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MARKET SIGHT LINES

Second Half 2022 and Beyond: Part 1: How Did We Get Here?

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We anticipated 2022 would be a volatile year given the various balancing acts that people, businesses, and government officials would have to contend with in order to satisfy often competing requirements. As we pass midyear, we believe it helpful to look back and objectively assess how these balancing acts have played out so far, before we look forward to the remainder of the year and beyond. In this week's Sight|Lines, we set the stage for this look forward to the second half of 2022 and beyond by first sharing Part 1: How did we get here?

FOUR BALANCING ACTS

We held a modestly positive view heading into 2022 but acknowledged that the range of potential outcomes was wider than in previous years. The external forces that contributed to the strong economic growth and equity markets were set to fade, and the economy would have to stand on its own. Some balancing acts that were in play included: (i) the Federal Reserve (Fed)'s campaign against inflation without triggering recession (ii) governments balancing pandemic shutdowns with their economic and human costs, (iii) companies wanting to protect margins while retaining workers, and (iv) the U.S. and China exploring ways to cooperate while remaining in a strategic rivalry. The uncertainty of outcomes related to these forces was enough to lead to heightened volatility. But few, if any, anticipated Russia's brutal invasion of Ukraine and China's strict zero-COVID policy that would tip the balance.

THREE IMBALANCES

We all now know that sustained, elevated inflation has caused real trouble in 2022. As we shared in Learnings From Economic Theory: Inflation Has Gone Vertical!, an imbalance in supply – too little – or demand – too much – can drive prices higher. Let's focus on three imbalances this year that ultimately triggered a bear market. First, consider the pandemic. We started the year at the peak of the fast-moving and wide-spreading omicron variant, slowing the reopening and reasserting pressures and imbalances in our supply chain. And we've watched as China broke away from the rest of the world with its zero-COVID policy, keeping cities and factories shut down to try to control the spread, extending imbalances in the world's supply chain and putting pressure on prices. Second, we experienced the unexpected and tragic Russian invasion of Ukraine, disrupting the flow of oil and food, for example, another imbalance limiting supplies. And then third, the U.S. and most other parts of the world have continued economic growth well above trend, fueled by highly supportive monetary and fiscal policy support, creating an imbalance of excess demand.

These imbalances have fueled sustained, higher inflation and have driven the Fed to pursue a more aggressive monetary policy, triggering fears of a recession.

MONETARY POLICY RESPONSE

Consider the Fed's Summary of Economic Projections (SEP), a summary of Federal Open Market Committee (FOMC) participants' projections for GDP growth, the unemployment rate, inflation, and the appropriate policy interest rate. Let's start with inflation. Back in December 2021, the SEP presented a median forecast for 2022 inflation of 2.6%. These forecasts were developed before FOMC participants were aware of the omicron wave, for example. They, and most of us, believed the pandemic was calming down. They therefore called for strong economic growth to continue, with forecasted U.S. GDP being 4.0% in 2022. With a strong economy and supply chain disruptions easing, they believed they would increase the policy interest rate to only 0.9%.

March was an interesting time. The omicron wave was mostly behind us, with the possibility that economies would continue reopening and supply chain pressures would ease. But Russia had invaded Ukraine the month before, and Fed officials and market participants alike looked for a quick path to peace there. FOMC participants incorporated some of these pressures into the SEP. They raised their 2022 inflation forecast to 4.3%, reflective of a delay in easing supply chain pressures and some anticipated impact from the war. They realized a less accommodative policy would be needed and increased their policy interest rate forecast to 1.9%. Higher rates would mean less economic growth, and they lowered their 2022 GDP forecast to 2.8%.

In June, we discussed inflation and the progression of Fed policy in Market Volatility: More Storms, Clear Skies, or Both? The latest SEP reports that after the May CPI report, the 2022 inflation forecast rose to 5.2%, the policy interest rate forecast jumped up to 3.4%, and with a slowing economy in response, the 2022 GDP forecast fell to 1.7%. The Fed has shifted policy dramatically, driven by its commitment to do all that it can to lower inflation.

MARKET RESPONSE

As we made our way through these events of 2022, markets reacted negatively. Interest rates rose, driving bond prices lower, all contributing to a year-to-date return for the Bloomberg U.S. Aggregate Bond Index of -9.8%. With higher interest rates and a slowing economy, stocks fell, with the S&P 500 posting a negative return of -19.6% over the first half of the year. Today, higher rates make bond investments more attractive looking forward, and lower stock prices mean equity valuations are more compelling.

CONCLUSION

We've taken an objective look at some balancing acts in 2022, highlighting numerous imbalances like constrained supplies and excess demand that are driving elevated inflation and declining markets. Next week, in *Second Half 2022 and Beyond: Part 2: Reasons for a Positive Outlook*, we will share our views on the slowing economy, recession, earnings, and our reasons for a positive outlook going forward.

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