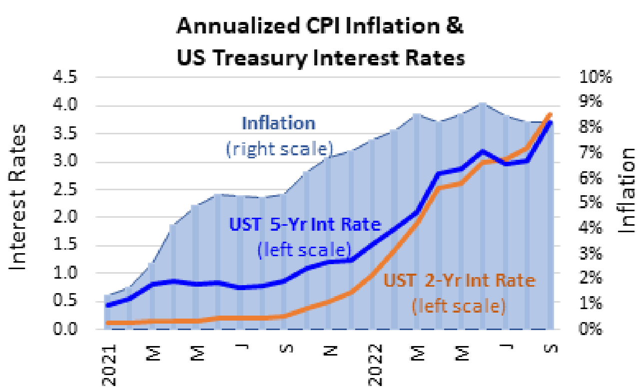
Wealth Management

QUARTERLY PERSPECTIVE

FALL 2022

An Inflation Surge Got the Bears Growling

The reigniting of inflation to its highest levels in over four decades has been the catalyst for the dramatic sell-off in stock and bond markets for the past year. Inflationary pressures began building in early 2021 as the result of several factors: revived consumer demand in the aftermath of the COVID shutdowns; supply chain disruptions from multiple sources; and the excessive monetary and fiscal stimulus from multiple COVID rescue plans implemented by the Federal Reserve and the Federal government.



Source: Federal Reserve Bank of St Louis

The Economy

In its effort to fight inflation, the Fed raised interest rates five times so far this year, including not one, but three rate hikes of 75 basis points each, for a total increase of three-percentage points on the Fed Funds rate – the overnight lending rate for banks. And with inflation running hot at over 8% annualized, the Fed has clearly signaled that it isn't done yet. Indeed, with interest rates having started the year near zero, the Fed indicated that it may push its Fed Funds target up another 1.25 percentage points to about 4.5% by year-end, and possibly higher. Meanwhile, short- and long-term interest rates began a game of "catch up," as bond investors demanded higher yields on fixed income assets to compensate themselves for the prospect of higher and sustained inflation. Yields on the shortest maturities have risen most, with 2-year Treasuries yielding more than 4% at the time of this writing.

Many analysts expected a temporary, post-COVID jump in inflation, due to pent-up demand and a normalizing of prices following the brief deflation during COVID (recall that many prices fell as consumption collapsed in early 2020). However, the ongoing shutdowns of overseas economies (particularly in China) have extended and worsened supply chain disruptions, as has an unusual decline in labor supply as many workers have effectively quit the labor force, creating bottlenecks and backlogs everywhere from restaurants to commercial shipping ports. Meanwhile, a different kind of supply disruption was created by curtailed US oil and gas production and embargoed Russian energy supply – a global sanction for that country's war on Ukraine. The resulting surge in energy prices further "fueled" inflation by raising the costs of production throughout the supply chain, from transportation to the fertilizer needed to grow global crops. Grain production was another tragic casualty of the war in Europe, resulting in a troubling food shortage that has also had global and inflationary consequences.

It has been rightly said that inflation can be described as the result of too much money chasing too few goods. Fiscal and monetary policy injected trillions of dollars into the US economy during the COVID crisis, and the Fed's newfound monetary retrenchment may help with that source of rising prices, but it can't resolve the supply issues resulting from other factors like war, regulatory restrictions, and lifestyle changes. Most of these may still prove to be temporary, though painfully prolonged.

However, the Fed's aggressive rate hikes have produced something else: a bear market in stocks. As the Fed pushes interest rates higher, the likelihood of an economic recession also grows. By traditional measures, the US economy was officially

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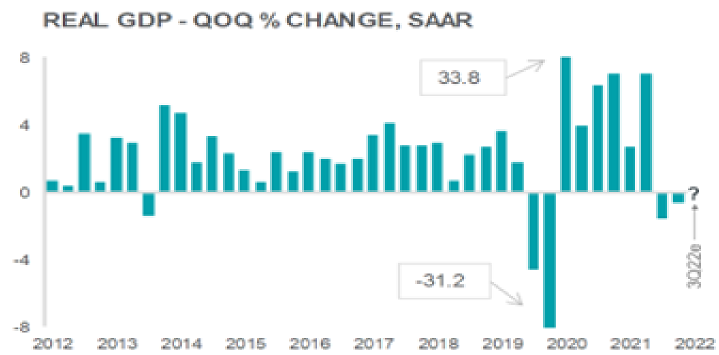
U.S. ECONOMIC GROWTH OVERVIEW



