QUARTERLY MARKET OUTLOOK

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2022 FOURTH QUARTER OUTLOOK

Is the Fed Fighting the Ghost of Inflation?

Overview

As we enter the fourth quarter, we are likely in the later stages of the U.S. Federal Reserve (Fed) rate hike cycle. However, the Fed is still predicted to hike rates another 1% to 1.25% by year end. Much of what we discussed in our 2022 outlook came to fruition in the third quarter, with slower economic growth, increased market volatility and the Fed playing a larger role in investor decisions.

In the past we have been critical of the Fed's slow response to inflationary pressures which they considered transitory. While the Fed may end up being correct in the end, inflation was less temporary than expected. Now the Fed is playing catch-up and raising rates at the fastest pace since the early 1980s. Before the most recent rate hike of 0.75%, the overall Fed funds level was the same as the peak in the prior cycle. However, it had taken three years to get to that level and in 2022 this level was achieved in only four months. With this fast pace of rate hikes, the risk of raising rates too high and causing a recession is rising.

Inflation data is backward looking, which creates even greater challenges for the Fed. While the overall rate of inflation looks high over the past year, there are signs that it could be coming down in the future. Which raises the question: is the Fed fighting the ghost of inflation by raising rates to kill inflation that may already be slowing? Unfortunately, this is not an easy question to answer. There are also signs inflation could remain stubbornly high for some time. And it depends a lot on how you measure inflation.

The good news is that the economy remains resilient. The goods sector of the economy is not fairing as well as the services side of the economy, but this is to be expected as consumers shifted expenditures from services to goods early in the pandemic and have since been shifting back. The labor market remains a bright spot for the economy, which is giving the Fed more ammunition to fight inflation. The overall unemployment rate is 3.7%, which recently ticked up, but only because more people entered the labor force.

Both stock markets and bond markets will likely remain volatile as we continue through this rate hike cycle. However, there are some positives. Earnings estimates have been lowered, creating room for upside surprises, and stock valuations are cheaper. Bonds offer more yield and much of the Fed rate hikes have already been accounted for in bond prices. The last six bull markets began with outsized gains in the first year, so that can serve as a reminder to stay invested and diversified across asset classes, sectors, and countries, while adhering to long-term risk and return objectives.

At-A-Glance

After two negative quarters of GDP, the Atlanta Fed currently estimates third-quarter GDP to be 0.3%.

Inflation, as measured by the Consumer Price Index (CPI), peaked in June at 9.1% year-over-year but has been slowing less than expected. CPI was 8.3% year-over-year in August.

The Fed increased interest rates by a total of 1.25% in the second quarter and 1.5% in the third quarter, putting the current target range at 3% to 3.25%.

The S&P 500 gained 17.4% from mid-June to mid-August but then retreated more than 10% after investors started to doubt the Fed's shift to become less aggressive. The Fed Chair's Jackson Hole speech had a lot to do with this sentiment.

Bond markets also had a choppy quarter. Returns in broad market bond indices were up from mid-June to early August, but then gave back most of these gains as yields began to rise. The 10-year Treasury yield has gained nearly a percent from its August 1 low of 2.6%.

Recession risks continue to rise as the Fed is determined to keep a lid on inflation. Investor fears are that the Fed will overtighten into a slowing economy.

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Global Economy

Risk of a Fed Mistake Increases

Our third quarter themes continue into the fourth quarter as inflation and the Fed continue to dominate investors' minds. With inflation still stubbornly high, but with underlying signs it is fading, the risk of the Fed overtightening and raising interest rates too fast and too high is also rising. This is what we describe as a "hard landing." Rising interest rates increase borrowing costs and slow the economy. If the Fed raises rates more than is necessary, it could hurt the economy more and potentially cause a recession.

