Now What?

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As the Fed approaches the end of the inflation fight, now what?

In 2022, equity markets faced a major dilemma. Inflation had launched from core CPI of barely 1% to a level quickly approaching 7%. The economy was growing at a fast pace and corporate earnings estimates were seemingly ratcheting higher every week. Equity valuations were coming off of their 2021 peak at forward P/Es of 23.5x and 31.5x for the S&P 500 and Nasdaq 100 respectively. To fight the 30+ year high inflation and the overheating economy, the Federal Reserve Board was aggressively raising interest rates at a pace of 0.75% per **meeting** – nearly unprecedented.

By the fall of 2022, the Fed had raised short-term interest rates from basically zero in the spring to 4.00%, including four increases of 0.75% in a row. The equity market response was decidedly negative, falling more than 20% and posting one of the worst returns in six decades. The Fed's goal through this environment? To achieve their stated mandates of full employment and price stability (low inflation)…with the additional goal of not torpedoing the economy into a recession.

Today the Fed Funds Rate stands at 5.00%. How is the Fed progressing on its goals and mandates?

Inflation:

In early 2021, core CPI was slightly over 1%. By mid-2022, CPI was closing in on 7%. Inflation has recently started to normalize, dropping over 1% from the peak. It appears inflation is poised to fall further toward the sub-4% area. Longer-term, pricing for Treasury Inflation-Protected Securities (TIPS) points to an inflation expectation of mid-2% over the next 5 and 10 years. The Fed appears well on its way to achieving price stability.

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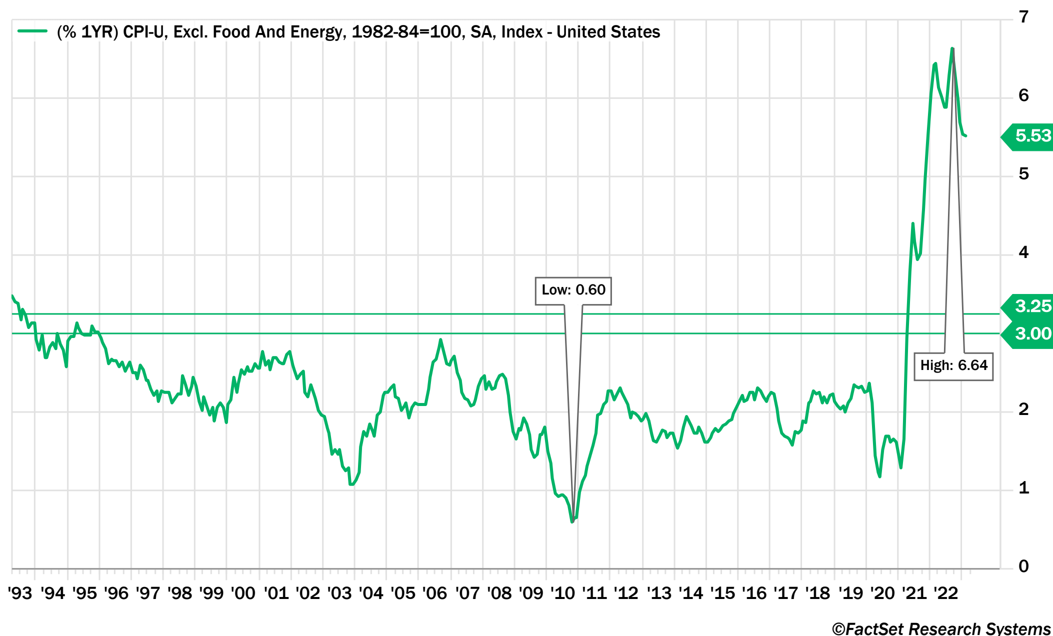
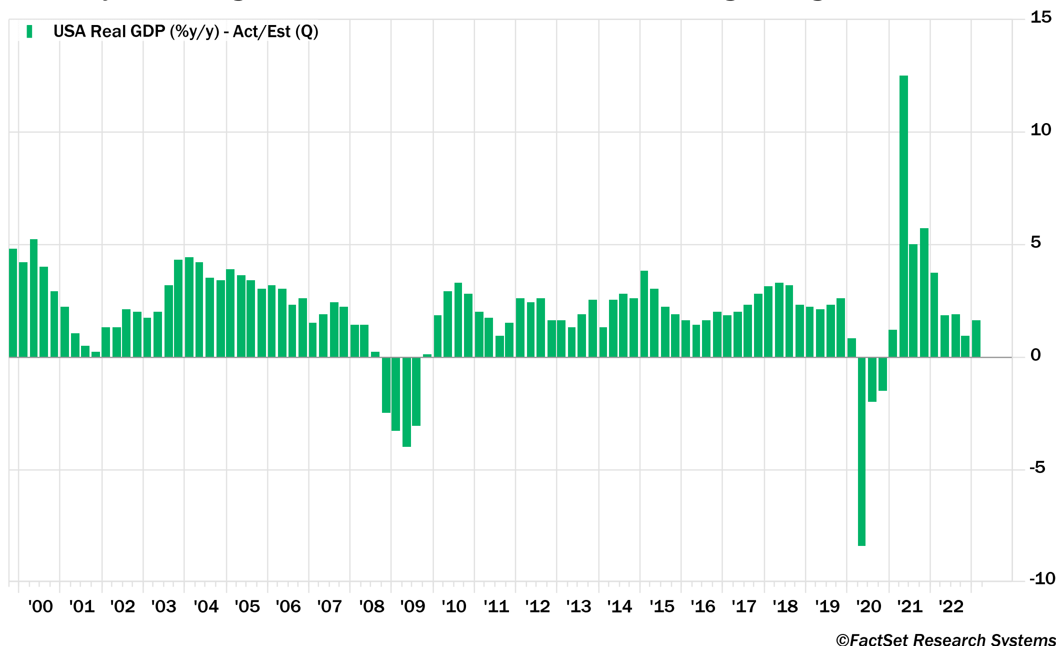


