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TAPERING IS ON THE WAY. BUT WHAT ABOUT RATE HIKES?

July jobs data showed the US economy added 943,000 workers, with the unemployment rate dropping to a pandemic low of 5.4%. GDP growth is expected to be mid-to-high single digits this year, while defaults in the US high yield bond market are trending to 2% or lower. Investors might reasonably expect Fed balance sheet tapering to commence, quickly followed by interest rate hikes. However, US payrolls are 5.7 million jobs short of pre-pandemic levels, suggesting there's a good amount of labor market slack to work through.

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Recent economic data has been softening rather than strengthening. Since early August core CPI, University of Michigan Consumer Sentiment, Empire State Manufacturing Survey, retail sales, housing starts, and Philadelphia Fed Manufacturing Outlook all missed expectations to the downside. In recent weeks commodity prices have experienced sharp declines. Crude oil is down 9% since July; copper is down more than 10% since its May high; and lumber continues its epic crash, down 72% from its May high. Meanwhile, geopolitical risks are rising in Afghanistan, threatening market stability. All of this suggests that the Fed has plenty of time on its hands to wait and watch.

These mixed indicators have led some FOMC ("Committee") participants to find the incoming data as providing a less clear signal about the underlying economic momentum, judging that the Committee would have information in coming months to make a better assessment of the path of the labor market and inflation. Several participants emphasized that the Committee should be patient in assessing progress toward its goals and in announcing changes to its plans for asset purchases.

In his August 27 virtual speech at the Jackson Hole symposium Chairman Powell noted the US economy "has now met the test of substantial further progress toward the Fed's inflation objective" and that "it could be appropriate to start reducing the pace of asset purchases this year." We expect a formal announcement in the fourth quarter signaling the beginning of a reduction of asset purchases. While Chairman Powell left the door open for a tapering announcement, he threw cold water on the idea of rate hikes in the foreseeable future saying: "we have much ground to cover to reach maximum employment, and time will tell whether we have reached two percent inflation on a sustainable basis. Long-term unemployment remains elevated, and the recovery in labor force participation has lagged well behind the rest of the labor market."

Inflation hawks will undoubtedly be disappointed that Chairman Powell continues to believe inflation is transitory and impacting a relatively narrow group of goods and services affected by the pandemic. In fact, many price spikes can be traced to supply-chain disruptions in semiconductors, port congestion, and shipping container shortages which cannot be alleviated by changes in monetary policy. Disinflationary factors like the aging population and rising indebtedness are powerful forces. Powell described "sustained disinflationary forces, including technology, globalization and perhaps demographic factors, as well as a stronger and more successful commitment by central banks to maintain price stability. While the underlying global disinflationary factors are likely to evolve over time, there is little reason to think that they have suddenly reversed or abated. It seems more likely that they will continue to weigh on inflation as the pandemic passes into history." Following the speech bonds and stocks rallied, a sign Powell hit the right notes in reassuring investors that the Fed has things under control.

Tapering should not be interpreted as a sign that rate hikes will soon follow. So when can we expect rate hikes? According to Powell not until the economy reaches maximum employment and inflation moderately exceeds 2% on a sustained basis. Referring to circumstances when hikes would be appropriate he said there was a "different and *substantially* more stringent test" than the one for tapering.

This commentary is consistent with what we see in the bond market today. The bond market is telling us to focus on future growth, not inflation. For months the US experienced surging GDP, supply chain shocks, labor-induced goods and service disruption, and rising wages feeding inflation concerns. Now the interest rate reversal points to a new narrative, suggesting slower growth is on the horizon post 2021 and inflation will be subdued. It is plausible US growth has already peaked and is going to decelerate in 2022. Investors should then consider how likely it is for the Fed to hike rates in a slowing growth environment. If the bond market is correct, it is unlikely we will see rates meaningfully increase in 2022 or potentially even 2023.

Fixed income investors should be very pleased with Powell's comments. Virtually everything Powell said is good for credit. The read through is for continued robust consumer spending on goods, now transitioning to services, and solid corporate earnings in the second half of 2021. This should continue to support tighter credit spreads as well as higher equity prices. Historically, a growing economy (even if growth decelerates), easy monetary policy, and strong corporate earnings have been supportive of credit asset classes like high yield bonds and levered bank loans. While credit spreads are tight on a historical basis it's difficult to see what factors would result in a sustained sell-off. With rate hikes seemingly off the table investors can once again gain confidence to buy corporate credit at spreads wider than they have been for the past few months.

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About Crescent

Crescent Capital is a global credit investment manager with $34+ billion of assets under management. For nearly 30 years, the firm has focused on below investment grade credit through strategies that invest in marketable and privately originated debt securities including senior bank loans, high yield bonds, and private senior, unitranche, and junior debt securities. Crescent Capital is headquartered in Los Angeles with offices in New York, Boston, and London and more than 180 employees globally.

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