The Advisor

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Market Update - Third Quarter, 2022

HAS INFLATION PEAKED? The consumer price index (CPI) for June registered 9.1% which was the highest annual rate of inflation since 1981. The question is, has it peaked? Let's try and answer this question from three different perspectives, the stock market, the bond market and the Fed.

The Stock Market

Stocks have rallied since July 13th, the day June CPI report was released. At the time of this writing, the Dow Jones Industrial Average is up over 3%, the S&P 500 over 4% and the Nasdaq 100 over 5%. We want to be careful in applying causation from the CPI report to stock market performance but if we look under the hood at some macro data, we can find a strong correlation.

Let's start by looking at some commodities. WTI crude, gasoline, copper, iron ore, aluminum, lumber, cotton, corn, soybeans, and wheat are all down from June levels. Prices in the futures market do not always transfer immediately to the real economy as price fluctuations can take time to work their way through the system before ultimately impacting input costs. But, generally speaking, down means less price increases.

Moving to the logistics side of the economy we find the Logistics Managers Index currently sitting at a 2-year low after declining for the third straight month. More specifically, container rates, shipping rates to the U.S. and trucking rates have all come down from recent highs.

Housing is showing signs of cooling as mortgage rates have climbed significantly along with decreases in building permits, housing starts and existing home sales. Rents remain high and traditionally follow home prices so if these trends continue to soften home prices, rents are eventually expected to ease as well.

Taking all the above on balance, we can draw the conclusion, for now, that the stock market is getting more comfortable looking past the inflation threat and onto other challenges, such as threat of recession.

The Bond Market

Fixed income markets, quite frankly, have never really bought into the narrative that inflation was the biggest threat facing the global economy. We can look to the yield curve for answers because it represents one of the deepest and most sophisticated places in financial markets. We'll focus on the U.S. Treasury (UST) curve due to its relevance in the global marketplace and coverage it receives in the media. But first, let's cover some basics.

The yield curve is a graph that plots the various yields of bonds to their corresponding maturity. Longer-term bonds normally yield more than shorter-term bonds to account for the various risks the holder of that bond faces over the longer period of time. If we were to plot this out on a graph, it would be upward sloping to show short-term bonds yield less and longer-term bonds yield more.

When the yield curve inverts, as it is now, it means shorter-term bonds yield more than longer-term bonds. For example, the 2-year UST yields more than the 10-year UST. We want to be clear, an inverted yield curve isn't normal and it takes something significant in the marketplace to cause inversion, like in this example, where a holder of a 10-year bond is completely content with being compensated less than the holder of a 2-year bond.

Understanding the mechanics behind why the curve takes its shape is complex but important. The short-end of the curve is heavily influenced by the Fed's expected path of rate policy. The reason is the Fed sets the overnight

rate (called the Fed Funds Rate) which establishes a benchmark for short-term lending in financial markets. USTs are considered a risk-free asset and they are backed by the U.S. dollar which is the world's reserve currency and therefore, USTs are a necessary tool for global commerce. In other words, USTs are more than simply investments; they are used as collateral, currency between global financial institutions and a source of liquidity. For these reasons, when the Fed adjusts the Fed Funds Rate, short-term USTs will follow and move accordingly just as they are now (moving up) with the Fed aggressively hiking their rate.

What about the long-end, you may ask? The long-end is not directly influenced by the Fed's policy but rather by global market participants' expectations for economic growth and inflation rates. Intuitively, this makes sense because the market has to put a price on what the future may hold; therefore, in 10-years, let alone 30, structural drivers in the global economy that determine GDP output such as changes in demographics, innovation, technology, inflation and debt levels will have a much bigger impact on yields compared to what the Fed is doing in the near-term.

In summary, we currently have an inverted yield curve as the front-end has risen higher (and faster) due to Fed policy while the long-end remains under buying pressure (keeping yields lower than the short-end) largely based on economic and inflation projections from global market participants. So, is this a recent development? Let's take a quick history tour and see.

In March 2021 the yield curve began to pause its upward slope and flatten out while a small inversion between the 7-yr and 10-yr developed – think of this as fixed income markets questioning the idea of a regime change into a version of the roaring '20's growth and inflation that was being suggested in the financial media on the back of the world reopening from Covid.

In May 2021, the curve became even more skeptical and started to rollover and by October 2021, an acceleration down the path of inversion had started. Here's the point that is often overlooked but is crucial in analyzing this yield curve – the Fed hadn't even mentioned the idea of tightening monetary policy, yet. In other words, the yield curve was compressing and heading towards inversion based on global marketplace participants' economic and inflation projections long before the Fed would even speak of their policy intentions let alone have a material impact on the yield curve.

It wasn't until December 2021 when Chairman Powell spoke to the media that signaled a change to monetary policy would be forthcoming. In January 2022, the Fed explicitly laid out plans to raise rates and tighten policy at their March meeting, which they did, raising the benchmark rate 25 basis points. From there the yield curve essentially collapsed, reaching inversion by the end of the month across several maturities representing a significant disconnect between the marketplace view for economic growth and inflation versus the Fed's.

The Fed

We don't have much ink to spill in this section because it's clear the Fed is not interested in answering the question of has inflation peaked. The Fed is only interested in confirming, after the fact, that inflation has been crushed as measured by the CPI data.

Final Thoughts

Stocks have been willing to look past the inflation threat, for now, and focus on recession probabilities. Bond markets are saying this will be one of the shortest hiking cycles in history and the Fed will be forced to pivot. The Fed has put the entire focus on CPI and job market data and will continue ratcheting monetary policy tighter until the data shows CPI is no longer public enemy number one.

We expect continued volatility and swings in equity and bond market prices as reconciliation between these competing forces plays out. However, we expect that reconciliation will eventually occur and opportunities, as history suggests, can be found in such times of economic and policy conflict.

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