Q4 2022 | Capital Markets Outlook

Jason R. Vaillancourt, CFA
Global Macro Strategist

Perspective on the global economy and asset classes with insight on market history.

Price stability and credibility

Central bankers choose their words **very** carefully. And although communication accidents can and do happen, they are rare. In Federal Reserve Chair Jerome Powell's press conference following the Fed's September 22 meeting, he described a committee that intended to "keep at it" with respect to its battle against inflation. That phrasing was intentional and echoes back to the title of former Fed Chair Paul Volcker's autobiography, ***Keeping At It: The Quest for Sound Money and Good Government.***[1] Powell has said of Volcker: "I don't think there has been a greater public servant in our lifetimes,"[2] and his admiration is not unusual. Volcker's willingness to push the economy into recession to defeat inflation is viewed in central banking circles as nothing short of legendary.

As great students of economic and financial market history, central bankers of course seek to learn just as much from past failures as from triumphs. One of the key failures in the run-up to Volcker's triumph was that monetary policymakers took their foot off the brake too early in the 1970s. That lesson will be front of mind in policymaking circles over the next year.

Insights from Jackson Hole

As investors, we try to learn from the past as well. A lesson we have found valuable over time involves the Kansas City Fed's annual Jackson Hole Economic Symposium. Much more can be gained from reading the academic papers selected to be presented at the event than from listening only to the Fed Chair's opening address. The array of research is a powerful signaling mechanism and provides critical insight into how central bankers see the world. The papers identify what hurdles they view as most pressing and immediate in guiding monetary policy in the near future. Two topics in particular stand out for their relevance

Asset allocations

● *Current quarter*
○ *Previous quarter*
›› *Change from previous quarter*

	Underweight	Neutral	Overweight
EQUITY			
U.S. large cap	●		
U.S. small cap	●		
U.S. value		●	
U.S. growth	●		
Europe	●		
Japan	●		
Emerging markets	●		
FIXED INCOME			
Interest-rate sensitive			
U.S. government		●	
Non-U.S. developed country	●		
Emerging markets	● ‹‹	○	
Corporate credit			
Investment grade / High yield / Floating rate	●		
Securitized			
Residential mortgage credit	● ‹‹	○	
Commercial mortgage credit			●
Prepayment risk			●
COMMODITIES			●
CASH		●	

Currency views

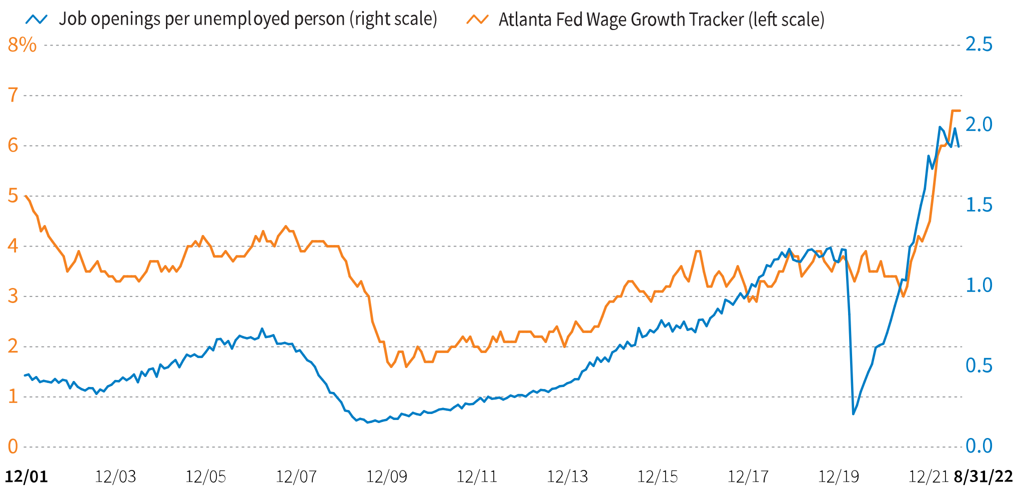
U.S. dollar versus	Favor other	Neutral	Favor dollar
€ Euro		●	
£ Pound		● ‹‹	○
¥ Yen		●	

Asset allocation and currency strategy views of the author at time of publication.

to financial markets as we enter the home stretch of 2022. First, central banks likely need to be even more hawkish when governments continue to ease fiscal policy, which tends to be counterproductive in the fight against inflation. (Apparently, U.K. Prime Minister Liz Truss and Chancellor Kwasi Kwarteng did **not** get that memo.) Second, the supply of aggregate labor (as measured by total hours worked) in the U.S. and Europe may have been even more constrained over the past decade than policymakers thought until recently. In other words, the unemployment rate may need to rise even more to curb demand and thereby tame inflation.