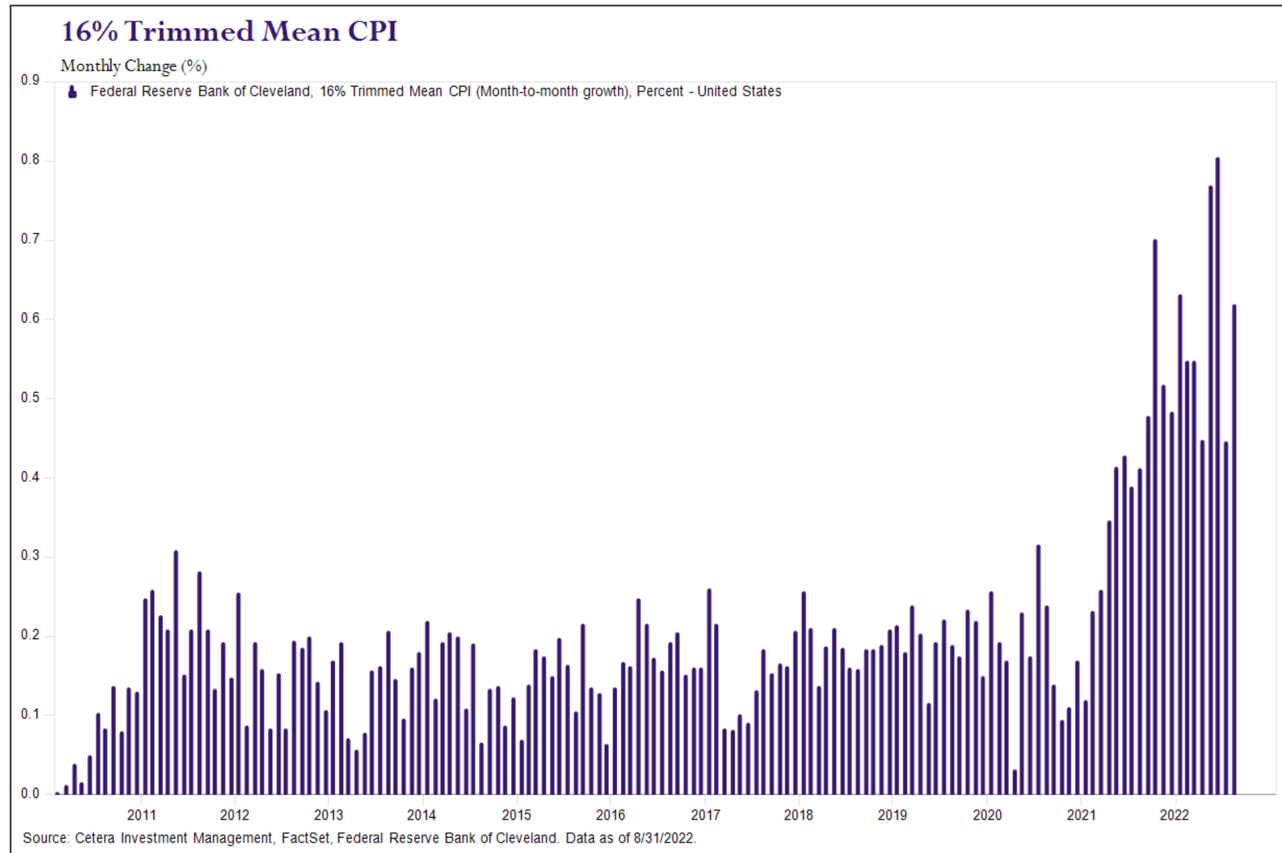
While these risks are increasing, we expect that the Fed will eventually surprise investors with less-than-expected rate hikes and possibly even cut rates sometime next year. Stock markets began to price in such a scenario, termed a "dovish pivot," in the third quarter before Fed Chair Jerome Powell spoke at the Jackson Hole conference and appeared to squash this idea. However, could investors have just been early in their anticipations? Also, could the Fed just be talking tough?

