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MARKET SIGHT LINES

Navigating the Rest of 2022:
Get Ready for More Volatility

By Michael O'Keeffe, *Chief Investment Officer*

In our Outlook 2022: Balancing Acts, we shared our expectation that 2022 would be more volatile than 2021. And with a war in Ukraine, jammed supply chains, and elevated inflation, this year has been even more volatile than we expected. We're in a bear market, and given the Federal Reserve (Fed)'s aggressively hawkish tone, investors are worried about higher rates, an economic slowdown, and the prospect of weaker earnings. For investors, Labor Day typically marks the transition from a "quieter" summertime to a more "energetic" environment as we head toward the end of the year. And history tells us that, with a pickup in activity, we should expect continued, and perhaps more, volatility during this period. In this week's Sight|Lines, we discuss some of our areas of focus as we navigate the remainder of 2022, including what history teaches us about volatility patterns throughout the year.

THE NEMESIS – SUSTAINED, ELEVATED INFLATION

We explored the data in Supply Chain Pressures May Be Easing and Inflation May Be Cooling, reviewing how supply chain pressures have fueled higher inflation into 2021 and 2022, and then how the easing of some supply chain issues may be cooling inflation given better-than-expected July inflation reports. But one decent month does not mean a trend, so without question, we will be monitoring inflation each month. As shared in Figure 1, the consumer price index (inflation) reports will be released on September 13, October 13, November 10, and December 9, so there is real potential for dramatic market moves on these dates. We're looking for a cooling trend.

A POSITIVE THAT'S A NEGATIVE? – STRONG EMPLOYMENT

On September 2, we learned that the unemployment rate increased to 3.7%, signaling that we remain near a historically strong job market. The Fed has a dual mandate of maximum sustainable employment and price stability. It has expressed price stability as a target inflation rate of 2%, and, of course, inflation has been well above that level for some time. So, as the Fed balances its dual mandate, it will be open to higher unemployment to achieve lower inflation. In his July 27 press conference, Fed Chair Jerome Powell said, "my own instinct is that the natural rate of unemployment is higher" than the then-current 3.6% rate.

A strong job market benefits the consumer and the economy. But an unemployment rate below the Fed's targeted natural unemployment rate can be a negative for the markets, as the Fed feels it has room to increase rates further to fend off inflation. Higher rates have been a negative for the markets. We will watch the employment reports released on October 7, November 4, and December 2, with real potential for market swings on those dates, as investors interpret employment's influence on Fed policy.

FED POLICY AND ECONOMIC PROJECTIONS

In some ways, monitoring the Fed's evolving Summary of Economic Projections (SEP) helps explain their increasing focus on inflation and continued hawkish tone. Back in December 2021, the SEP signaled the expectations of falling inflation, muted rate hikes, and above-trend economic growth. In March, they adjusted these projections with higher inflation, more rate hikes, and still above-trend but more muted economic growth. In June, the 2022 inflation projection increased more, which led to a signal of higher rates and GDP growth falling to around long-term trend, or slightly lower.

We will monitor Fed meeting results, the SEP, and Fed minutes through the balance of the year, with key dates including September 21, October 12, November 2, November 23, and December 14.

THE PROSPECT FOR ECONOMIC "PAIN"

With the Fed in a hawkish policy shift and a signal for more, market interest rates have risen. The Fed wants this to happen because higher rates typically lead to a slowing economy and softening demand. And with reduced demand, inflation should cool. What signs do we see of a slowing economy, and where might we soon experience "pain?" With higher rates, the average 30-year mortgage rate has risen to a level not seen in years, and we're seeing a slowdown in what has been a very "hot" housing market. So, we can expect real estate prices to level out and possibly fall some. Some leading economic indicators are signaling a slowdown, as are purchasing manager indices (PMIs) – business surveys about future expectations. Of course, housing reports on September 20/21, October 19/20, November 17/18, and December 20/21 will tell the housing story. And we'll fully analyze the third quarter GDP (advance estimate) when it's released on October 27. Finally, we'll monitor consumer and retail sales data, the latter of which will be released on September 15, October 14, November 16, and December 15.

MARKET VOLATILITY

Inflation, employment, Fed policy, and a cooling economy will all contribute to market volatility for the balance of the year. Figure 2 shows the average annualized volatility, as measured by the VIX index, for the last 30 years, along with the same measures for the first 8 months of 2022. Volatility is elevated this year, and we can also see that the months of September, October, and November are typically elevated compared to other months of the year. These figures, and our discussion above, present reasons for continued volatility for the remainder of the year.

CONCLUSION

Long-term investors typically stay invested through elevated volatility, often rebalancing asset allocation positions and even looking to identify investment opportunities created by this volatility. But we also benefit from understanding the drivers of volatility, as this knowledge and recognizing what to potentially expect and when helps us maintain our composure as we stay invested. For those interested in a more in-depth discussion on these topics, check our latest Investment Strategy Brief.

