TOUGH TALK FROM THE FED: AUGUST 2022 MARKETS

SEPTEMBER 2022

August 2022 provided another roller coaster for markets.[3] The S&P 500 index declined 4.24% for the month, following a summer rebound in July and the first half of August.[4,5]

The yield on the two-year Treasury bond, which is more rate-sensitive than other bonds, hit a 15-year high.[6] Meanwhile, the difference in yields between two and 10-year Treasuries—known as the yield curve—remained negative.[7] Many market watchers view an inverted yield curve as a predictor of an approaching recession, as it indicates that prospects for the economy could be declining.

QUICK TAKE

August was another rollercoaster ride for markets as aggressive Fed talk poured cold water on the summer rally.[1,2]

Index Returns
(August 2022 and Year To Date)

Bloomberg Barclays Aggregate Bond Index US investment grade bonds	-3.30% for August*	-10.75% for the year*
S&P 500 Index Large US Equities	-4.24% for August*	-17.02% for the year*
MSCI World Index Large/mid developed world equities (ex-US, CAN)	-4.14% for August*	-17.50% for the year*
MSCI Europe Index Large/mid developed european equities	-6.22% for August*	-21.62% for the year*
MSCI Emerging Markets Index Global emerging market equities	0.46% for August*	-17.23% for the year*

* As of August 31, 2022

Jackson Hole

At this year's Jackson Hole Economic Symposium, Fed Chairman, Jay Powell, delivered his most hawkish message to date on the central bank's commitment to taming inflation, warning that "restoring price stability will likely require maintaining a restrictive policy stance for some time."[8,9] He also mentioned that a sustained period of below-trend growth as well as a softening labor market were both likely.[10]

The new guidance seems to be higher interest rates for longer, and notably absent was discussion of a soft landing.[11,12] Powell left the option open for another 0.75% increase in the federal funds rate next month, noting that the recent slowdown in inflation still "falls far short" of what policymakers want to see.[13] Committing to restrictive rates shows that the Fed won't blink in the fight against inflation.

Several members of the Federal Reserve board chimed in to support this hawkish policy messaging. Cleveland Fed President Loretta Mester says that the Fed needs to increase interest rates probably a little over 4% and hold them there until there's compelling evidence that inflation is moving down.[14] Short term rates are currently at a target range of between 2.25% and 2.5%.[15] Atlanta Fed President Raphael Bostic believes the economy needs to weaken before inflation starts moving down, and this shift could require the Fed to hold rates higher for 18 months to two years.[16]

Earlier this summer, the hope that the Fed might end up cutting rates in 2023 seemed to give equity markets reason to rally. But central bank officials effectively quashed hopes of such a dovish pivot, resulting in a significant shift in interest rate expectations for next year.[17] Interest rate expectations have repriced at the fastest speed in years, but according to Goldman Sachs, "the worst may be behind us as markets now embrace Fed policy guidance and its inflation-fighting priorities."[18]

That said, markets responded with some negativity, with the S&P 500 index and tech-heavy Nasdaq had their biggest one-day decline since the middle of June.[19] Before Jackson Hole, the S&P 500 index had rallied nearly 11% since mid-June.[20]

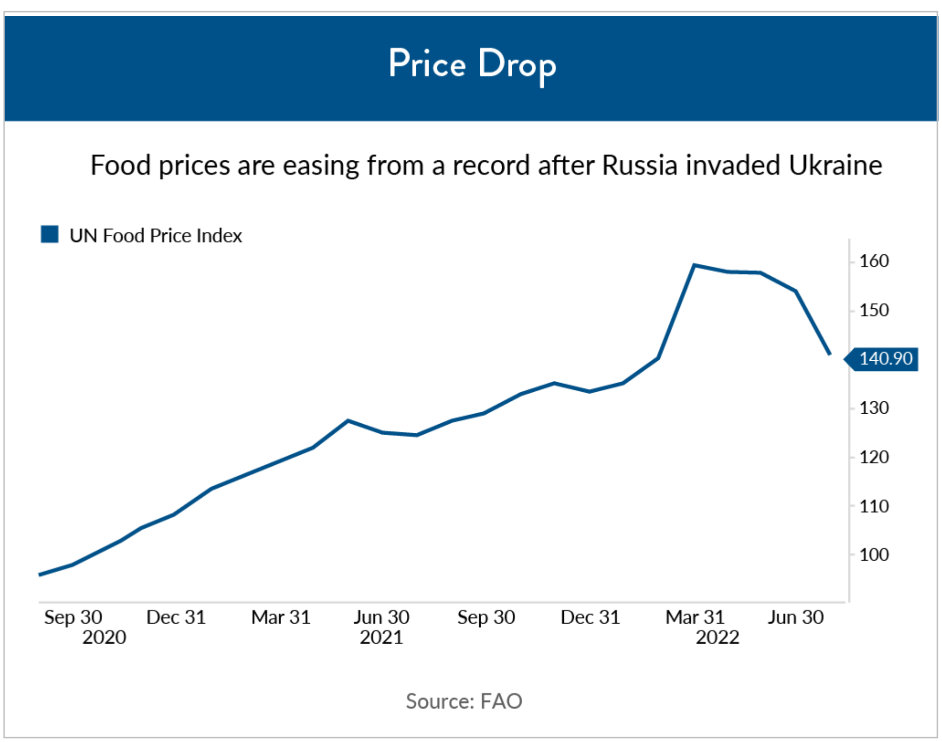
Political Picture

Central banks may not be the only ones trying to fight inflation. In August, President Joe Biden signed a $750 billion health care, tax, and climate bill into law called the Inflation Reduction Act.[21] The act gives Medicare the power to negotiate certain prescription drugs and aims to raise over $700 billion in government revenue over 10 years, part of which would reduce the budget deficit.[22] A reduced federal deficit leaves less money floating in the economy, which can potentially reduce inflation and lower demand.[23]

