

STICKY INFLATION

After backing off a few times last month, the S&P 500 finally broke into bear market territory on Monday with a nearly 4% decline on the day and is now down roughly 22% from the January 3rd high. The more heavily technology-weighted NASDAQ index has been in a bear market for nearly two months now. The Dow Jones Industrial Average, which is comprised of more cyclically sensitive stocks which typically trade at lower valuation multiples, has yet to break into bear market territory, but is perilously close.

The primary catalyst for the recent downswing in equities was the May CPI report which showed both headline and core inflation remaining at elevated levels. By this time, we believed we would see strong signs that inflation had peaked and was beginning to decline. And for good reason: supplies were largely replenished, and consumer demand transitioned away from spending on goods to services such as travel. In an economy more fully reopened from Covid, that is significant.

Despite signs that higher inventories and decreasing demand for goods are leading to outright deflation in certain goods sectors, the invasion of Ukraine and subsequent sanctions placed on Russia by the West have exerted continued upward pressure on energy and food prices. Moreover, the Chinese approach to Covid outbreaks in imposing continued strict mobility restrictions on the key industrial city of Shanghai threatens to delay, or even worsen, global supply chain disruption. Meanwhile, the pickup of spending on services has been even greater than expected as evidenced by a nearly 13% year-over-year increase in airfare.

The persistency and apparent intractability of inflation is forcing the Federal Reserve to become even more aggressive in implementing their monetary tightening policies to prevent an inflationary psychology from becoming entrenched. A Wall Street Journal article on Monday discussed the potential for a 75 bps fed funds rate increase at this week's FOMC meeting. That news appeared to originate from a strategic leak within the Fed itself in advance of the meeting. It now appears the tightening process will accelerate with 75 bps rate hikes at both this and next month's meeting, with an additional 50 bps in September. This will take the Fed funds rate to 3.0% by the beginning of the Fall.

Money markets are now pricing in a 4% terminal Fed funds rate at the conclusion of the tightening cycle compared to our original terminal target of 2.50%-3.00% as the Fed "normalizes" policy after a prolonged period of excessive monetary ease. The bond market is reflecting this more aggressive stance driving yields higher across the maturity spectrum.

The sharper move higher in shorter term treasury notes is notable compared to the intermediate and longer maturities. This has caused a pronounced flattening of the yield curve with the closely watched spread between the 2- and 10-year treasury basically the same. A flat-to-inverted yield curve is often a leading indicator of protracted economic weakness and potential recession.

While some consumer and business sentiment surveys have notably deteriorated over the past few months, others, such as the national supply managers' survey, have merely declined to still expansionary levels. It is difficult to foresee a recession with weekly jobless claims still at historically low levels and the national unemployment rate at levels not seen since the prior century. Admittedly, employment statistics could be viewed as more lagging indicators as businesses wait for a pronounced trend of declining sales growth before they start terminating employees. Beyond the survey, we are more interested in how businesses and consumers behave in their spending patterns since retail sales and capital spending have so far held up reasonably well given the specter of monetary tightening.

A strong argument can be made that the year-to-date decrease in equity prices has been driven primarily by contracting valuation multiples in a rising interest rate environment. Markets may have yet to fully price in the increasing risk that more extreme monetary tightening will lead to recession and lower corporate earnings over the coming quarters.

One measure of market risk that has yet to break out to levels that have historically implied recession is the VIX index of option volatility — although it has begun to spike higher this week. Another indicator is the spread of high yield interest rates to that of same maturity treasuries. While the spread has indeed widened year to date, it has not approached the levels of past recessions. This is an encouraging sign that the market does not expect a meaningful increase in corporate default rates.

It is not clear how the markets will react to a Fed pivot to 75 bps rate increases. This can either be taken positively as an indication the Fed is finally catching up to the inflation reality or more ominously as increasing the risk of a policy error by tightening too aggressively into an economy that is already slowing as consumers struggle with higher prices.

Given this apparently more aggressive monetary policy stance, we advise caution in deploying cash into the equity markets.

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