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FIGURE 1
Key Dates for Remainder of 2022

SEPTEMBER	
2	Employment
13/14	Inflation
15	Retail Sales
16	Consumer Sentiment
20/21	Housing
21	Fed Policy Decision
21	FOMC Economic Projections

OCTOBER	
7	Employment
12	FOMC Minutes
13/14	Inflation
14	Retail Sales
14	Consumer Sentiment
19/20	Housing
27	3rd Quarter GDP (Adv Est.)

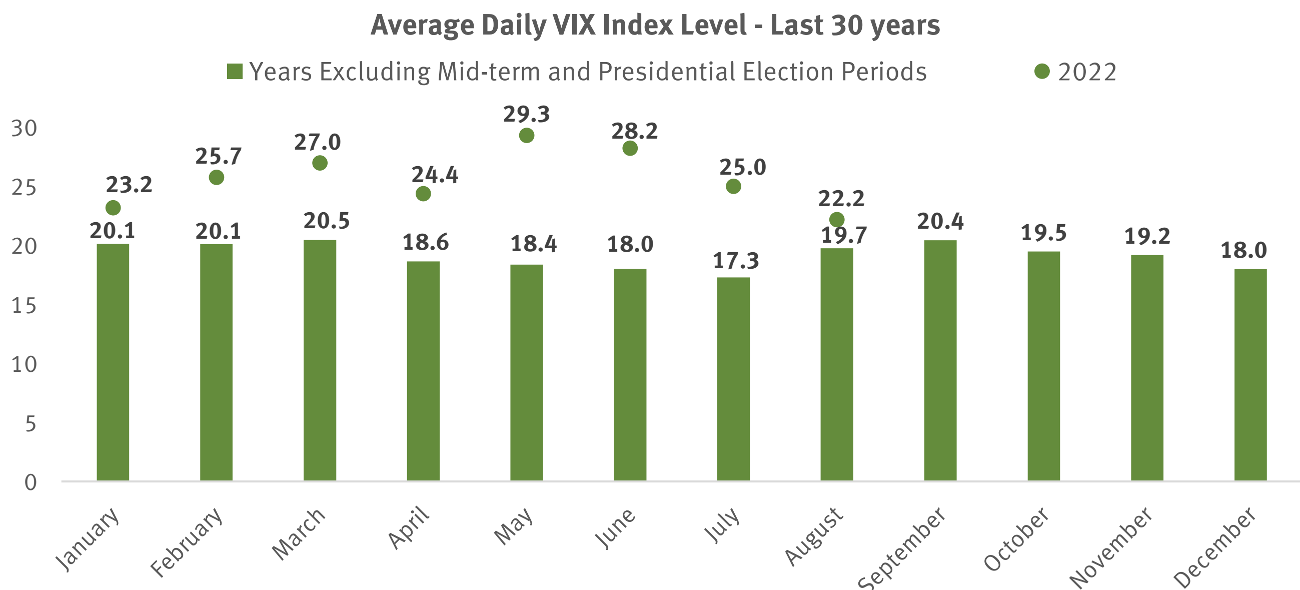
NOVEMBER	
2	Fed Policy Decision
4	Employment
8	Mid Term Elections
10	CPI/Core CPI
11	Consumer Sentiment
15	PPI/Core PPI
16	Retail Sales
17/18	Housing
23	FOMC Minutes

DECEMBER	
2	Employment
9	Consumer Sentiment
9/13	Inflation
14	Fed Policy Decision
14	FOMC Economic Projections
15	Retail Sales
20/21	Housing

OTHER IMPORTANT TOPICS

- Russia-Ukraine War
- China-Taiwan Tensions
- Progression of Earnings Forecasts
- 3rd Quarter Earnings Season
- Progression of PMI measures
- Business and consumer sentiment
- Global Inflation
- Global Central Bank Policy

FIGURE 2
Historical and 2022 Volatility



Source: Stifel Investment Strategy via Bloomberg, as of August 31, 2022

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Asset allocation and diversification do not ensure a profit and may not protect against loss. There are special considerations associated with international investing, including the risk of currency fluctuations and political and economic events. Investing in emerging markets may involve greater risk and volatility than investing in more developed countries. Due to their narrow focus, sector-based investments typically exhibit greater volatility. Small company stocks are typically more volatile and carry additional risks, since smaller companies generally are not as well established as larger companies. Property values can fall due to environmental, economic, or other reasons, and changes in interest rates can negatively impact the performance of real estate companies. When investing in bonds, it is important to note that as interest rates rise, bond prices will fall. The Standard & Poor's 500 index is a capitalization-weighted index that is generally considered representative of the U.S. large capitalization market. The Dow Jones Industrial Average (DJIA) is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the NASDAQ. The DJIA was invented by Charles Dow back in 1896. The MSCI EAFE index (Europe, Australasia, and the Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. and Canada. VIX is a trademarked ticker symbol for the Chicago Board Options Exchange Market Volatility Index, a popular measure of the implied volatility of S&P 500 index options.

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