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An elusive inflation peak weighs on equity markets

Key takeaways

- The U.S. Labor Department's May Consumer Price Index report, released on June 10, showed that inflation remains high, and in some areas is actually continuing to accelerate. Equity and bond markets broadly sold off ahead of this week's Federal Reserve (Fed) policy meeting.
- There is no recession yet in the U.S. economy, but the inflation news only reinforces our view that a mild recession is likely to occur, beginning late in 2022 and extending into 2023.

What it may mean for investors

- Based on our expectation that economic growth will resume later in 2023, our outlook has several implications for proactive investors, depending on their investing horizons.

A troubling May Consumer Price Index report

The Labor Department's reported May Consumer Price Index inflation rate bucked expectations by hitting a new year-on-year peak of 8.6% from April's 8.3%. A rise in food and energy prices led the way following a short-lived decline in April, leaving the two up more than 10% and 34%, respectively, in the past year.

Outside of food and energy, the so-called "core" goods prices reaccelerated on resurgent new and used car prices, alongside a bounce in apparel prices. Services inflation also remained robust with strong upside in hotels, airfares, and travel-related expenses. Costs related to homeownership increased at the fastest sequential pace since 1990. The takeaway is clear: Inflation remains high, and in some areas is actually continuing to accelerate, setting a hawkish tone heading into this week's Fed policy meeting.

The hot inflation report provided a double dose of bad news for the economy and for stocks. First, it added to the pressure on households' real (inflation-adjusted) income and, second, it stoked the debate over more aggressive rate increases by the Fed beyond the two half-percentage-point hikes expected next week and at the late July policy meeting.

Only a few weeks ago, investor hopes for a nearby inflation peak and for the Fed to ease rate hikes later this year drove a rally of 7.1% in the S&P 500 Index from 3901 to 4176. Looking ahead, that hope increasingly seems misplaced. The June 14 Producer Price Index report is likely to show a sharp gain as well. What's more, interest rate futures contracts are now pricing in a third half-percentage-point rate increase at the policy meeting on September 20 – 21.

For their part, consumers' concerns are growing. In early June, the University of Michigan's Consumer Sentiment Index hit a record low and showed that long-term (5 – 10 year) inflation expectations buckled, rising to a 26-year high of 3.3%, up from 2.8% a year ago. Higher inflation expectations have been a big concern for Fed officials, who worry that increases like that could be self-perpetuating and difficult to reverse. Fortunately, longer-term inflation expectations among investors are up from their low but still below 3%.

U.S. economy unlikely in recession now

We have been noting for most of 2022 that the risks of recession have been rising gradually, but there is still no recession yet. The quarter ending in June likely will post a positive rate of economic growth. The economy has notable strengths at this point, including still-sizable cash balances, the strong labor market, and related wage gains.

However, inflation and rising borrowing costs are eroding that buffer, creating disagreement in markets about how quickly the economy may slow. For example, the national average 30-year fixed-rate mortgage now exceeds 5% for the first time since February 2011, and housing activity is starting to slow. Job gains are still healthy, but softening, and ultimately should blunt wage growth. On days when the inflation news is particularly disappointing, equity markets have adjusted their views more to the negative.

Our guidance

Last month's stock market rally was one based on hope. Hope cannot be an investment strategy, but neither is fear. It is natural to fear further market declines and to wonder where the bottom of the market may be. But it is nearly impossible to predict a bottom. In our experience, optimism and pessimism are equally poor guides to investing.

We strongly prefer what we believe is a more realistic approach, based on where the economic data are trending. That trend is for growth now, but a recession later. On May 19, we wrote that a mild recession, extending from late 2022 into early 2023, is our base case for the economy. Aggressive Fed rate hikes and an unprecedented shrinkage of its balance sheet are policies likely to slow the economy quicker than inflation cools, since the Fed has only indirect influence on inflation from China's COVID-19 lockdowns and the war in Ukraine. The economy might manage through any one of the inflation or policy shocks, but their rapid convergence now has reached a point where we expect a growth contraction.

A central point of our guidance has been that investment opportunities typically arise throughout an economic cycle, but a recession requires extra patience. Based on our expectation for a resumption of economic growth, we believe this recession will most likely occur later in 2022 and into 2023. That outlook has several implications for proactive investors, depending on their investing horizons.

Going to cash now means having to be right twice: Many investors would pick the bottom of the current sell-off, because they want to time going to cash now and reentering later. That strategy involves deciding when to sell and when to buy again — two decisions that are normally very difficult to pull off without potentially delaying the eventual recovery of savings from the market's sell-off. Put another way, an investor who makes one decision — to sell — still does not necessarily know when to make the second decision, to reinvest. Especially if going to cash is based on fear, it may be very difficult to put aside that emotion to know when to reenter. In that case, investors may face tax consequences from the sale and miss the opportunity to recoup losses if their confidence does not return until at or near the next market peak. In all cases, staying in cash amid high inflation rates (and health care inflation rates are even higher) effectively erodes the purchasing power of that cash in the future.

Time can be the ally of a long-term investor: Although long-term investors usually diversify for times like these, we favor working with an investment professional to create a disciplined and incremental plan to deploy any available cash today over the coming year, or longer, and to emphasize quality and defense in an effort to preserve capital.

A short-term horizon does not have to mean a short fuse: Some short-term investment objectives may benefit from holding additional cash. One important goal of our strategy is to avoid selling investments when prices are at low levels. To manage home, tuition, or travel expenses for the coming months, we favor holding that cash separately, or in short-term fixed income, to make cash available when the payments are due.

Yet, in cases where the investor seeks short-term opportunities, we have been shifting our investment preferences systematically away from economically sensitive to more quality-oriented and defensive assets, and we expect additional entry points in the coming months. For most of this year, we have favored more liquid, high-quality U.S. stocks. More recently, sector recommendations have tilted toward Energy and more defensive Health Care, while maintaining a favorable view of Information Technology on the long-term opportunities in economic digitalization. We also have shifted to a favorable rating on U.S. Short Term Taxable Fixed Income and U.S. Intermediate Term Taxable Fixed Income, which are least vulnerable to interest rate increases expected during the balance of 2022.

Risk considerations

Forecasts and targets are based on certain assumptions and on views of market and economic conditions which are subject to change.

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