints have been high (June CPI 9.1%), longer-dated treasuries have pulled back from their recent peaks suggesting the expectation that inflation will moderate. Falling inflation could clear the way for the Fed to cut interest rates if economic conditions were to deteriorate.

Lower prospective interest rates would be supportive of financial markets if accompanied by lower inflation. However, as discussed below, the balance between lower inflation and interest rates will be the fundamental pace of corporate growth and credit.

2. U.S. GDP Confirms Slower Growth

Real gross domestic product (GDP) decreased at an annual rate of 0.9 percent in the second quarter of 2022 according to the advance estimate released by the Bureau of Economic Analysis.



Real GDP decreased less in the second quarter than in the first quarter, decreasing 0.9 percent after decreasing 1.6 percent. The smaller decrease reflected an upturn in exports and a smaller decrease in federal government spending that were partly offset by larger declines in private inventory investment and state and local government spending, a slowdown in personal consumption expenditures, and downturns in nonresidential fixed investment and residential fixed investment. Of note, while inventory reduction accounted for the largest portion of the drop, consumption growth slowed to just +1.0%, its slowest pace of the expansion and compared to the +2.6% average pace in 2017-2019. Government spending also contracted (federal -3.2%, state and local -1.2%).

While GDP contracted for the second consecutive quarter, the official definition of a recession is a judgmental mix of levels and rates of change across several variables (notably employment), most of which continued to expand in the first half of the year. So, despite the second quarter of negative headlines, the U.S. may not officially be in a recession, but growth has undoubtedly slowed.

In addition to the release of U.S. GDP this week, the IMF released its most recent World Economic Outlook report this past week cutting its global growth projections for 2022 and 2023, dubbing the world's economic outlook "gloomy and more uncertain."

The IMF now expects the world economy to grow 3.2% this year, before slowing further to a 2.9% GDP rate in 2023. The revisions mark a downgrade of 0.4 and 0.7 percentage points, respectively, from its April projections. Worsening growth prospects in the U.S., China, and India drove the IMF's downward revisions. The IMF indicated that its revised outlook indicated that challenges such as soaring global inflation, a worse-than-expected slowdown in China, and the ongoing fallout from the war in Ukraine were driving the lower revisions.

Focusing on the U.S., the IMF's U.S GDP outlook was lowered 1.4 percentage points to 2.3%, driven by weaker-than-expected growth in the first half of 2022, reduced household purchasing power, and tightening monetary policy.

Thinking Ahead

This week saw the release of the much anticipated and expected 0.75 percentage point increase in the federal funds rate, but perceived dovish commentary was taken as a potential sign of peaking rate increases and served as a catalyst for financial markets. This rally occurred despite data showing slower economic growth and lowered expectations for the remainder of 2022 and 2023. The balance between valuation support on peak or lower interest rates and slower growth or recession will continue to play out over the ensuing weeks and months as further data and outlooks are digested from corporate earnings and inflation data.

Pallas Capital Advisors will continue to monitor economic, political, and corporate data for implications to markets.

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