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MC Interview | We have to live with both inflation and recession for the time being: Devina Mehra, First Global

The Fed stance seems to be slightly more dovish but we have to wait for more data, Devina adds.

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What stood out for you from the Fed presser and the market rally thereafter?

Three things. First, the path to a soft landing is getting narrower essentially means a recession is likely. Second, in terms of having been behind the curve in starting the tightening, the response was: yes, we were late but other countries that started earlier still faced the same inflation so it didn't really matter. Third, the markets expect Fed to stop hikes a bit earlier than what they did a day earlier. This is evident in the implied terminal rate, ie the expected maximum rate to which Fed will raise rates this year suggested by the Jan 2023 Fed Funds Futures was a tad lower at 3.33% vs 3.40% pre-FOMC.

Overall, the 75 basis points hike by the Fed was on expected lines. For now, the Fed has to position itself as the inflation hawk and keep repeating that it will do what it takes to control inflation. Of course, with the addendum that it should be with minimum hurt to labour markets and the economy.

Agreed. The market seems to be interpreting the stance as dovish. I thought they said the obvious and nothing that gives a clue on what lies ahead really. What's your sense?

They said in a way that the Fed is front-loading the increases and will watch data. Even by the time the September meet comes around more data will be in hand. I would think they sounded marginally more dovish than before, as they said they may take a pause sooner than later if the data warrants.

But that can also be interpreted the other way around – that if the data is unsatisfactory, we continue on the same path and be more aggressive.

Yes. Of course. Powell kept repeating that not tackling inflation isn't an option even if means temporary pain as that is for the long-term health of the economy and the labor market.

Powell said the path to a soft landing is getting narrower, and also that the Fed doesn't want to create a recession. How do you read these things together? If the Fed is determined in reining in inflation, as it says, it doesn't really matter to them whether there is a recession or not.

The statement that the path is getting narrower means a recession is more likely. And the Fed is prepared to go through with it till the inflation targets are in sight. For now, according to the Fed, with the labor market being as buoyant as it is, it doesn't smell or feel like a recession.

Would you hazard a guess on by when will inflation come back to the targeted level of 2%? It seems way too off. Is that the level Fed will want to see inflation at to reverse rate action?

Agreed that currently 2% appears some way off but commodity prices have been cooling rapidly. Food and fuel are likely to be down in the next inflation print. I would also expect some other categories like shelter inflation (housing) to also begin to slide. Retailers like Walmart are also cutting prices.

The net result of all this? Like the Fed, we will have to wait for the data to come through. The target will have to be somewhere in sight for the Fed to stop and reverse the tightening cycle.

What is a bigger threat right now – recession, or that inflation remains stubborn at relatively higher levels, or both?

The probability of recession is getting stronger even as inflation is likely to remain high for some more time. So, at least for a time, we will have to live with both.

I'm reminded of what Milton Friedman said on monetary policy and inflation: Increasing the money supply is like alcoholism. When you start drinking, the good effects come first and the bad effects come later. That is why you tend to overdo it. When you stop, it is the other way around: the bad effects come first and you have to wait for the good effects.

So some pain will have to be undergone before the US comes out on the other side.

Are markets getting ahead of themselves?

I had written in the middle of June that while the bad news on the macro front was not over, it was probably already in the price.

I had also separately written that the risk of being on the equity markets was outweighed by the risk of sitting it out and not being invested.

At that stage, the NASDAQ was almost the worst performing index in the world - it has rallied smartly from those lows.

Markets tend to be a step ahead - not always but often enough.

So do you think the market will build on these gains in the near term or a correction is due now? What will be the trigger for a reversal?

In the short term, I remain positive on the US markets. The outlook is hazier in the medium term.

Just as after side-stepping the COVID crash, we went back into the markets in the third week of March 2020. At the time it was clear that a rally was overdue but it was less clear whether it would be a temporary one or something more. As it turned out it was a huge run-up that lasted more than a year and a half - in spite of the fact that the pandemic-related uncertainty continued for a long, long time.

Do you expect any big negative surprises in economic data?

Difficult to say at this stage. I don't expect big ones but as Chairman Powell said in more polite language that anyone being very certain of outcomes in the current situation doesn't know what they're talking about.

Anything else that stood out from the presser?

On a lighter note, in my opinion, the best question posed during the presser to the Fed Chair: "You are saying that there is no recession in the US economy whereas the majority of economists and consumers are expecting one. Why should they believe your statement when it is coming from the same people who told them that inflation was transitory?"

To Powell's credit, he kept a straight face.

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