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MARKET SIGHT LINES

Connecting the Dots: Drivers of Market Performance

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While we often dive into a single topic in Sight|Lines, this week we take a step back to discuss how a variety of topics are connected and ultimately drive economic and market performance.

EMPLOYMENT

We start with the employment environment, which is positive. The unemployment rate sits at 3.6%, after having peaked at 14.7% in April 2020. There are 6.0 million unemployed people looking for work and 11.4 million jobs available. Employers have had to increase wages to retain and attract employees, with wages growing 6% over the last year as of April 2022. Notably, wages tend to grow in response to and as a driver of inflation.

INFLATION

We've all read about and personally experienced the sustained, higher inflation over the last year. The consumer price index (CPI) accelerated unexpectedly in May (up 8.6% year-over-year) after slowing slightly in April. Other measures, like the producer price index and the personal consumption expenditure price index, also remain elevated. Drivers of this higher inflation include higher wages, increased demand as we reopen after the pandemic, and supply chain issues, especially those caused by the Russia-Ukraine war. Both employment and inflation are important inputs into Federal Reserve (Fed) policy.

FED POLICY

The Fed sets monetary policy to pursue its dual mandate: maximum employment and price stability. During the pandemic shutdown, prices were stable and, as discussed above, unemployment ballooned. The Fed set a highly supportive monetary policy, lowering the fed funds to near zero and expanding its balance sheet to $7.4 trillion. With the job market recovered and inflation higher, the Fed refocused on its "price stability" mandate and pivoted to a hawkish stance, hiking the fed funds rate by 0.75%, signaling additional hikes, and initiating quantitative tightening to reduce the size of its balance sheet. The market is pricing in another 2% in rate hikes by the end of the year. The Fed's near-term goal is to reign in higher inflation hopefully without triggering a recession, or a "soft-ish landing." But, of course, this shift in Fed policy has impacted interest rates and forecasts for economic growth.

INTEREST RATES

Market interest rates like U.S. Treasury yields tend to move in anticipation of Fed funds rate policy changes. For example, the benchmark 10-year Treasury hit a low of 0.51% on August 4, 2020, rose to 1.51% at the end of 2021 signaling some Fed rate hikes, and then jumped to 3.13% on May 6, 2022, in response to the Fed's policy shift. The 10-year Treasury rate currently sits just over 3%. A second component of interest rates is corporate

"spreads," or the excess yield earned on corporate bonds to compensate for the credit risk of the issuers, for example, the risk of default of a particular issue, however remote. The option-adjusted spread of the Bloomberg U.S. Aggregate Corporate Index, which measures the investment-grade corporate bond market, hovered around 1% but rose above 1.4% in March and May. The spread is currently 1.30%. Higher interest rates dampen economic activity and push bond prices lower. But before we get to the economy and markets, let's consider other trends in D.C.

D.C. TRENDS

The Democrats swept the 2020 election. As President Biden entered office, he had a healthy approval rating, with 55% of Americans approving of him, and 32% disapproving. But with only a slight majority in the Senate and meaningful differences between Democratic progressives and moderates, the administration and Congress have made limited progress. We saw bipartisan support in 2021 for pandemic relief and traditional infrastructure, but tax increases and the Build Back Better legislation have stalled. With all that is going on, the president's approval rating has fallen to 41%, with 56% of Americans disapproving, increasing the risk the Democrats will lose one house of Congress in the upcoming midterms, a common outcome for a first-term president. Brian Gardner, Stifel's Chief Washington Policy Strategist, publishes [regular updates] on these topics.

ECONOMIC GROWTH

After the brief 2020 recession and a U.S. GDP decline of -3.4% that year, highly accommodative monetary and fiscal policy fueled recovery, with U.S. GDP growing 5.7% in 2021. As we started 2022, GDP was expected to grow by 3.9%, well above trend. But given the shift in Fed policy, higher rates, and other challenges like the Russia-Ukraine war and China COVID shutdowns, the consensus forecast for 2022 GDP growth has fallen to 2.6%. Clients remain concerned about a recession, but we believe a recession will not likely happen until the second half of 2023 or after. Lindsey Piegza, Stifel's Chief Economist, publishes [regular updates] about the economy.

MARKET PERFORMANCE

Rising rates cause bond prices to fall, with the Bloomberg Aggregate Index returning -9.9% year to date. The stock market also reacted to elevated inflation, the war, and shifting Fed policy, with the S&P 500 falling -18.2% from the beginning of the year through May 19, since recovering by about 5.5%. The S&P 500 has therefore returned -13.7% year to date. Investors have been worried about stressed company profits in this environment, but consensus 2022 earnings growth for the S&P 500 sits at 10.5%, a positive for stocks. We expect stock market volatility to continue but also expect stocks to be higher a year from now.

CONCLUSION

2022 has been a volatile year so far, with a number of factors influencing the economy and markets, like the strong employment environment, elevated inflation, Fed policy, interest rates, and D.C. trends. We will continue to monitor these and other factors as we actively engage Stifel Financial Advisors and their clients.

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