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Weekly Market Commentary
August 15th, 2022

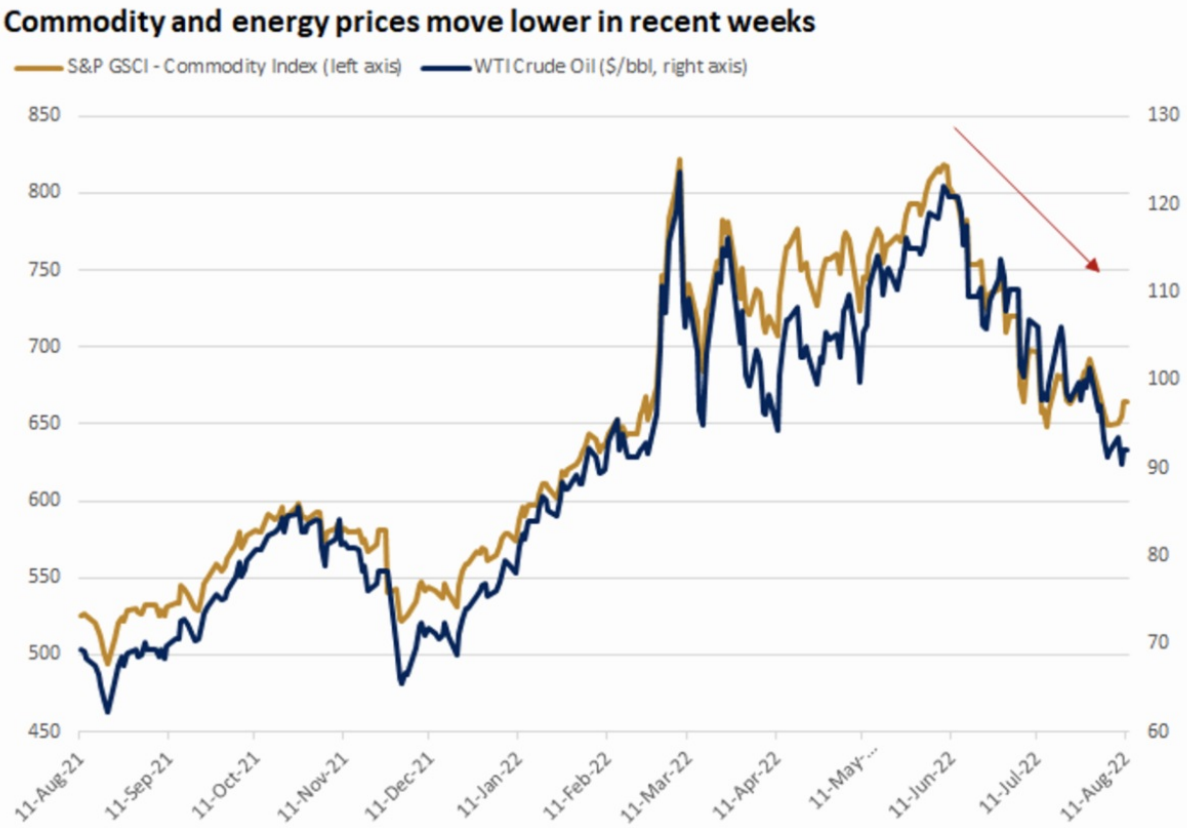
Inflation came down to 8.5%...where do we go from here?

Last week both CPI (consumer price index) and PPI (producer price index) inflation data for the month of July moved lower. After surprising to the upside last month, markets welcomed the lower-than-expected headline and core readings. However, inflation remains elevated compared with almost any period in history, and you can expect the Federal Reserve to continue to push rates higher in this backdrop. Nonetheless, investors cheered this first step in the right direction. While you may see increased volatility in the weeks ahead, if inflation continues to moderate consistently, markets could be poised for a more sustained rally longer-term.

Headline CPI was notably lower than last month, while core CPI came in largely in line

As many expected, headline inflation came in nicely below expectations for the month of July, largely driven by lower fuel and energy prices. In July we had seen average U.S. gasoline prices fall by around 8% and WTI crude oil down by 11% over the month of June. This supported a headline CPI inflation that came in at 8.5%, versus expectations of 8.7%, and below last month's 9.1% reading. But perhaps the more pleasant surprise for markets was the lower-than-expected core inflation reading, which came in at 5.9% year-over-year, versus a forecast of 6.1%. This was driven by lower prices in areas like used cars, select apparel, and airline fares. However, we continue to see inflationary pressures remain sticky in components like shelter and rent pricing (about one-third of the CPI basket), as well as services inflation, which has been driven higher by elevated wage growth as well. Over time, we would expect the impact of a cooling housing market and a potentially softening labor market to continue to put downward pressure on core inflation, albeit with a lagging impact.