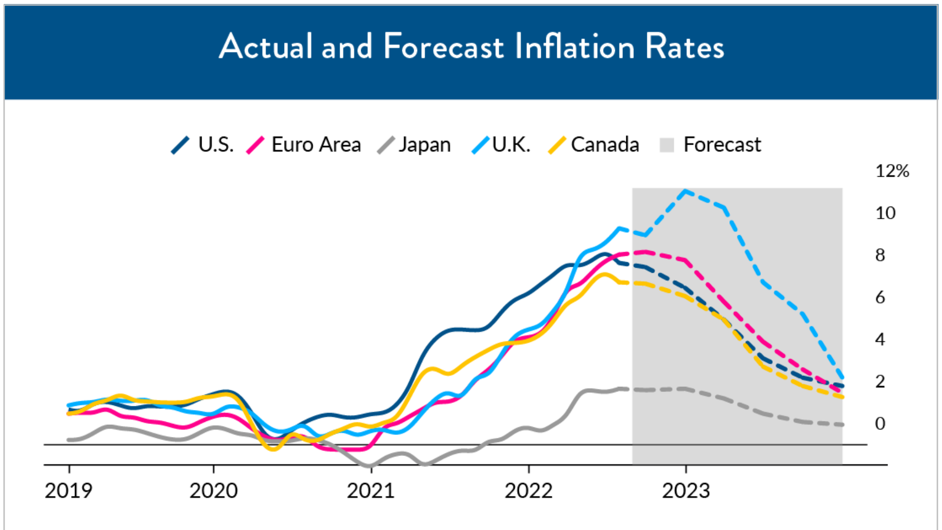
However, towards the end of the month President Biden also announced a plan to forgive up to $20,000 in student loan debt for over 40 million federal loan borrowers.[24] The plan raised additional concerns of inflationary pressures. However, Moody's Analytics chief economist Mark Zandi called the effect on inflation "largely a wash."[25] The White House argues that since the plan restarts loan payments (that were previously on hold), there would be no net impact on inflation.[26]

Price Relief

Since inflation remains the core driver of Fed policy, price data will be closely watched. Global food prices have fallen the most since 2008 after Ukraine reached a deal to restart exports, and the United Nations index of world food costs plunged almost 9% in July.[27] Wheat and corn prices have eased, though reopening Ukraine ports will take some time.[28] While raw material prices are easing, consumer prices could still see high prices for the time being.[29]



Overall, the feverish pace of inflation has finally started to cool off, and JPMorgan estimates that increases in consumer price inflation will roughly halve in the second half of this year, to 5.1%.



Sources: Official statistics agencies, Bloomberg economist surveys

Looking Ahead

Most traders expect a 0.75% interest rate hike at the Fed's September meeting, which would be the third consecutive hike of that size, while looking for the Fed funds rate to end the year at around 3.7%. Even though the messaging from the Fed troubled markets, it's important to remember that the Fed's credibility with respect to inflation policy is very important for keeping inflation expectations anchored. Expectations can be something of a self-fulfilling prophecy, so at this point we believe it makes sense for the Fed to use stronger language.

We anticipate continued market volatility or macroeconomic headlines. In these situations, tough as it can be, we believe that the best course of action is to keep calm and carry on with a long-term plan. Further, if you are looking to deploy cash, higher interest rates and a depressed market present far more attractive opportunities than earlier this year. There are planning opportunities such as Roth IRA conversions, which would also be worth considering in a down market. Please let us know if you wish to schedule a meeting to discuss the opportunities further.

We would like to take a moment to note the passing of Queen Elizabeth II. For 70 years, she was admired around the world for her grace and devotion to her subjects. We pay tribute to her life of service.

As the summer comes to a close and kids go back to school, we wish everyone a lovely fall—despite the very summerlike heat wave!

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Asset Allocation and Diversification do not guarantee a profit or protect against a loss.

The Bloomberg Barclays U.S. Aggregate Bond Index measures the investment-grade U.S. dollar-denominated, fixed-rate taxable bond market and includes Treasury securities, government-related and corporate securities, mortgage-backed securities, asset-backed securities and commercial mortgage-backed securities.

The S&P 500 Index is an unmanaged, market value-weighted index of 500 stocks generally representative of the broad stock market.

SPX, or the Standard & Poor's 500 Index, is a stock index that is comprised of the 500 largest U.S. publicly traded companies by market capitalization, or the stock price multiplied by the number of shares it has outstanding.

The Nasdaq Composite is a market-capitalization-weighted index consisting of all Nasdaq Stock Exchange listed stocks that are not derivatives, preferred shares, funds, exchange-traded funds or deben¬ture securities.

The MSCI World Index is a broad global equity index that represents large and mid-cap equity performance across 23 developed markets countries and covers approximately 85% of the free float-adjusted market capitalization in each country.

The MSCI Europe Index captures large and mid-cap representation across 15 developed markets countries in Europe and covers approximately 85% of the free float-adjusted market capitalization across the European Developed Markets equity universe.

The MSCI Emerging Markets Index captures large and mid-cap representation across 26 emerging markets countries and covers approximately 85% of the free float-adjusted market capitalization in each country.

A Roth IRA is an Individual Retirement Account to which you contribute after-tax dollars. While there are no current-year tax benefits, your contributions and earnings can grow tax-free, and you can withdraw them tax- and penalty-free after age 59½ and once the account has been open for five years.

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