The Fed probably wants to influence investor and consumer behavior, which can pressure inflation higher as it did the 1970s. For instance, when people think goods will be more expensive in the future, they rush to buy them now. This behavior only feeds more inflation. To borrow a line from Franklin D. Roosevelt, could the only thing to fear be fear itself? We anticipate inflation to slow more rapidly, but there is still plenty to fear other than just consumer behavior, regardless of how valid that fear is. The biggest fear may be that the Fed is fighting the ghost of inflation. Economic data can often be backward looking and there are signs future inflation is coming down even though it remains elevated in backward-looking data.

Inflation: It's Complicated

Before we get started on why we think inflation could cool, we will break down August inflation data. Data can be very complicated and the size of the U.S. economy at nearly $25 trillion only makes things more difficult. Inflation data isn't as clear-cut as you might think, and there are also many different inflations measures. While we often hear about CPI in the news, the Fed's preferred inflation metric is the Personal Consumption Expenditure Price Index (PCE). One can also look at data that looks at the mean (or average), median (or middle), or even the mean stripping out outliers to the downside and upside. This can be a good gauge of how widespread inflation is in the economy or if it is just being caused by a few specific categories such as housing or energy. If we look at the 16% Trimmed-Mean Consumer Price Index published by the Federal Reserve Bank of Cleveland, we can get a better feel if inflation is more broad-based. This inflation index strips out the top and bottom 8% of all inflation categories and then reports the mean (average). As illustrated in the chart below, you can see that this index is still relatively high compared to the past and it rose in August. While some major headline inflation items, like oil prices, are falling, inflation is unfortunately rising on a very broad level across the economy.

Figure 1: 16% Trimmed-Mean Consumer Price Index



Inflation: It's also Personal

Some of you might be surprised by the recent inflation readings, thinking that inflation should have dropped last month, and you aren't alone. That's because inflation indexes measure inflation across the entire economy, but inflation for individuals and families is very personal. We all buy different baskets of goods and services. The effects of inflation we all experience will be different. With that said, inflation may have felt strong depending on your individual basket.

Electricity and natural gas, new vehicles, shelter, education, and medical care all contributed to a higher CPI figure in August. If you did not buy a new car, visit a doctor, or renew an apartment lease last month, the effects of inflation on you were probably not as bad.

Reasons for Optimism

To understand why we think the Fed will eventually pivot to be less aggressive, let's look more closely at the inflation data. The August Consumer Price Index (CPI) surprised markets and rose 8.3% from the prior year.

Core CPI, which excludes volatile categories such as food and energy, rose 6.3%. Both metrics were higher than consensus estimates, and the S&P 500 index dropped over 4% the day the report was released.

Yet oil prices fell nearly 7% in August. This is important because oil impacts almost all areas of the economy as goods are transported by ship, plane and truck and rely largely on gasoline, which was down over 10% in August. Additionally, oil impacts food prices even more because food not only needs to be transported but crops rely on fertilizer, another petroleum-based product. Major categories that were pushing inflation higher also started to abate. Wholesale used car prices, wheat prices and airfares all fell.

These falling categories could be considered leading categories because they impact inflation in other categories. There is a lag before this happens, but this could point to slowing inflation across other categories. We already mentioned oil's important role in other categories. Additionally, wheat is a raw material used to produce other food products like chips, cookies, crackers, and more. Wholesale used car prices falling will eventually mean lower prices in the retail used car market and as a substitute for new cars, it will likely impact new car prices too. With these input costs falling, it will eventually mean lower price growth for consumers, but that takes time. Companies will try to resist this and keep price levels even. As an example, potato chip manufacturers may offer deals without cutting prices. You could see packaging advertising 30% more in boxes and bags of chips as companies keep prices the same but give you a little extra instead (by the way, they won't tell you when it is 30% less!). Falling input costs for businesses can also mean increased profit margins and that is a long-term predictor of stock returns.

Also adding to the thesis that inflation may be easing soon is retail inventories. Inventories dropped to extremely low levels last year but now are rising quickly for many types of businesses, though the auto sector is one exception. This is because supply chains are normalizing, and along with that, freight costs are falling. Shipping delays from last year resulted in excess inventories this year for many consumer products. Businesses will eventually have to get rid of these inventories to make room for new products and this often means discounts are coming. This could be good news for consumers as we enter the holiday season.

