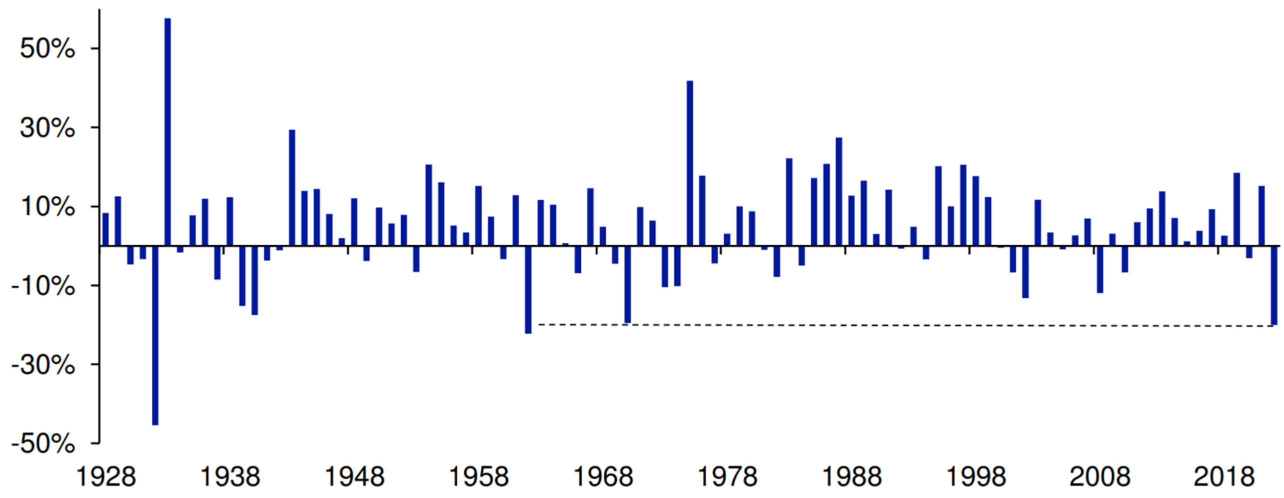
Markets, Inflation and the Fed

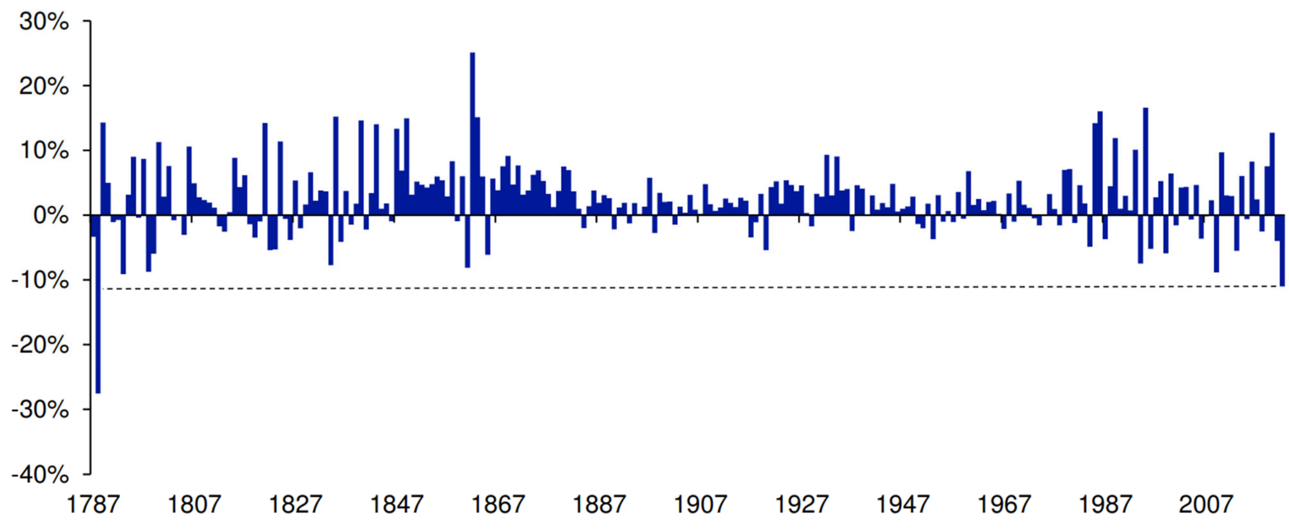
No sugarcoating it, stock market returns this year have been bad. The S&P 500 (down 20% year-to-date as of this afternoon) is off to one of its worst starts in index history.[i] Bonds are faring even worse.[ii]

Figure 2: H1 S&P 500 total returns. The worst first half since 1962.... just avoiding the worst year since 1932 with small rally in second half of June



Source : Bloomberg Finance LP, Deutsche Bank, Updated as to close on Thursday June 30

Figure 1: H1 Total Returns of US 10-yr Treasury (or proxy) index. The worst H1 since 1788!



