DENVER

PRIVATE WEALTH MANAGEMENT

MARKET UPDATE:
Q3 2022

The Inflation Outlook and Your Investments

These are trying times around the world, with the recent devastation in Florida to the continued unrest overseas. For those with family or friends affected by these events, you are all in our thoughts and we hope for better days ahead. Given the recent market volatility recently, we wanted to offer some perspective in these uncertain times and to share some potential signs of relief that we are tracking here at Denver Private Wealth Management.

Markets sagged to new lows last week after a worse-than expected consumer price index (CPI) report and a hawkish Fed meeting that removed any doubt about its stance toward inflation. The table shown here allows us to take a closer look at the four major indexes at different key points across the last several months:

- Market peak
- Level and percentage changes at the market's trough at June's end
- Level and percentage changes from the top of the "Bear Market Rally" in mid-August
- Where the market stood relative to its year-end peak at the close on Thursday, September 22

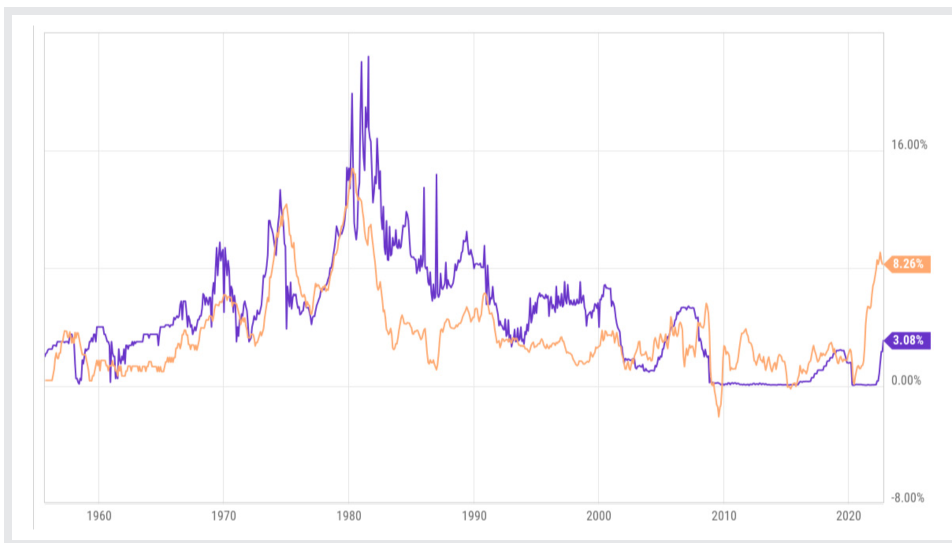
BEAR MARKET RALLY

	Peak	6/30/22	6/30 change from Peak	Mid-Aug	Mid-Aug change from Peak	9/22/2022	9/22 change from Peak
DJIA	36,432	30,755	-15.5%	34,152	-6.3%	30,077	-15.5%
S&P 500	4,797	3,785	-21.1%	4,305	-10.3%	3,758	-21.1%
Nasdaq	15,982	11,029	-31.0%	13,128	-17.9%	11,067	-31.0%
Russell	2,443	1,708	-30.0%	2,021	-17.3%	1,722	-30.0%

Note that the DJIA and S&P 500 have now fallen below their June lows, with the other two indexes within a hair's breadth. Breaking below those lows, from a technician's view, is bad news for the equity markets. However, any forthcoming positive news on the inflation front may signal to the market that things may not be as bleak as it seems.

So, What Just Happened?

The chart below shows the consumer price index (CPI) in white, alongside the federal funds rate in blue. These two data points move together for the most point, which makes sense intuitively: if inflation starts to run hot, we typically see the Fed attempt to cool it down by raising federal funds rates, thereby slowing down growth. We see the same basic pattern unfold in the most recent data on the righthand side of the chart. The difference this time around, however, is the noticeable lag between the spike in the white line (CPI) and the corresponding move in the blue line (Fed). This is what most people are referring to when they make comments about the Fed being "behind the curve." The Fed got off to a noticeably late start in the most recent inflationary cycle, and therefore needs to act more swiftly if inflation persists.