Growth:

In 2021, due to pent up demand from the global pandemic, GDP shot higher, piercing the 20-year record of 5% GDP growth. Growth was stubbornly high at the end of 2021 when the Fed started to raise interest rates. By the fourth quarter of 2022, GDP growth was under 1%. The first quarter of 2023 may print a growth rate just above 1%. The Fed has certainly slowed the economy, but the question remains if the Fed has merely slowed growth or if its rate increases are beginning to cause a recession.



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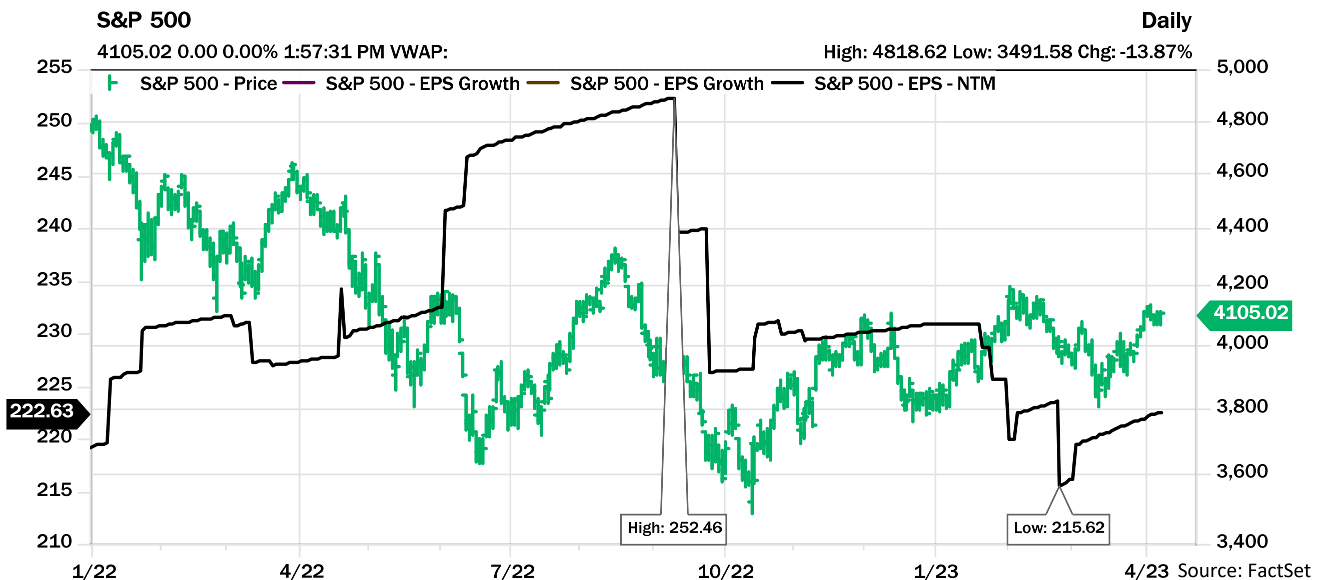
Earnings:

By the summer of 2022, earnings growth estimates for the next year-out had risen by over 15% from the start of the year. As the economy started to slow and the interest rate increases began affecting corporate fundamentals, earnings estimates began a downward revision cycle. Last month, future earnings estimates that once were $252 per share for the S&P 500, hit $215 per share, a negative revision of 15%. The interest rate increases have worked to slow corporate earnings growth.



Valuation:

After reaching a high not seen since 2000, the S&P 500 two-year forward price to earnings ratio (P/E FY2) has normalized due to the 2022 bear market which reduced equity prices by over 20%. The S&P 500 is within 5% of the 20-year valuation average. Major valuation headwinds, seen just a year ago, have disappeared.

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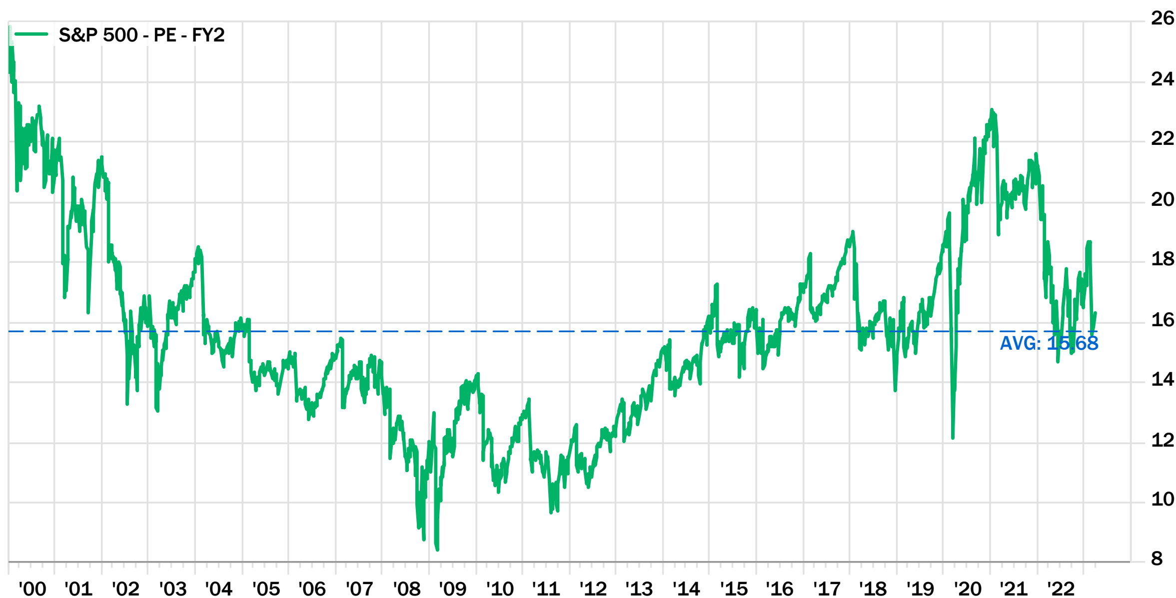
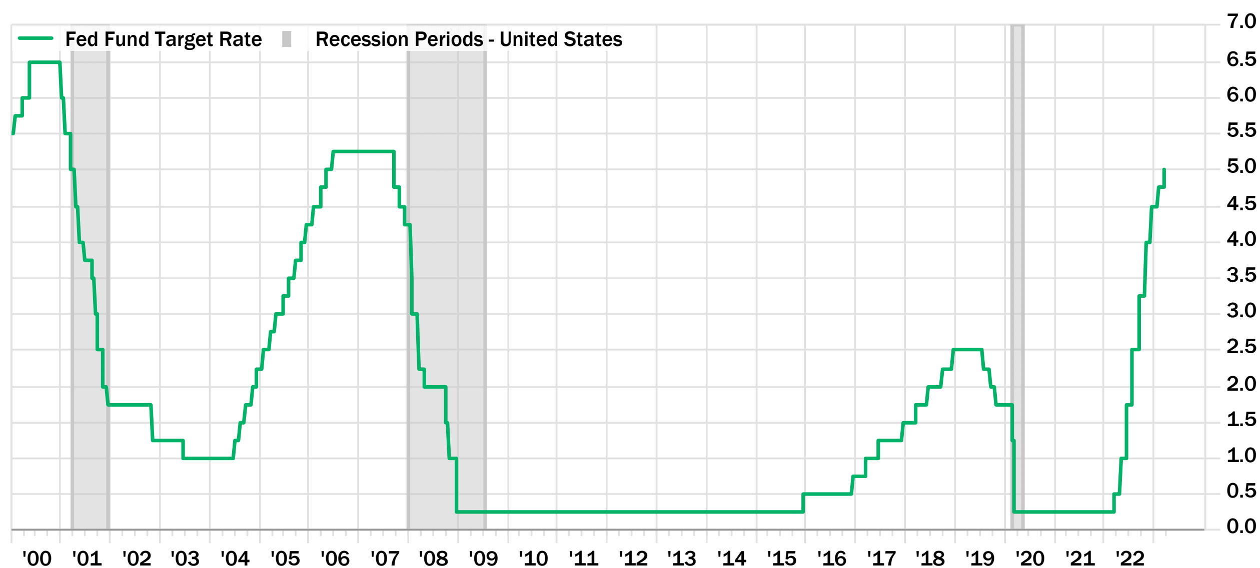


Interest rates:

If the Fed raises the Fed Funds rate one more time, the rate will equal the 2006/2007 high of 5.25%. The Fed would have achieved this level in record time. Will this level be enough to tame inflation?