Source : GFD, Deutsche Bank

As we highlighted in our last communication, the list of market challenges is broad. While the year began with elevated equity valuations and low interest rates (which on their own are headwinds), markets have also needed to contend with:

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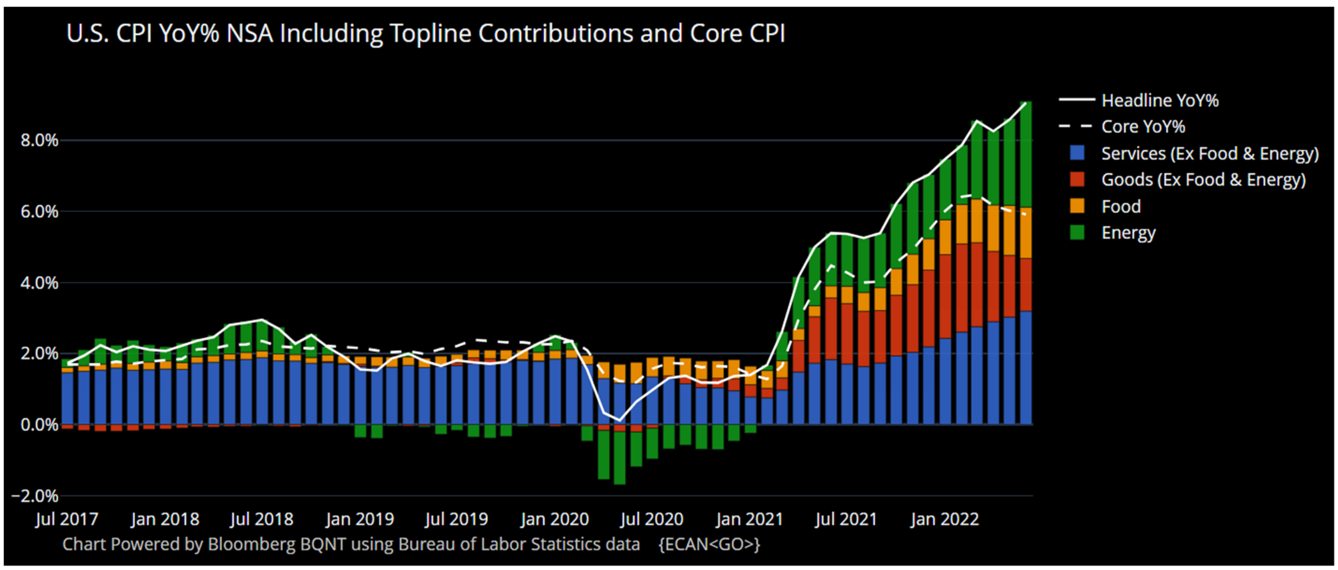
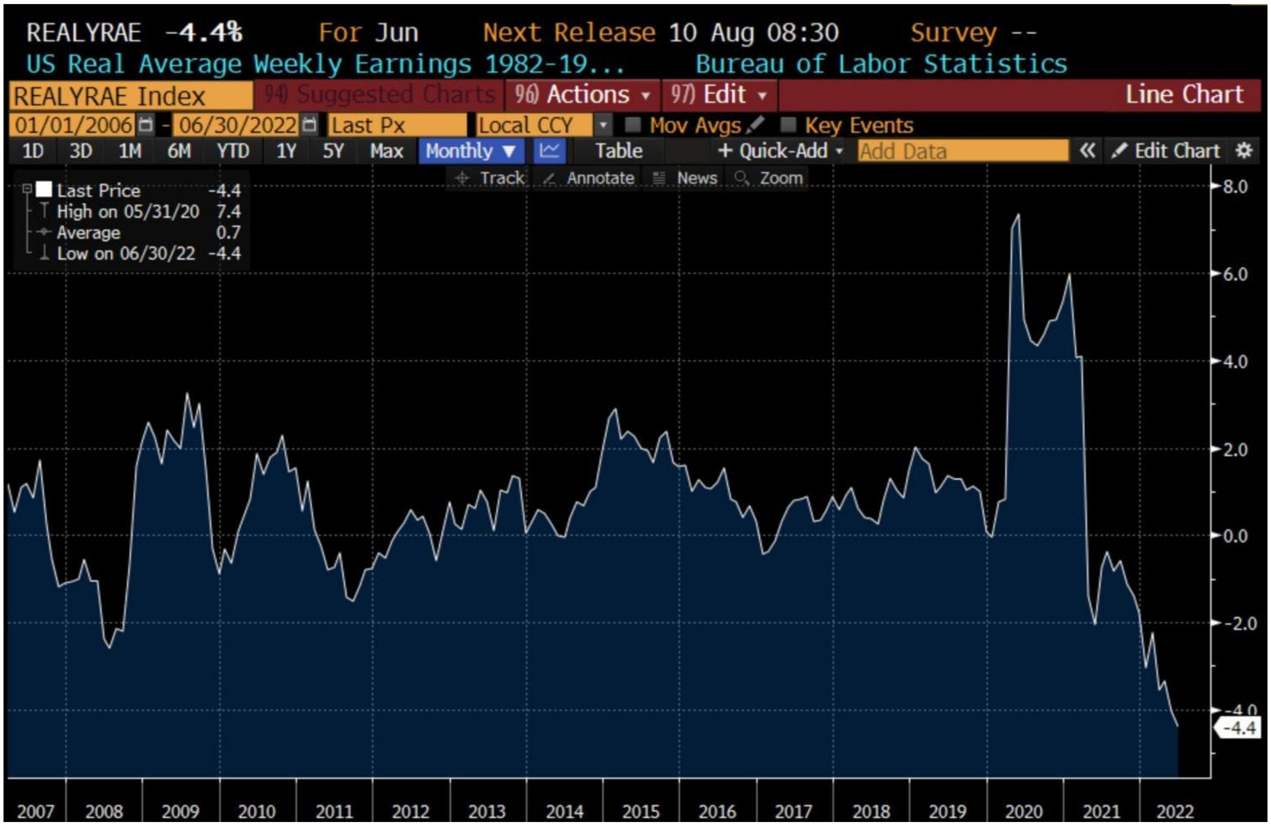
- Continued supply chain challenges
- Resource shortages
- Persistent and rising inflation
- Interest rate volatility
- Tightening financial conditions due to the Federal Reserve's hawkish monetary policy
- Declining consumer and business sentiment
- Slowing economic activity