Another reason for optimism is base effects. Inflation is a measure of price increases. If you are measuring the price increase from a year ago and prices were high then, further increases have a higher hurdle to hit.

Economic Strength: A Foundation for Optimism

We spent a lot of time writing about inflation because that is what will largely drive the Fed's decisions, which will have a large impact on the economy. Economic fundamentals remain solid. The labor market remains robust with labor market growth at very high levels. The unemployment rate did rise in August from a very low level, but the reason for the rise was also promising: more people decided to re-enter the labor force. Some companies are starting to scale back hiring and even laying off workers in response to tighter financial conditions ahead, but this could still be considered good news. A little bit of bad news in the labor market could be good news in the sense it shows Fed policy is having an impact and cooling labor inflation. In the recent Federal Open Market Committee (FOMC) press conference, Powell mentioned his intention to cool labor inflation more than a few times.

Forward looking data, or leading indicators, still point to expansion and not contraction of the U.S. economy. August surveys of different business decision-makers were promising. The Institute of Supply Management (ISM) Manufacturing Purchasing Managers Index (PMI) was 52.8 and ISM Services PMI was 56.6. Anything over 50 indicates expansion. Moreover, the new orders index for both these indices increased in August. Consumer spending remains around 70% of the total U.S. economy, so we can't understate its importance. Retail spending is 30% above pre-pandemic levels but has been trending lower on an inflation-adjusted basis since the spring of 2021. If we get a reprieve in inflation, this could help real spending, and if the labor market remains strong, we expect spending growth to continue. Consumer confidence in August finally increased after three consecutive months of declines. Consumer optimism increased on both the present situation and

expectations about the future. Gasoline prices can have a large influence on consumers, so falling gas prices probably helped improve their optimism.

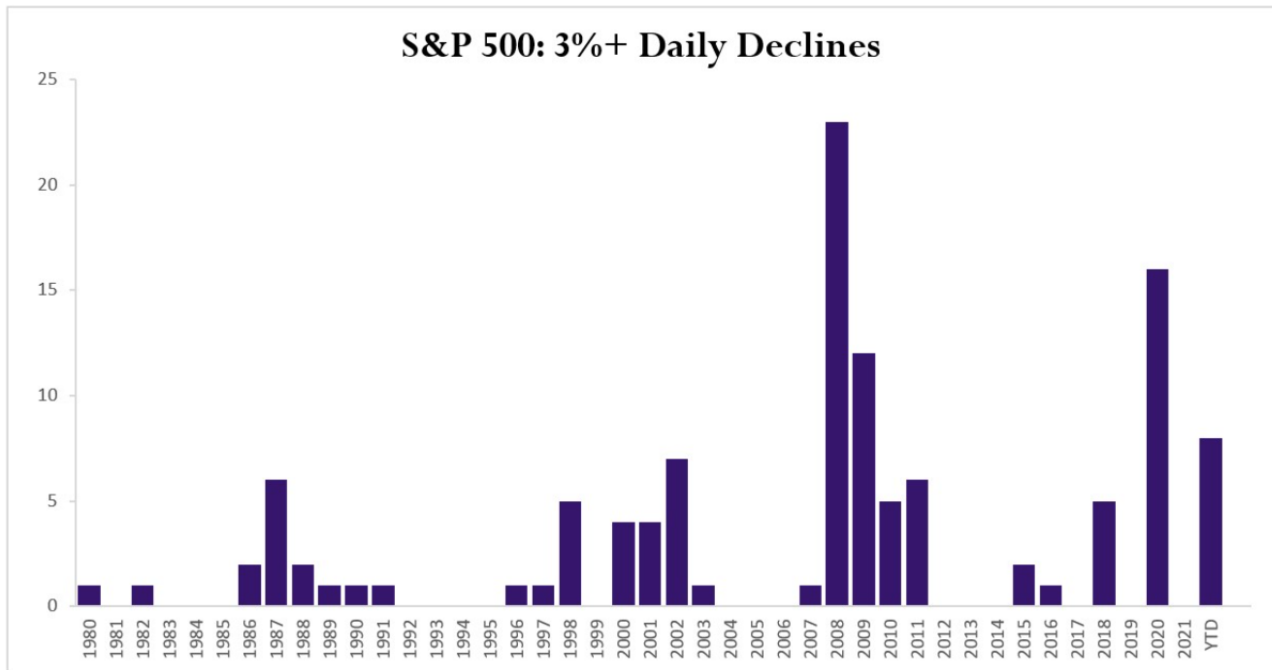
Global Economy: Slow Growth Isn't a Bad Thing

