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## Inflation — Slowing But Not Forgotten

Before this bout of broad economic price instability, what was the widely held belief regarding inflation fighting? It was that monetary policy authorities should act well in advance of price pressures, because when inflation does arrive, the campaign necessary to contain it is extraordinarily difficult, fraught with challenging tradeoffs and most likely quite lengthy. Additionally, it was widely understood that significant amounts of the population would be hurt during inflationary regimes.

When the Senator from Massachusetts, Elizabeth Warren, challenged Federal Reserve Chair Jerome Powell during testimony in front of the Senate Banking Committee in March of this year, the resulting exchange summed up the predicament quite markedly. The Senator posited that the Federal Reserve's policy of raising interest rates aggressively was actually aimed at raising the unemployment rate in order to slow the economy and thereby inflation. Using the economic projections of the Federal Reserve Board's own members, she pointed out that this would be at the expense of 2 million jobs. Chair Powell's retort: "I would explain to people, more broadly, that inflation is extremely high and it is hurting the working people of this country badly, all of them, not just 2 million of them, but all of them are suffering under high inflation and we are taking the only measures we have to bring inflation down."

Five months on from this exchange, data from the labor market surveys has not yet shown material job losses though there are early indications of a weakening trend. Continuing unemployment claims, for example, are rising in a slow manner, yet they are broadly rising. Revisions to the establishment nonfarm payrolls data have been downward and the number of payroll additions seems to be slowing. Inflation is slowing as well, albeit it is still elevated and perhaps not moving down rapidly enough to sharply improve consumer sentiment. Financial commentators are debating the likelihood of a "soft landing", which would be an outcome where the economy slows but it does not fall into an outright contraction with accompanying job loss. For now, it seems as though U.S. economic growth is faring better than economies in Europe and Asia.

The Bull case would be a function of sustained above trend growth migrating towards slower below trend growth over time with sustained tighter labor markets. Corporate suite behavior would most likely keep workers employed and therefore spending. Another key aspect to this view is that the Federal Reserve is likely to settle its policy rate and balance sheet in just the right places, where the restrictive stance acts as a brake, but it does not crash the economy into a wall. The policy rate could then be lowered due to the threat of further sustained inflationary pressures subsiding.

Threats to this Bull view may come from various areas. First, the weakness in the rest of the world would have to not materially impact the American economy going forward. Secondly, the recent past will not be prologue. The hiking cycles of the late 90's, 2004 to 2006 and 2016 to 2018, all ended in recession and the rapid raising of rates this time will have to meet a better set of circumstances to not end up at the same place.

At present, Bears typically reside in one of two places. The first argument is that we may have already reached the appropriate policy rate which is currently restrictive and weakness won't show up in the data until after a sufficient time lag. The higher cost of capital will eventually grind down sectors of the economy and unprofitable companies over time and this will inevitably lead to some level of job losses. In short, credit will contract and there will be harder outcomes where credit is needed but no longer being supplied. This slow process is not averted as the Bulls suggest, it just will take more time to be felt. A second, harsher view in the Bear space, is that inflation is so hard to contain that it will wax and wane and then lift higher again as it did during the 70's and early 80's dynamic. The Federal Reserve will be forced in the direction of continuing a tightening path that is ultimately too much for the economy to take. The level of tightening thus far has been significant and nominally has surpassed or equaled the last two cycles already, but with far more overall leverage in the system, more hikes would surely push us toward harder outcomes.

In this challenging environment, we can observe what is in front of us today: The S&P 500 has rallied this year as the worst of the near outcomes have thus far been averted. After this rally, and versus longer term averages, the index price-to-earnings multiple is trading at a premium. Valuations may be slightly elevated with certain sectors worse than others. Should the Bull case prevail and, in some cases, mildly elevated valuations today, could cap potential upside in the future. If the Bear case re-asserts itself, then earnings could contract, pushing the market lower. In balanced stock and bond portfolios, the mitigating factor to this difficult risk dynamic lies in the bond markets where rates have already reset much higher. Quality investment grade bonds and U.S. Government securities offer attractive risk-reward profiles in the event of slower growth and inflation ahead of us. Properly managed, bonds may offer a mild real return over inflation, as they produce income and could serve as a buffer should harder landings occur. Selective and prudent equity exposures can still capture potential upside, while attempting to limit the worst outcomes on the downside.

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