To be sure, markets are forward looking, and all of this is essentially "yesterday's news." The question going forward for investors is whether markets have sufficiently discounted these challenges such that we can again feel constructive about deploying capital. Generally, we think the answer is yes if you have a long enough investment horizon and are selective in your investment criteria (which is our job to help with). But we don't want to dismiss potential risks.

June's headline CPI at 9.1% and monthly CPI at 1.3% was - to put it mildly - a problem.



Unlike rising unemployment which impacts a subset of the population, almost everyone "feels" inflation. Rising prices are crushing earnings power for US consumers, with real wages at negative 4.4% (real wages reflect wage gains minus inflation).



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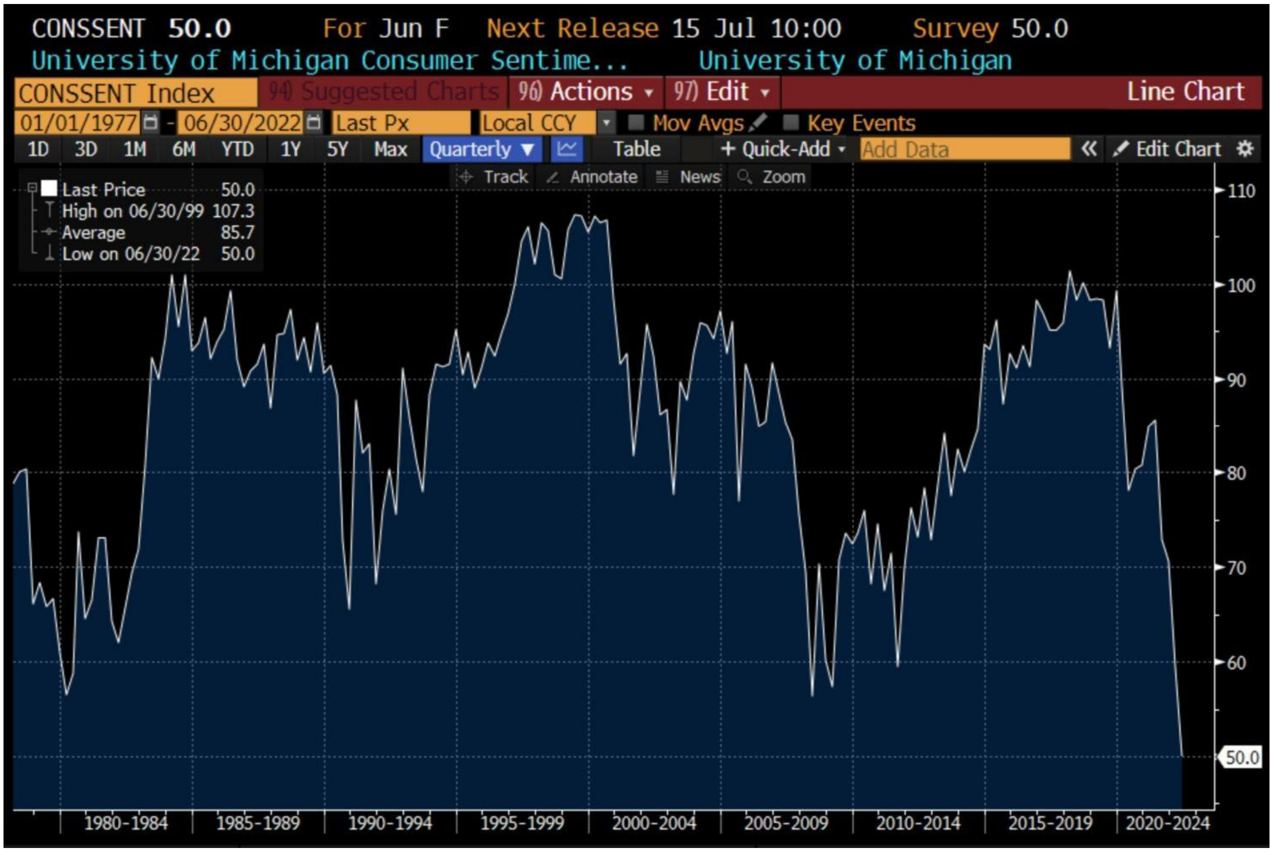
From middle- and working-class families struggling to buy food and gas, to the wealthier whose portfolios have declined, almost everyone right now feels poorer. That's why consumer sentiment is at an all-time low. And what happens when everyone feels lousy? Usually nothing good.