Figure 1. The move lower in commodity and energy prices supported a July headline CPI inflation figure below expectations



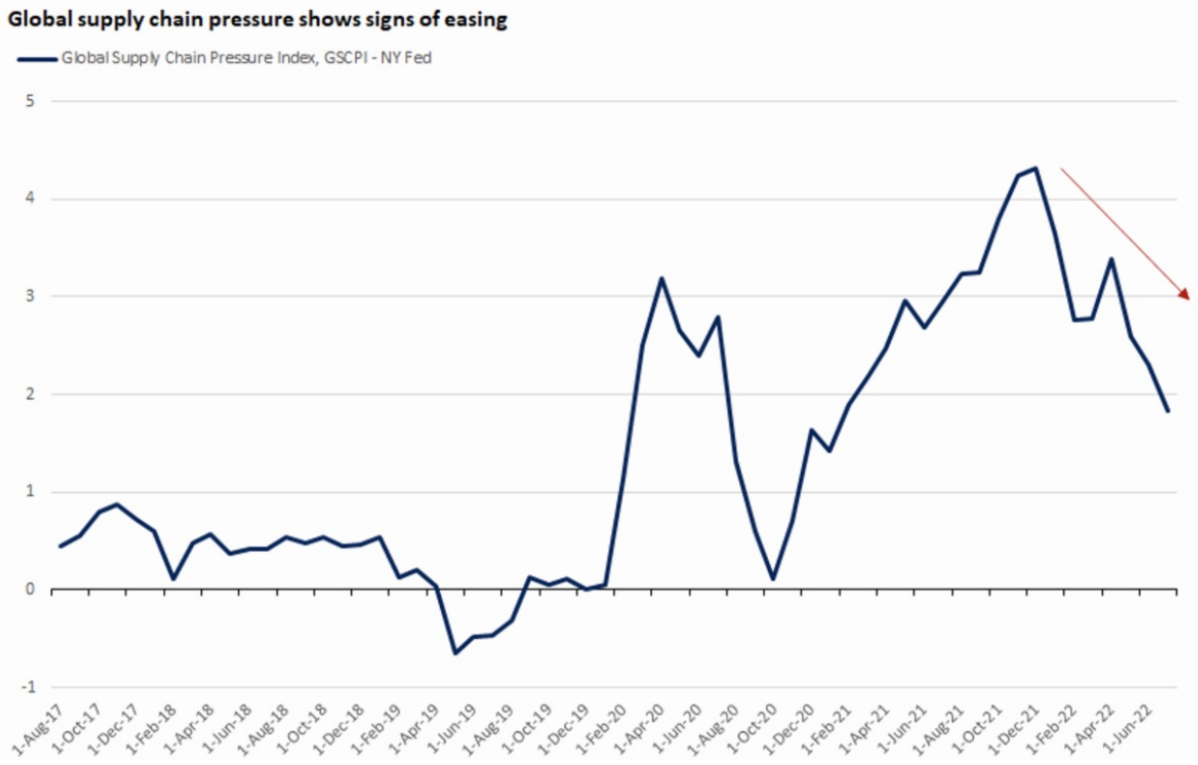
Source: FactSet.

This chart shows the recent fall in oil prices and the S&P GSCI commodity index as increased oil supply and supply chain issues iron out.

PPI figures were similar – elevated but moving in the right direction.

Like the CPI reading, U.S. PPI figures also came in below expectations, although they remain elevated versus history as well. Headline PPI came in at 9.8% year-over-year, versus an expectation of 10.4%, and well below last month's 11.3% reading, benefiting from the lower energy prices1. Core PPI came in at 7.6%, also below forecasts of 7.8%. Producers generally are also benefiting from gradually improving global supply chains, as evidenced by measures like better delivery times, lower shipping-container rates, and a decline in the Fed's Global Supply Chain Pressure Index. Over time, if both the demand and supply drivers of inflation move in the right direction (softer demand and improved supply), prices may be able to move more sustainably back toward pre-pandemic levels.

