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# Powell Warns Of A 'Two-Sided Risk', And That's Bad News

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#### About this article

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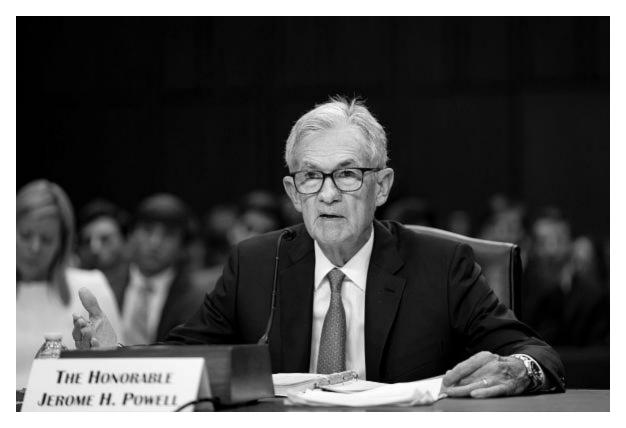
# **Summary**

Fed Chair Powell warns of two-sided risk facing monetary policy: elevated inflation and risk of recession.

The labor market is already signaling a recession, however, the Fed still sees the labor market as "strong, but not overheated".

Thus, the Fed is likely to hold interest rates restrictive for longer, until the labor market further weakens, which is likely to cause a deeper recession.

The S&P500 is facing a recessionary bear market with the bubble bursts - or a deep drawdown.



**Bonnie Cash/Getty Images News** 

#### The two-sided risk

The Fed Chair Powell, in his Semiannual Monetary Policy Report to the Congress on July 9th, warned about the two-sided risk facing the monetary policy implementation at the moment.

First, Powell emphasized that the Fed has a dual mandate of full employment and a sustainable 2% inflation over the long run, and both of these mandated are equally important.

Powell then explained the current challenge of meeting both of these mandates:

We know that reducing policy restraint too soon or too much could stall or even reverse the progress we have seen on inflation. At the same time, in light of the progress made both in lowering inflation and in cooling the labor market over the past two years, **elevated inflation is not the only risk we face**. Reducing policy restraint too late or too little could unduly weaken economic activity and employment.

Thus, Powell warns that the Fed is currently still facing the risk of elevated inflation, and consequently, it needs to keep the interest rates in restrictive territory for longer. However, at the same time, the risk of a recession is rising.

Practically, that means that the Fed's first cut could come in reaction to 1) more evidence that inflation is sustainably falling towards the 2% target, or 2) the spike in the unemployment rate and a recession.

## Why is this important?

The emergence of the two-sided risk is actually bad news for the stock market.

Specifically, just until recently, we were facing only one-sided risk - elevated and sticky inflation well above the Fed's 2% target.

Thus, with each inflation report that showed a continued disinflation, or the fall in annual inflation rate, the market was cheering the prospects of a soft-landing, or even a no landing.

A soft-landing scenario assumed that the inflation would fall enough for the Fed to start lowering interest rates - before the labor market weakens and before the recession hits.

Practically, the soft-landing crowd was looking at the unemployment rate to stay at 4% or below - this is in fact what the Fed predicted in the Summary of the Economic Projections. At the same time, the expectations were that inflation would fall towards the 2% target - and this would allow the Fed to normalize the interest rate policy. This scenario supported the bull market from October 2022 to current.

Unfortunately, the labor market has already weakened past the 4% unemployment rate, with the recent reading of 4.1% for June. More importantly, the leading indicators are pointing to a continued weakening of the labor market.

Thus, now we are facing the risk of a recession and the risk of elevated inflation at the same time - that's the two-sided risk.

Practically, this means that the soft-landing scenario can be ruled out, and that's the bad news for the stock market bulls.

Given that inflation still remains elevated, while the trend of weakening in the labor market has been clearly established, suggests that the Fed will have to hold interest rates longer, which is likely to cause a deeper recession - and that's the hard landing scenario.

The hard landing scenario or a deeper recession means that the corporate earnings will likely fall by 15-20%, and that S&P500 PE multiple will likely sharply correct, both of which point to a deep recessionary bear market in the S&P500.

#### Powell's statement was hawkish

When describing the labor market, Powell stated:

The unemployment rate has moved higher but was still at a low level of 4.1 percent in June.

This is actually a hawkish statement with respect to monetary policy. Powell acknowledges that the unemployment rate has moved higher, but he views the current unemployment rate level as still "low" and the labor market overall as "strong, but not overheated"

Thus, the clear implication is that the Fed is still willing to tolerate the unemployment rate at 4.1%, and not going to cut pre-emptively until the unemployment rate spikes even higher.

That's a problem because based on the Sahm rule, the recession is usually triggered when the unemployment rate increases by 0.5% above the cyclical low point (3.5% during the recent cycle).

So, we are at that point where the Sahm rule suggests that we could be in an imminent recession. The current Sahm Indicator is at 0.43% because it's based on the three-month averages, so another month at 4.1 or higher will officially trigger the recession warning.

But the Fed does not see it because the unemployment rate is still very low, and actually still indicates full employment based on the historical data.

Thus, the Fed is likely to allow the unemployment rate to rise to 4.5%, based on some earlier SEP projections, when Powell warned about "pain" and that would likely cause be a full-blown deeper recession.

### **Implications**

Here is some data from the household survey (which reports the unemployment rate):

the number of unemployed people increased by 814K over the last 12 months

the number of people who work full-time has decreased by 1.5M over the last 12 months

Both of these numbers are consistent with a recession. The unemployment rate of 4.1% itself is also consistent with a recession, based on the Sahm rule.

Yet, these numbers are not sufficiently weak yet to bring inflation down to the 2% target, as Powell stated.

The Committee has stated that we do not expect it will be appropriate to reduce the target range for the federal funds rate until we have gained greater confidence that inflation is moving sustainably toward 2 percent.

Thus, the Fed will be forced to trigger a deeper recession. In fact, that's a normal cycle based on the historical data. The Fed usually cuts in reaction to a recession, which is also when inflation falls as demand collapses.

The S&P 500 (SP500) is waiting for that deep recession with the bubble-like valuations - the PE ratio over 24, Shiller PE ratio over 36, and the Buffett indicator at the highest level in history.

Thus, the S&P 500 (SPX) (SPY) is facing a recessionary bear market with the bubble burst - and that suggests a deep drawdown. However, like with every bubble, the timing of the burst is difficult to predict.

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