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Historically, people don't react well to a decline in living standards. When enough of the population feels worse off, you risk social and political instability. That's why rising prices are so pernicious. Painful as it may be for those losing a job, society doesn't fall apart if unemployment jumps a few percent, but it might if people can't afford food and energy (see our article from last fall: History 101).

In choosing the least bad option, the Fed is likely to aim for relieving the pain for as many people as possible (i.e., combatting inflation at the expense of the overall economy and unemployment rate).

International | From inflation to insurrection

Costly food and energy are fostering global unrest

Many governments are too indebted to cushion the blow to living standards

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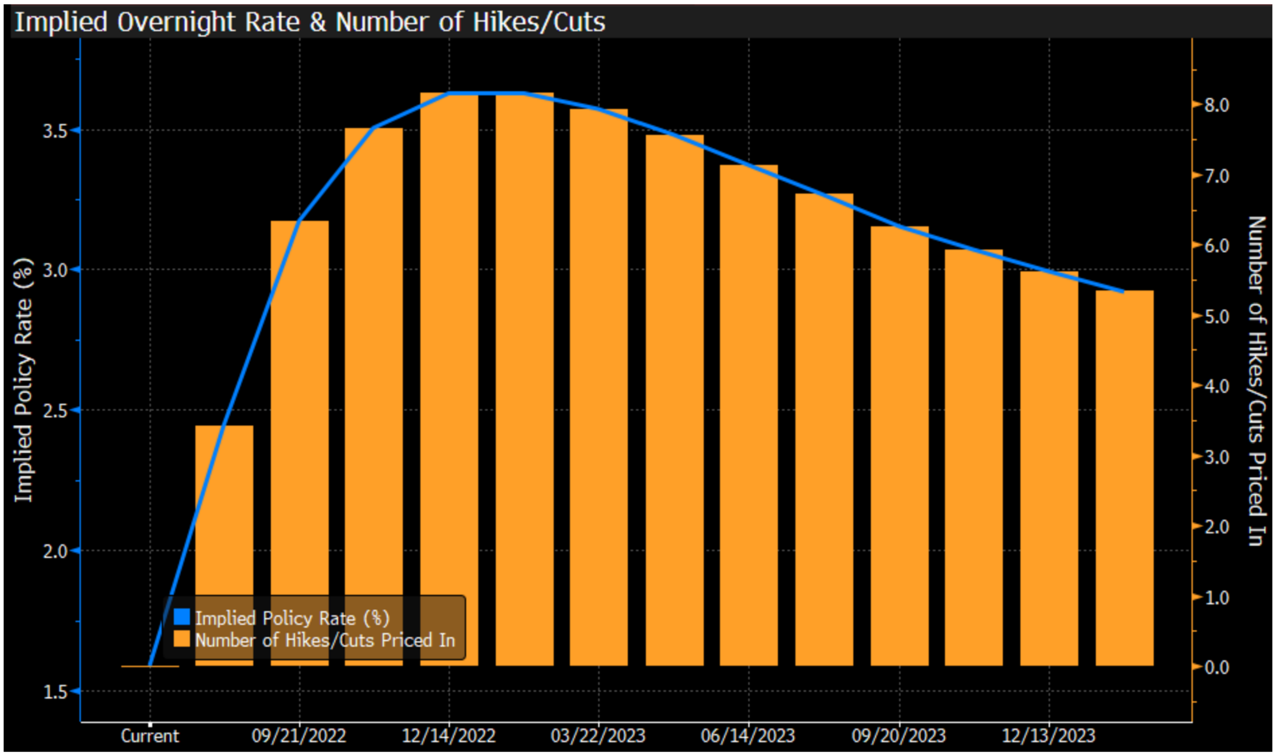
Prolonged inflation that diminishes real purchasing power has a history of leading to populist backlashes or "strongmen" type governments, or worse. If economic misery for a portion of our country contributed to the soft populism of Trump, what might economic misery for almost everyone result in? Again, the Fed probably doesn't want to find out.