Inflation is currently a global phenomenon. Worldwide inflation was 7.6% in August, well above the average of 3.5% witnessed from 2000-2018. London-based economic research firm Capital Economics predicts worldwide inflation to drop to 3.4% next year and to 2.5% in 2024. Their GDP forecasts show world economic growth increasing from 2.5% in 2022 to 2.7% in 2023. This is below past averages (3.6% from 2000-2018) signaling a period of slower economic growth. While not a rosy outlook, it also isn't grim. We think there is potential for some upside surprises, too. Currently a lot of bad news is baked into outlooks. If the Russian invasion of Ukraine comes to an end, we could see European energy prices fall more quickly and their economies could rebound faster than expected. Reduced inflation could also trigger central banks to reverse course and cut rates if economic growth starts to fade.

Equity Markets

The third quarter was really a tale of two halves for stock markets. The S&P 500 had rallied 17.4% from mid-June to mid-August but seemed to hit a wall, falling more than 10%, after it approached its 200-day moving average. As of the time of this writing, the S&P 500 had eight days in which it declined more than 3% in 2022. Shown in **Figure 2,** since 1980, only three years had more declines over 3% (2008, 2009 and 2020).

Figure 2: Number of S&P 500 Daily Declines Over 3%



Source: Cetera Investment Management, Yahoo Finance, Standard & Poor's. Data as of 9/13/2022.

Overall, this has been a challenging year for almost all asset classes, including bonds which we will discuss in the next section. As of September 22, the S&P 500 is flat for the third quarter. If this quarter wraps up flat on

performance, the S&P would be down roughly 20% year-to-date entering the final quarter of the year. Growth stocks have been hit more than twice as hard as value stocks and smaller capitalization stocks are not fairing any better than larger capitalization stocks. Nine of the eleven S&P 500 sectors are down this year, with energy and utilities as the exceptions. International developed and emerging markets are down even more than the U.S. While this is painful news, it is also old news. No one has a crystal ball to predict the future, but we can look at earnings projections and valuations to see how expensive stocks may be relative to history. Over the long run, corporate earnings drive stock returns.

Stock prices relative to their earnings are much better than at the start of the year following a sharp decline in stock prices. We publish this data in our quarterly chartbook. Price/Earnings ratios (P/E ratios) had been in very high percentiles last year. Large cap stocks were near their 15-year highs, now they are closer to their 15-year averages. Smaller capitalization stocks are near 15-year lows, meaning they are cheap relative to their earnings. International stocks are in the 25th percentile for developed countries and 15th percentile for emerging market countries, so they are also relatively cheap. We calculate these ratios using historical earnings though and earnings growth is slowing.

The good news is that downgraded earnings have largely been factored into current stock prices. S&P 500 earnings growth is expected to be 3.4% in the third quarter, down for estimates made in March for a 9.4% increase. Fourth-quarter earnings growth was revised from 8.9% in March to 4.8%. Keep in mind that lowered estimates make it easier for companies to surpass expectations.

Profit margins hit 70-year highs but have been falling as companies increasingly have to absorb inflation costs that they can no longer pass on to consumers. The good news is that they are still high relative to historical precedents. If inflation moderates, that will be good for profit margins because companies will likely try to keep prices stable. Another headwind that could become a tailwind for stocks is the strength of the U.S. dollar. The dollar index, which measures the U.S. dollar versus a basket of other currencies, is up over 14% this year and rose to a 20-year high. This can be a challenge for U.S. companies because they get a lot of revenue from abroad. U.S. goods are now more expensive to foreign buyers, so this could impact sales revenues. Currently, S&P 500 companies get around 40% of their revenue form overseas. When they bring profits back to America, they are worth less because they were generated in other currencies that fell in price.