Source: Northern Trust Asset Management

in recession after two quarters of contracting gross domestic product (GDP) during the first half of the year. GDP performance for the third quarter is uncertain, but many analysts expect it to be soft at best. Nevertheless, unemployment remains remarkably low at 3.5% and business hiring remains relatively strong, though much slower than at the start of the year – likely a product of the unusually low labor force participation rate. Still, a weak economy translates into lower profits – a direct reduction of one of the key factors supporting stock valuations. Furthermore, rising interest rates mean that the present value of expected future corporate earnings (now revised downward) is also lower, exacerbating the decline in stock prices.

The Markets

As measured by equity returns through the third quarter, US and global stocks are in a bear market, with declines of more than 20% from their recent highs. For the first nine months of the year, the S&P 500 declined nearly 24%. Most of those declines came from the growth side of the market (down more than 30%, as measured by the Russell 1000 Growth and NASDAQ indices), where technology companies, especially, retreated sharply. Having led the gains in stocks for much of the past ten years, they have been leading the way lower for most of the past twelve months. Value companies have performed much better year-to-date – but are still down roughly 17% for the Russell 1000 Value index and the much-watched Dow Jones Industrials. Nevertheless, during the third quarter, value stocks performed slightly worse than growth companies, as fears of recession spread.

Index Returns as of 9/30/2022	Q3 2022	YTD
S&P 500	-4.88%	-23.87%
Russell 1000 Growth	-3.60%	-30.66%
Russell 1000 Value	-5.62%	-17.75%
Russell 2000 Value	-4.61%	-21.12%
Dow Jones US Real Estate	-10.44%	-29.37%
MSCI EAFE (Net)	-9.36%	-27.09%
MSCI Emerging Markets (Net)	-11.57%	-27.16%
Bloomberg U.S. Aggregate Bond	-4.75%	-14.61%
Bloomberg Municipal Bond	-3.46%	-12.13%
Bloomberg U.S. High Yield	-0.65%	-14.74%

Source: Morningstar

While bonds are often the beneficiaries of falling stock prices and a "flight to quality," that is not the case in this market cycle, as the inflation-driven surge in interest rates means the value of bond portfolios decline. In fact, the most common measure of US bond market performance declined year-to-date by nearly 15% – only slightly better than the performance of value stocks and the Dow.

Uncertainties Ahead

Looking forward, investor expectations for inflation and the trajectory of interest rates will likely remain the key drivers of market conditions, though other factors can provide unexpected positive or negative surprises for the market. The midterm elections are looming, an event that often creates market uncertainty. Many pundits anticipate a shift in control of one or both houses of Congress. While that could result in gridlock, the markets often respond favorably to divided government that makes dramatic change (and, therefore, uncertainty) less likely. The war in Ukraine, a source of increasing worry in recent weeks, could move things in either direction. Clearly, an early end to that conflict would be welcome for many reasons, and especially to bring relief to the untold human suffering that is occurring.

Uncertainties abound. Excluding the depression-era, the average bear market for the S&P 500 has averaged about 16 months, so we may yet have more financial pain to deal with. Even so, stock valuations generally have become much more appealing. Some sectors of the market look very attractive, providing opportunities for income as well future growth. While recovery from losses in the bond market will likely take time, recovery from stocks can come swiftly. And the rising consumer prices that are currently battering stocks and bonds will eventually flow through to corporate revenues and the bottom line, meaning stocks may offer the best long-term protection from our current bout of inflation. That doesn't mean we should all start buying stocks. That decision should be considered in the context of your personalized financial plan. Though uncertainties abound, your CNB advisors are here to help you navigate our current financial challenges.