So what does this mean for markets? Well, as we said before, markets are forward looking. Investors have factored in a restrictive Fed which then begins to reverse course and cut the overnight interest rate, possibly in response to a recession or slowing economy. Just yesterday, Apple announced that it was slowing hiring and spending on some teams. This type of announcement has been commonplace, especially from tech companies. As the Bespoke Investment Group wrote:

> *"While that move doesn't exactly speak to panic from AAPL management, keep in mind that this company is not some small, capital markets-dependent start-up; the company generates over $100bn in free cash flow per year, with total capex accounting for less than 10% of operation cash flow. These sorts of decisions are exactly what is required to move the US economy from a hot labor market underpinning rapid nominal consumer spending to a broad retrenchment in economic activity referred to as a recession."*



If there is indeed another leg down to equity markets, it will likely come from earnings revisions rather than from valuations adjusting to rising rates. As of last week, analyst targets for the S&P 500's year-end price level remained quite rosy, with few downward earnings revisions factored into outlooks. This week companies are beginning to announce results for last quarter.

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Exhibit 1: S&P 500 Strategist Estimates for the End of 2022

Firm (in alphabetical order)	S&P 500 Forecast (year-end 2022)	S&P 500 Forecast (year-end 2022, as of March 31, 2022)	S&P 500 Forecast (year-end 2022, as of June 30, 2022)
Bank of America	4,600	4,600	4,500
Barclays	4,800	4,500	4,500
BMO	5,300	5,300	4,800
BNP Paribas	5,100	4,900	4,400
Cantor Fitzgerald	4,800	4,800	3,900
Citigroup	4,900	4,700	4,200
Cornerstone Macro / Piper Sandler*	4,600	4,800	4,000
Credit Suisse	5,000	5,200	4,900
Goldman Sachs	5,100	4,700	4,300
Jefferies	5,000	5,000	4,650
JPMorgan	5,050	4,900	4,800
Morgan Stanley	4,400	4,400	3,900
RBC Capital Markets	5,050	5,050	4,700
Scotiabank	4,800	5,000	4,600
UBS	4,850	4,850	4,850
Wells Fargo	5,200	4,715	4,715
Average 2022 Forecast (points)	**4,909**	**4,838**	**4,482**
2022 Forecast Standard Deviation (%)	**4.9%**	**5.0%**	**7.5%**

*Cornerstone Macro was acquired by Piper Sandler in February 2022.

Source: Bloomberg, Research Reports, as of 30 June 2022. Industry estimates are hypothetical in nature, do not reflect actual investments and are not guarantees of future results.

Investors should remain selectively opportunistic. We don't think the world is falling apart, but we may be entering a new valuation regime where technology stocks no longer trade based on potential growth, because monetary policy is no longer as accommodative. However, the market sell-off has created valuation dislocations in certain industries where we think long-term investors can enter or increase existing investments.

Sincerely,

Peter Karmin
Managing Member

Stuart Loren
Director

Citations and Disclosures

[i] Bloomberg and Deutsche Bank. All data cited herein is from Bloomberg unless otherwise noted.
[ii] Deutsche Bank.

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