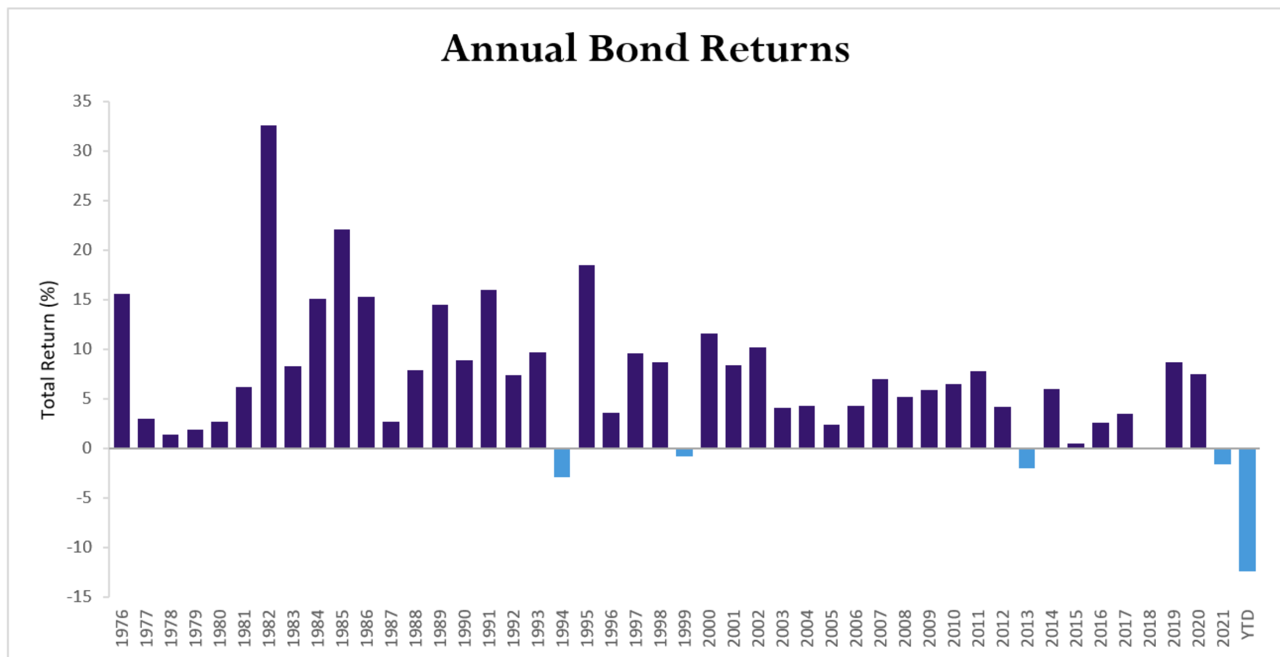
So, if inflation falls and the U.S. dollar starts to fall relative to other currencies, this could be a tailwind for U.S. companies. The major risk remains the Fed and their interest-rate policy. If the Fed raises rates too fast and too much, it will increase borrowing costs and slow economic growth. Some companies have already started to prepare for an economic downturn. A large retailer, the largest private employer in the United States, announced corporate layoffs last month and several employers ranging from automobile manufacturers, cell phone companies and technology companies have also announced job cuts. A global logistics company also recently missed earnings badly, which could signal that demand and business activity is slowing. This could tame inflation in the U.S. labor market, but we anticipate labor market growth to remain positive. The problem could be that inflation data may be lagging what is currently happening. Again, if the Fed is making decisions on this lagging data, that could compound any sort of economic slowdown.