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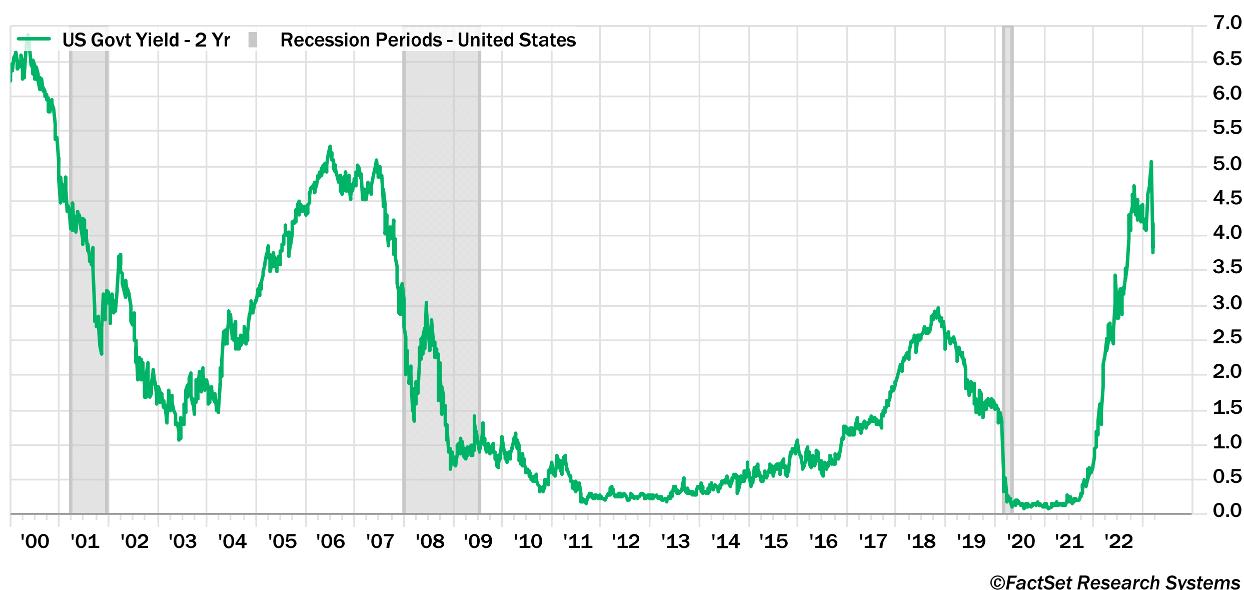
Our work points to the 2-year U.S. Treasury yield as a strong indicator of the future path of the Fed Funds rate. Historically, we have found the 2-year yield rises with the Fed Funds rate and starts to roll over, or begins to fall, just prior to Fed Funds peaking. Recessions generally emerge when the 2-year yield falls steeply and continuously. Recently the 2-year yield touched 5%, matching the 2006/2007 peak area, then fell to around 3.7%. Seeing the 2-year normalize at lower levels would be welcome.



To summarize, the Fed raised short-term interest rates from nearly zero a year ago to 5.00% today to combat inflation which has now started to fall and is potentially headed toward sub-4%. Economic growth has slowed to a level of 1% year-over-year, below the long-term average of over 2%. The slowing economic growth has caused corporate earnings estimates to contract by 15% while last year's bear market reduced high valuations toward the long-term average. At the same time, interest rates overall may have peaked for this cycle.

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The Fed certainly knows inflation overall is slowing but remains concerned that services inflation remains elevated. If both inflation measures continue to normalize, the Fed may cease the tightening cycle with one more increase to 5.25% on May 3rd. The result of this tightening cycle may be a mild

recession or an earnings recession where earnings growth is negative, but the economy does not contract meaningfully.

This scenario would affect our portfolio asset classes in varying ways. For example: For U.S. equities, corporate earnings estimates could bottom and start to rise over time. If interest rates gently glide lower, valuation upside would increase, especially in growth equities that tend to be valued on future earnings discounted (via the level of interest rates) to the present. Lower interest rates generally equate to higher valuation multiples.

In Fixed Income, the Investment Team purchased a large number of individual bonds on the interest rates spikes from late 2022 through 2023. Although lower interest rates in the future make bond yields less enticing versus other asset classes, we could see above average appreciation from the bonds purchased in 2022 and 2023.

In Natural Resources, while blindly buying a commodities index may not deliver outsized returns in the future, there continue to be sub-segments in natural resources where supply is scarce and demand is increasing. Finally, watch Foreign Equities closely. As much of the world exits the slowdown before the U.S. and the U.S. dollar may have peaked for the cycle in the fourth quarter of 2022, Foreign Equities, trading at over 30% discounts to the U.S., have quietly outperformed the U.S. since the October equity market lows. The ingredients could be assembled for a more extended period of Foreign Equities outperformance, just as most managers and individual investors are majorly underweight.

Thus far the Fed has achieved the goal of reducing inflation and slowing an overheating economy. Regardless of the policy path the Fed follows from here and the policy's lagged impact on inflation and growth, the Investment Team will use our style-agnostic approach within a diverse, robust asset allocation framework to guide your portfolio through all potential future environments. ■

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