# BULL & BEAR BULLETIN

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## Will the Fed's Inflation Fight Tighten Financial Conditions Further?

The S&P 500 has rallied sharply from the intraday low seen in mid-June through mid-August, where markets again met resistance. At the time of this writing, the main benchmark index is down over 18% for the year. We have seen two negative quarters of real GDP in Q1 and Q2 which, when observed in the past, have tended to coincide with the declaration of an economic recession. At present, there remain some resilient economic factors which, when combined with the absence of a labor market downturn, may indicate that a technical recession call is premature. The current period is dynamic with patches of strength, resilience and weakness in the incoming data, though the sentiment measures of consumer and business leader confidence are more universally agreed to be weak.

Despite conflicting opinions on where the economy is positioned in the business cycle, we can observe that the unemployment rate has not risen substantially yet, which is a typical feature of a recessionary condition. The current interest rate tightening is aimed at subduing the higher levels of inflation which we have most recently seen in August's Consumer Price Index (CPI) report. Assuming that the Federal Reserve will credibly reign in inflation, the environment which follows, irrespective of a soft or hard landing, will likely be one of more subdued growth. The extent of labor market weakness needed to dampen income and soften aggregate demand in order to soften prices and the amount of time it will take to do this is what is being debated amongst market participants.

August's CPI data release brought a headline CPI print of 8.3% year-over-year. While down from 9.1% in June, the data was still seen as an upside surprise mostly due to non-energy related component price increases. Gas prices have been falling consistently for about two months now. This may still lead to some relief in the CPI prints in the next couple of months provided that categories such as food, motor vehicles and parts, rents, medical care and transportation do not continue to see sustained price increases.

The bull case for risk assets may rest with clear evidence emerging through the rest of the year that inflationary pressures are waning. This would likely bring us closer to the end of the tightening cycle or a statement by the Fed that they are going to pause the pace of hikes so as not to risk overtightening. What also may have to happen in order to see a bull case emerge is that demand will likely have to slow without a consequential downturn in the labor market. Lastly, any cessation of hostilities in Ukraine and on the geopolitical front could open up raw materials and energy supplies to flow more freely, alleviating price pressures from the supply side of the economy. Corporations, in this scenario, may be able to navigate through this slowdown and plan for the future without the most drastic cost cutting measures.

The bear case would challenge the bulls in this way: Assuming that the supply side of the economy is not suddenly going to open up and bestow more quantities of key inputs into the production process for goods and services, the rate hike tightening cycle will be a mechanism which attacks the inflation pressures ultimately from the demand side. If firms anticipate that the demand for their output is fading and that they need to take bolder action as a result, the adjustment process could lead to harsher outcomes. Should rising labor, material and capital costs (due to the higher borrowing rates) all continue to build at the same time, then the action needed may be to quickly get their cost structures in line with the reality of the reduced demand picture. The quickest way to accomplish this for some industries may be to lay off workers. This is likely the sequence that would lead to a recession.

It should be noted that there is a lag between rate hikes and the tightening effect they have on the economy and, given the tightening that has already occurred, we may experience a more noticeable softening early to mid-2023. We are beginning to see this in the housing market, as rising mortgage rates contribute to the decline in housing affordability. The 30-year fixed rate mortgage is at 6.02%, which is the highest level since the Global Financial Crisis.

The unemployment rate represents a lagging indicator meaning that the observation of the rise in the rate will follow the actual economic contraction. In short, it is after the fact, when economic players realize that costs need to be cut and layoffs occur. Many companies such as Apple, Netflix, Shopify and Oracle have begun to either slow hiring or to lay off employees. This slowdown is consistent with many companies giving lower guidance in their earnings call for the latter half of the year. The bottom line is that the unemployment rate troughed at 3.5% in July and it currently stands at 3.7%. If the bear case plays out, a recession would see the rate rise from these low levels.

In this type of environment, where we may be approaching late cycle dynamics, there are prudent actions that can be taken in portfolios. Short term U.S. Treasury bills are yielding in the vicinity of 4% and offer a safe place and an alternative to holding cash. Longer duration U.S. Treasury bonds and quality corporates hold less risk than equities and are also offering higher yields in some instances. In the equity space, looking to more defensive types of sectors such as Consumer Staples and Healthcare for quality selections may be favorable to more cyclically oriented sectors. Large, established companies with strong free cash flow and balance sheet dynamics should be prioritized, as these types of corporations are likely to better navigate through the cycle.