International stocks have many of the same issues. A reversal of U.S. dollar strength could hurt exporters, but if there is a resolution in the Ukraine war, that could help Europe's energy woes and inflation related to it. While most of the world is hiking rates to slow inflation, China is cutting rates trying to revive demand in its economy that has been set back by its strict zero-Covid policies. Overall, risks in international markets seem higher than domestic markets. We still recommend diversification internationally, however, because some of these factors could abate and drive markets higher. We expect continued stock volatility as the Fed navigates this interest-rate cycle and investors become hypersensitive to Fed officials' comments and economic data.

Fixed Income

Equities were not the only volatile asset class this quarter. Bonds continued their rocky path. The 10-year Treasury yield peaked out at 3.49% on June 14 before bottoming at 2.6% on August 1. Yields move inversely to prices, so this equated to a gain in the Bloomberg U.S. Aggregate Bond index of over 5.5%. Since August 1, yields have rose to over 3.5% again, causing a drop of over 5%. A 10% swing in roughly 90 days in this index is unprecedented. As it stands now in **Figure 3**, the index is down over 12% year-to-date, by far its worst year on record going back to 1976. Its previous worst year was 1994 when the index was down less than 3%.

Figure 3: Calendar Year Bond Returns



Source: Cetera Investment Management, Morningstar, Bloomberg. Bond returns are total return based on the Bloomberg US Aggregate Bond Index. Data as of 9/16/2022.

Looking at even shorter maturity bonds, the yield on the 2-year Treasury rose above 4%, continuing to surpass yields on longer maturity bonds. This seems counterintuitive because one should be rewarded with additional yield to take greater interest-rate risk with longer-term bonds. However, the yield curve can invert like this and many times it indicates a recession on the horizon as it could be a signal that future economic growth may decrease. But, it is also a sign that inflation is expected to be lower in the future.

While the yield curve being inverted is an ominous sign, credit markets are not flashing red. Typically, when a recession is nearing, bond investors in lower grade issues, known as high-yield bonds, demand more yield to compensate them for added credit risk for defaults or downgrades. The yield these investors are receiving over risk-free Treasuries is higher than pre-pandemic levels that were very low. But as it stands, the spread over Treasuries is around 5%. That is not at a level of concern or one that would be reminiscent of a recession looming. To put this in context, this spread reached double digits in the past three recessions.

With this backdrop, many bond investors are unsure about their allocations. However, there are some positives with bond yields rising and bond prices falling. The additional yield in both Treasuries and corporate bonds cushions a potential drop in price if yields move higher, or credit spreads widen. Bonds can also protect against equity volatility, so should be viewed in the context of a well-diversified portfolio. When constructing a bond portfolio, your financial professional can help you create one that suits your specific goals and objectives.

The Bottom Line

In short, our same themes remain. We are continuing through the Fed rate hike cycle, looking for clues in economic data such as inflation data, paying close attention to what Fed officials are saying. We could be nearing the end of this Fed tightening cycle. The Fed was late to hike rates, thinking inflation was transitory, and now it is making up for lost time. The potential problem it faces is that inflation data is backward-looking and there are signs inflation could slow more quickly in the future. The transitory aspects of inflation may be working their way out of the system as manufactured goods prices are coming under disinflationary pressures. Shipping costs are lower due to falling oil prices and that is normalizing supply chains. Housing prices and car prices should ease as financing costs and inventories rise. Falling home prices should mean falling rents. Wheat prices are also falling, which should create downward pressure on food prices.

However, there is a lag in these pressures that we may not see for possibly another quarter or even year. Are they truly fighting the ghost of inflation? It may be too soon to tell, and the overall level of the Fed Funds rate is still modest.

While we expect volatility to remain in both stocks and bonds, there are some positives in both broad asset classes. Stock valuations are cheaper compared to a year ago, and bonds offer more yield. Investors are compensated more for taking on risk and this could provide a better entry point for new investors or investors with some cash on the sidelines. Your Cetera financial professional can help you through these volatile times to keep you focused on your personal goals and objectives.

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Glossary
The S&P 500 is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

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