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MARKET SIGHT*LINES*

Market Volatility: More Storms, Clear Skies, or Both?

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We started 2022 focused on Balancing Acts like (i) the pandemic, omicron, and how officials would manage re-openings; (ii) elevated inflation, and how the Federal Reserve (Fed) might manage policy; (iii) the looming midterms, and the balance of power in D.C.; and (iv) geopolitics, and how governments would respond to increased protectionism. On that last point, few anticipated Russia's brutal invasion of Ukraine and the related negative impact on the global economy. We did anticipate market volatility and numerous equity market corrections throughout the year. Recent events have shaken the markets further, and this week the S&P 500 entered a bear market.

In this week's Sight|Lines, we continue last week's discussion on drivers of market performance, reviewing a recent inflation report, learnings from the Fed's June meeting, and our views going forward.

MAY CONSUMER PRICE INDEX

Most are feeling the pinch of higher inflation, with the average price of gas above $5 a gallon, food prices climbing, and rents rising materially for many. The release of the May consumer price index (CPI) told the story, with headline year-over-year (YoY) CPI coming in at 8.6%, above the consensus of 8.3%, and an increase over April. And by this measure, inflation didn't peak in March at 8.2%. Markets reacted. From the release up to the Fed announcement:

- The S&P 500 has declined 5.8%, moving into bear market territory.
- Interest rates have climbed, with the 10-year Treasury moving from 3.04% to a high of 3.49%.
- Markets priced in 2.75% in 2022 Fed rate hikes, even anticipating a 0.75% move in June.
- Inflation expectations jumped, with the 5- and 10-year rates peaking at 3.18% and 2.81%, respectively.

The CPI report offers some interesting learnings. Energy prices continue to be impacted given the supply/demand imbalances stemming from the Russia-Ukraine war and were one of the biggest positive contributors to inflation, climbing 3.9% in May. Less demand or more supply from other sources should lower energy prices. Owners' equivalent rent (roughly 24% of the CPI basket) also experienced the largest month over month increase in 30 years. When we exclude energy and food (core CPI), less than 20% of the sectors are experiencing inflation at or below the Fed's 2% target. The May YoY core CPI was 6%, roughly in line with expectations and reflecting declines from March to April to May. So, core CPI did peak in May, at least so far.

LEARNINGS FROM THE FED'S JUNE MEETING

In the wake of the CPI report market, participants priced in a 0.75% hike this month, and they got it right. The Fed increased its fed funds rate by 0.75% at this meeting, above the 0.50% it previously communicated. The Fed reiterated it would be data dependent, explaining this change to be the result of recent higher-than-expected inflation figures. In its Summary of Economic Projections (SEP), the Fed also:

- Forecasted the funds rate at 3.4% by year end, rising to 3.8% in 2023, and falling modestly from there;
- Reduced its 2022 GDP projection from 2.8% to 1.7%, so lower economic growth due to tighter policy;
- Increased its unemployment rate forecast from 3.5% to 3.7%, now rising to 4.1% in 2024, levels it still considers reflective of a strong employment environment; and
- Increased its 2022 PCE inflation projection from 4.3% to 5.2%, with 2022 core PCE expected to be 4.3%.

Chairman Jerome Powell strongly reiterated the Fed's commitment to managing policy to achieve stable prices and maximum employment and that such moves would not trigger a recession, as reflected in its GDP forecast.

OUR VIEWS GOING FORWARD

This environment, more than others, is uncertain. In such a setting, we find it helpful to define and evaluate scenarios based on what might happen, how likely it is to happen, and the corresponding economic and market implications. Here are two such scenarios:

Clouds Darken Ominously – Storms More Likely	Skies Begin to Clear – Rays of Sunshine and Hope
• Inflation remains elevated given supply/ demand imbalances the Fed cannot influence with policy (e.g., supply chain, commodities). • Interest rates rise with fear of more Fed action. • Equities decline further given these negatives. • A more hawkish Fed policy triggers a recession.	• Supply chain pressures start to ease and commodity prices (e.g., oil) fall, and headline inflation levels out and starts to decline. • Rates stabilize as Fed policy softens demand. • Equities rise on relief, given signs of hope. • We remain "mid-late cycle," delaying recession.

In our industry, we are surrounded by experts who today recognize that the path for the economy and markets is more uncertain than normal. Over the last week, my team and I have reviewed about a dozen reports by these experts offering a view of the unfolding environment from here. I'd say about eight of those reports (67%) are offering a positive outlook. The remaining four (33%) have a negative outlook. Coincidentally, these percentages align with our assessment. We see about a 2-in-3 chance (67%) the skies will begin to clear, inflation and interest rates will stabilize and start to fall, equity markets move higher, and we don't yet enter a recession. But we see a 1-in-3 chance, really driven by continued supply chain pressures and higher commodity prices, that the skies remain cloudy, inflation remains elevated, the bear market continues, and we enter a recession later in 2022.

CONCLUSION

We started the year with amplified uncertainties and various Balancing Acts. Consumers and investors alike are increasingly gloomy, fearful of the storm clouds that have formed and the Fed's ability to pilot us to a "soft-ish" landing. While we acknowledge the increased probabilities of recession and a sustained bear market, we see higher chances of a break in the clouds, continued growth, and market recovery from here.

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Want to go deeper? Watch our Investment Strategy Brief (ISB)
The June ISB will be released on 6/21/22