Figure 1: A very tight labor market

Wages and job openings, 2001–2022



Sources: Bureau of Labor Statistics (job openings) and the Atlanta Fed (wage growth). The Wage Growth Tracker represents the median percent change in the hourly wage of individuals over 12 months.

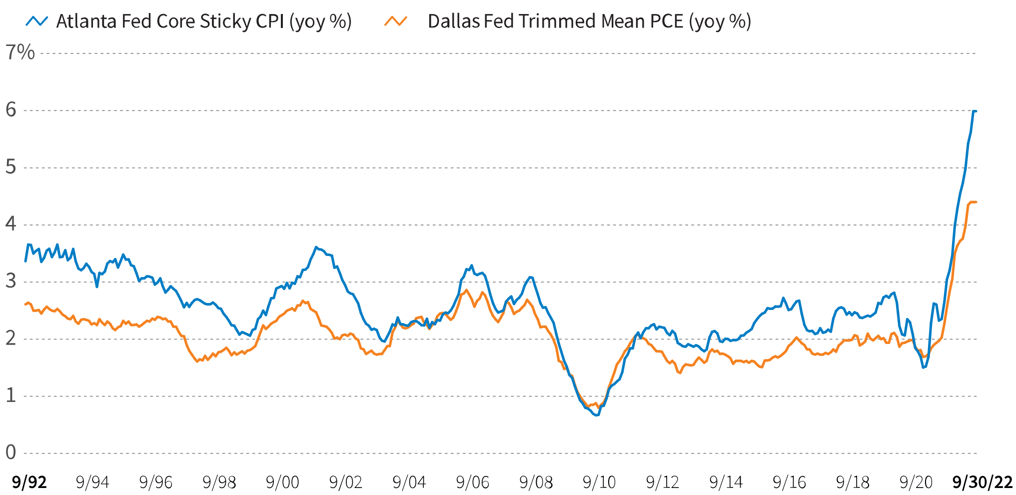
The primacy of price stability

The Fed has a dual mandate: to pursue both price stability **and** maximum employment. Twelve to eighteen months ago, there was some uncertainty on the part of market participants over what the Fed's reaction function would look like if the two parts of the dual mandate were in direct conflict with each other, but the answer has become increasingly clear over the past several months. Many major central banks would claim that without price stability, no other policy works.[3] We can quarrel over what price stability means exactly (Is it zero inflation? 1.8%? 2%? etc.). But central bankers are in no mood to debate the topic unless and until they are able to declare mission accomplished, lest they risk surrendering the credibility that has taken decades to build. After all, many central banks have, in the period between the European Sovereign Credit Crisis (2011–12) and the Covid-19 pandemic, proclaimed they needed their new quantitative easing toolkit to stave off the big unknown of deflation and its second-order effects. They often dismissed associated risks, saying "we already know how to deal with inflation." Well, they had better prove it, and quickly.

There will be a cruel race to watch in the fourth quarter: Will inflation slow **enough** to satisfy central banks before the real economy begins to show signs of substantial slowdown? Recent academic research suggests that somewhere in the vicinity of 60%–75% of 2022 inflation has been driven by demand,[4] much to the dismay of "team transitory." It seems to us that it will be tough to convince the Fed that demand has cooled sufficiently so long as the labor market remains as tight as it is. And while the bulls would argue that inflation is already decelerating, what matters to financial markets is not what the Fed **should** do, but what it **will** do. The picture painted by more nuanced data, including trimmed mean inflation[5] and sticky price inflation,[6] suggests price pressures are broadening out and unlikely to revert to a satisfactory level anytime soon (see Figure 2). We should take the Fed at its word when its policymakers tell us they will be data dependent. And so far, the data continues to be uncomfortably strong.

Figure 2: Stubborn inflation indicators at multidecade highs

Sticky (slowly changing) components of CPI and alternative core PCE, 1992–2022



Sources: Atlanta Fed and Dallas Fed.

