Market Perspective from the Investment Advisory Group

Inflation to remain Fed enemy number one and choppy waters to persist

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Highlights

- This CPI report put cold water on a building market narrative that a potential easing in inflation data could provide the Federal Reserve (Fed) cover to ease up on its aggressive tightening campaign.
- Part of the sharp sell-off yesterday is just a giveback from the 5%-plus market rally since early last week heading into the CPI print. The market remains largely in the same trading range it's been in since May.
- The biggest and growing downside risk for the market is increasing recession risk as the Fed aggressively tightens into a slowing economy.
- On the other side, the biggest market asset is investor expectations are low and already braced for bad news.
- Consequently, we expect the market to remain in choppy waters and still advocate for a more defensive and up-in-quality portfolio positioning.

What happened

A hotter than expected inflation report led to the sharpest one-day selloff for global markets since June 2020. The S&P 500 declined 4.3% and the tech-heavy NASDAQ Composite was down 5.2% on Tuesday. The monthly Consumer Price Index (CPI) for August showed inflation rising 8.3% on a year-over-year basis, off the recent peak of 9.1%, but still near a multi-decade high. Core CPI, which excludes energy and food prices, rose 6.3%, up from 5.9%, speaking to the broader-based nature of inflation, and above market expectations.

Consequently, interest rates rose as the market started to bake in an even more aggressive near-term Federal Reserve (Fed) rate hike path to combat inflation, and the yield curve inverted more steeply. The debate around the Fed's meeting next week has shifted from whether it will be a 50 or 75 basis point^ increase to whether it will be 75 or 100 basis points.

Our take

This CPI report put cold water on a building market narrative that a potential easing in inflation data could provide the Federal Reserve (Fed) cover to ease up on its aggressive tightening campaign. **This report will keep the Fed squarely focused on enemy number one – inflation**. Indeed, earlier this year, Fed Chair Powell said the current backdrop is "not a time for tremendously nuanced readings of inflation," and the Fed will keep tightening policy until inflation comes down in "a convincing way."

This report suggests we are not there yet, especially, as inflation remains far from the Fed's 2% target. Thus, any hope for a Fed pivot has once again been reset. **Our view has been that the Fed would likely keep interest rates at an elevated level for longer given the scar tissue** left behind due to the inflation challenges of the past year, even if this requires more economic pain. Historically, **once inflation exceeded 5%, it has generally taken a recession to bring it back down**.

Market implications

Our core thesis remains that **we expect the markets to stay in choppy waters** and continue to advocate for more **defensive and up-in-quality portfolio** positioning.

Still, some perspective is in order. Part of the sharp sell-off yesterday is just a giveback from the 5%-plus market rally since early last week heading into the CPI print. The S&P 500 is actually still up since last Tuesday as it initially bounced sharply from the deepest oversold level since the mid-June market lows before yesterday's selloff.

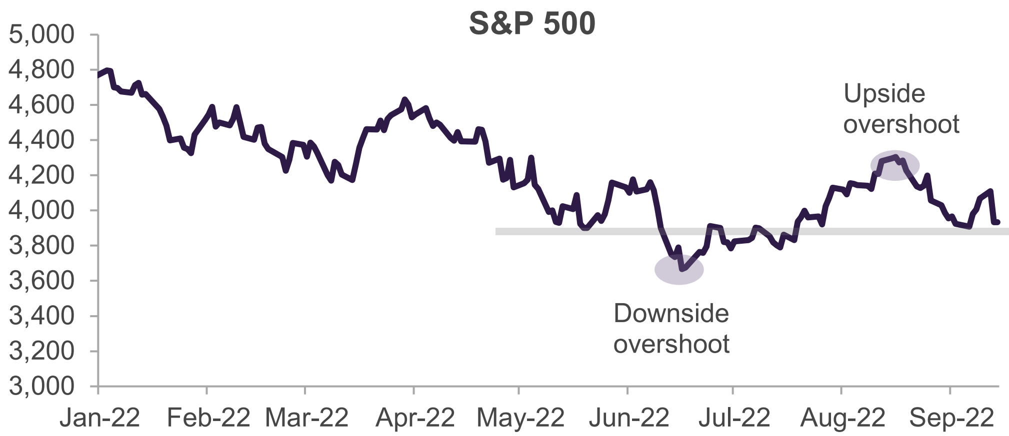
^1 basis point = 0.01%; 100 basis points = 1%

Past performance does not guarantee future results

Notably, the broader choppy trading range from about 3650 on the S&P 500 to 4200-4300 remains largely intact. The roughly 3900 level remains a key near-term battle ground (S&P 500 Tuesday close = 3932).

Importantly, while we have seen overshoots in both directions—to the downside in mid-June, and to the upside in mid-August—the market is trading at the same level as in early May and largely in a choppy range since then.

Perspective: Despite violent swings, market has largely been confined to wide trading range since May



Data source: Truist IAG, FactSet. Past performance does not guarantee future results

In our view, the biggest and growing downside risk for the market is increasing recession risk as the Fed aggressively tightens into a slowing economy.

On the other side, there is at least one partial offset: Investor expectations are low and already braced for bad news. Recall, markets are less about *good* or *bad* but instead *better* or *worse* relative to expectations.

The just released BofA Global Fund Manager Survey showed survey respondents' cash levels at the highest level since 2001, global economic growth expectations near an all-time low, and fund managers' equity exposure at a record underweight.

This survey is consistent with other sentiment indicators. Less than 20% of retail investors have a positive market outlook, according to the American Association of Investors. Also, traders in the futures markets, such as hedge funds, individuals, and large institutions, are already positioned against the market. This simply suggests that, even if it's a lower probability, the market is vulnerable to good news given most investors are not positioned for a positive outcome.

Bottom line

The wide range of economic and market outcomes in this complex post-pandemic period is leading to more erratic daily trading. Each data point is overanalyzed and over-extrapolated. Still, the CPI report resets the clock for an eventual shift in Fed policy. We continue to believe the Fed will keep rates higher for longer given the scar tissue caused by the elevated inflation of the past year. Consequently, we expect the markets to remain in choppy waters and still advocate for a more defensive and up-in-quality portfolio positioning.

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