INFLATION VS FED TARGET RATE

- Effective Federal Funds
- US Consumer Price

Source: Y Charts

This all leads up to the most recent Fed meeting in late September. With a stronger-than-expected CPI reading just a week prior and a resilient labor market, the Fed was not going to be tardy to the inflationary party again. Here are the key takeaways from the unequivocally hawkish meeting:

Forecasts painted a gloomy picture: GDP growth forecasts for 2022 and 2023 were ratcheted down materially to 0.2% and 1.2%, respectively, on a year-over-year basis (down from 1.7% for both years). Meanwhile, projections for unemployment and inflation were revised modestly higher. While the Fed's updated outlook might not seem all that controversial relative to market consensus, recall that until recently, the central bank had painted a reasonably benign picture of the U.S. economy.

The federal funds rate is expected to stay higher for longer: The Fed's median estimate of where the federal funds rate will be by the end of 2022 has been pushed up by a full percentage point to 4.4%. Fed officials now expect the benchmark policy rate to hit 4.6% in 2023 before easing.

Hawkish comments from Chair Powell: The hawkish message that was implicit in the projected estimates was made explicit by Chair Powell at the late September press conference, during which he confirmed that the Fed's first priority was to get inflation back to its target rate of 2%. He also reiterated the central bank's commitment to achieving that goal even if it meant compromising economic growth to get there.

Relief on the Horizon?

The key driver going forward will be inflation data. Inflation metrics like consumer price index (CPI), producer price index (PPI), and personal consumption expenditures (PCE), will be closely watched as markets looks for any signs of a slowdown. While the recent CPI reading and most recent Fed meeting painted a bleak picture, there may be signs of relief ahead:

- Gasoline prices fell -9% in August and the trend continued through September.
- Stabilized natural gas prices will soon trickle down to utility bills.
- Significant declines in grain, dairy, and other agricultural prices will soon drive down grocery store pricing.
- Used vehicles are selling for significantly less at auction in recent months.
- Supply chain improvements will drive down consumer goods inflation, and the stronger dollar will continue to push down the prices of imported goods (which fell -1.0% in August and -1.5% in July).
- Private-sector measures of rents have slowed sharply.
- Travel-sensitive categories including hotels and airlines have seen declining prices recently.
- Healthcare costs are trending lower according to the personal consumption expenditures price index (PCE).
- Pricing intention surveys have been falling recently.
- According to Chairman Powell, inflation expectations are well-anchored, suggesting that the risk of a wage-price spiral is negligible.
- Core crude PPI (ex-food and energy – at the very early stages of production) has deflated -1.6% Y/Y in August. A year ago, at this time, this was +42%!
- Core intermediate PPI (ex-food and energy for semi-processed goods) fell -0.9% M/M in August and was -0.2% M/M in July.

Where Do We Go From Here?

It is clear the Fed is moving forward with strong hawkish policy. Rising interest rates have markets fearing the worst and looking for any modicum of good news on the inflation front to lift spirits – and stock prices. While this inflationary surge will surely take more time to ease than most had originally expected, disinflationary momentum could provide the comfort that markets have been looking for. As JP Morgan recently mentioned below in a memo to clients, markets may be starting to price the worst:

J.P. Morgan notes the potential silver linings...

> Fed hawkishness leaves stocks very oversold: The global inflation trajectory is becoming even more central for tactical asset allocation and it could keep volatility elevated until the next set of CPI releases. However, we note some encouraging signs on the inflation front given declining core goods as supply chains normalize further and the strong dollar puts downward pressure on input prices, lower Energy prices, and falling leading indicators on rents. Meanwhile, some pre-conditions for a market bottom are falling into place: stocks are looking increasingly cheap and approaching deep-value outside of the US, and positioning is extremely depressed.

J.P. Morgan

As we wait for inflation to recede, there are numerous actions that we can take in the face of higher rates and market volatility. Here at DPWM we have been busy repositioning portfolios to take advantage of these conditions:

- Higher interest rates now give us the opportunity to add Treasury securities that are currently offering over 4.0% with maturities ranging from 1 – 5 years. For reference, one year ago a basket of similar securities would have yielded a paltry 0.50%.
- The higher volatility allows us to increase certainty within portfolios by adding opportunities that give us better risk/reward structures.

If you would like to hear more about how we are actively navigating these markets or for more perspective on the current market environment, please don't hesitate to call our office for a review. We know that these times can be challenging and want you to rest assured that we are here for you to answer any questions you may have.

2000 South Colorado Boulevard | Tower One Suite 3700 | Denver, Colorado 80222
720.354.3850 Phone | **720.354.3854** Fax