We continue to believe the major central banks, their reasoning reinforced by the research at Jackson Hole, are hiking their way into recession, and as such, earnings estimates for 2023 need to come down much further. Bear markets typically end with equities becoming undeniably cheap (we are not there yet) or with a policy reaction, which may be receding farther in the future.

Also, in the aftermath of the policy response to the pandemic, many governments find themselves in the uncomfortable position of inching closer to unsustainable fiscal burdens at a time when rising nominal yields are putting upward pressure on debt service costs. This leaves us to echo our message from last quarter, which is for investors to continue to exercise caution in risk assets (equity and high-yield credit) while being aware that bear market rallies can be violent.

1 Powell famously carried around with him a copy of Volcker's book for quite some time after he had been appointed chair in early 2018.

2 The quote is attributed to Powell from his comments at the 2019 conference for the National Association for Business Economics.

3 For a good summary of the history of this debate, see Michael Ng and David Wessel, "The Hutchins Center Explains: The framework for monetary policy," Brookings.edu, January 4, 2018.

4 See Julian di Giovanni, "How Much Did Supply Constraints Boost U.S. Inflation?" on Liberty Street Economics blog of the New York Fed, August 24, 2022.

5 The Trimmed Mean PCE inflation rate is an alternative measure of core inflation in the price index for personal consumption expenditures (PCE), using data from the Bureau of Economic Analysis (BEA) (source: Federal Reserve Bank of Dallas).

6 The sticky price index sorts the components of the consumer price index (CPI) into either flexible or sticky (slow to change) categories based on the frequency of their price adjustment (source: Federal Reserve Bank of Atlanta).

For informational purposes only. Not an investment recommendation.

This material is provided for limited purposes. It is not intended as an offer or solicitation for the purchase or sale of any financial instrument, or any Putnam product or strategy. References to specific asset classes and financial markets are for illustrative purposes only and are not intended to be, and should not be interpreted as, recommendations or investment advice. The opinions expressed in this article represent the current, good-faith views of the author(s) at the time of publication. The views are provided for informational purposes only and are subject to change. This material does not take into account any investor's particular investment objectives, strategies, tax status, or investment horizon. Investors should consult a financial advisor for advice suited to their individual financial needs. Putnam Investments cannot guarantee the accuracy or completeness of any statements or data contained in the article. Predictions, opinions, and other information contained in this article are subject to change. Any forward-looking statements speak only as of the date they are made, and Putnam assumes no duty to update them. Forward-looking statements are subject to numerous assumptions, risks, and uncertainties. Actual results could differ materially from those anticipated. Past performance is not a guarantee of future results. As with any investment, there is a potential for profit as well as the possibility of loss.

Diversification does not guarantee a profit or ensure against loss. It is possible to lose money in a diversified portfolio.

Consider these risks before investing: International investing involves certain risks, such as currency fluctuations, economic instability, and political developments. Investments in small and/or midsize companies increase the risk of greater price fluctuations. Bond investments are subject to interest-rate risk, which means the prices of the fund's bond investments are likely to fall if interest rates rise.

Bond investments also are subject to credit risk, which is the risk that the issuer of the bond may default on payment of interest or principal. Interest-rate risk is generally greater for longer-term bonds, and credit risk is generally greater for below-investment-grade bonds, which may be considered speculative. Unlike bonds, funds that invest in bonds have ongoing fees and expenses. Lower-rated bonds may offer higher yields in return for more risk. Funds that invest in government securities are not guaranteed. Mortgage-backed securities are subject to prepayment risk. Commodities involve the risks of changes in market, political, regulatory, and natural conditions.

Our investment techniques, analyses, and judgments may not produce the outcome we intend. The investments we select for the fund may not perform as well as other securities that we do not select for the fund. We, or the fund's other service providers, may experience disruptions or operating errors that could have a negative effect on the fund. You can lose money by investing in a mutual fund.

In the United States, mutual funds are distributed by Putnam Retail Management.

A world of investing.®

Putnam INVESTMENTS

Investors should carefully consider the investment objectives, risks, charges, and expenses of a fund before investing. For a prospectus, or a summary prospectus if available, containing this and other information for any Putnam fund or product, call your financial representative (or call Putnam at 1-800-225-1581). Read the prospectus carefully before investing.