Figure 2. Increasing measures point to gradually improving global supply chains, including the New York Fed's Global Supply Chain Pressure Index



Source: New York Federal Reserve Bank

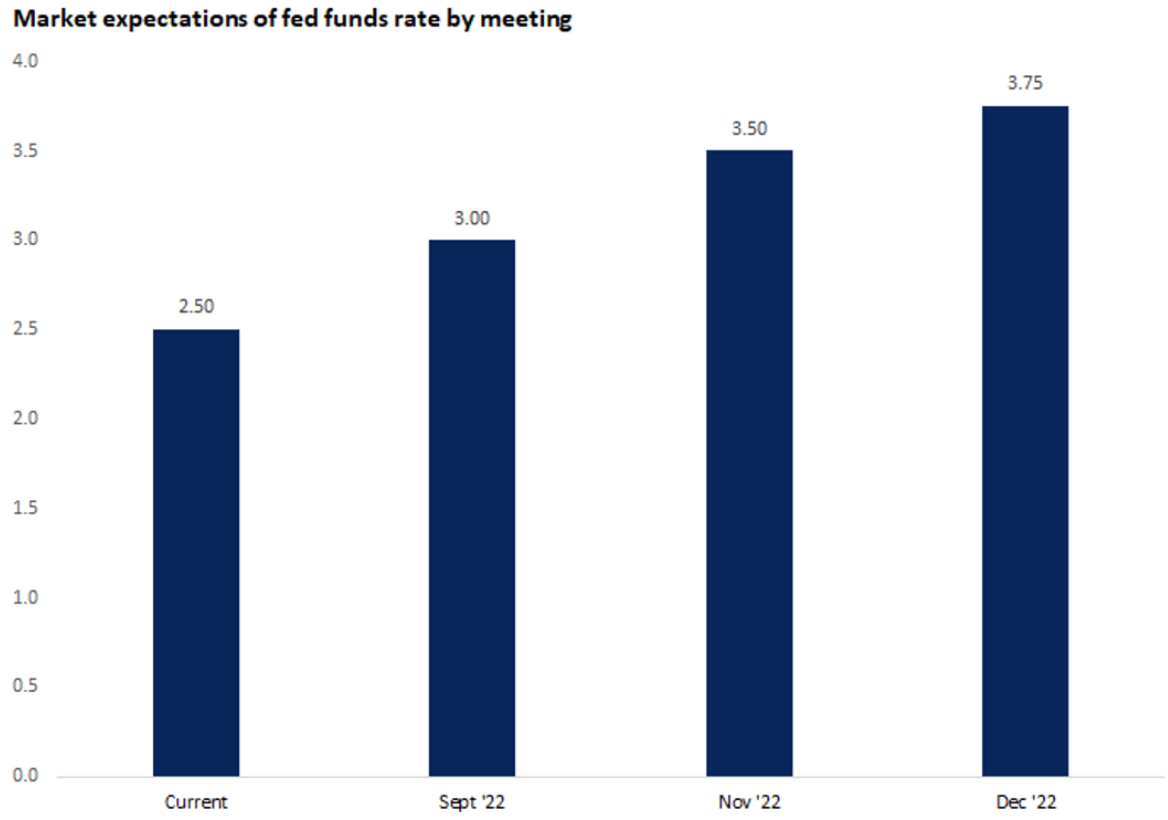
This chart shows the supply chain index which reached record levels during the pandemic but has recently started to roll-over and come down as manufacturing ramps up.

How will the Fed react? It will need to see more data before pausing rate hikes.

Overall, while this month's inflation readings were an encouraging step in the right direction, prices continue to remain elevated by almost any historical measure. Keep in mind that the Federal Reserve has told us that it would need to see "clear and convincing" evidence that inflation is moderating before it would consider altering its rate-hiking path. You would likely need to see two to three additional moves lower in inflation before considering it a trend, and thus we would not expect this week's inflation data to materially alter the path of the Federal Reserve.

What we have seen because of this month's inflation readings is a shift in the market expectations of the magnitude of Fed rate hikes. Markets now expect a 50-basis-point rate hike (0.50%) at the September meeting versus a 75-basis-point hike just earlier this week. The expectation now is for another 50-basis-point hike in November, followed by a 25-basis-point hike in December, bringing the fed funds rate to a 3.50%-3.75% range before pausing. In our view, this is a reasonable terminal fed funds rate, as it brings interest rates into more restrictive territory and will continue to put downward pressure on demand and consumption, particularly in interest-rate-sensitive parts of the economy.

Figure 3. Markets expect the fed funds rate to climb to the 3.50% - 3.75% range in 2022, before pausing in 2023



This chart shows the Fed Funds rate rising to 3.75% in December from the current 2.5% rate.

Where do markets go from here? Don't expect a straight line higher.

Since the beginning of the third quarter (June 30), equity markets have had a stellar move higher, with the S&P 500 up over 12%, cutting its losses for the year nearly in half. Similarly, the technology-heavy Nasdaq is up about 17%, bringing its losses for the year down to about -17%. And this week's inflation readings have only helped add to the positive momentum we have seen over the past six weeks or so.

However, you should not expect markets to continue this rally in a straight line higher through year-end. In our view, markets are likely to experience some volatility, driven in large part by the ongoing rate hikes by the Fed in the months ahead. In addition, the Fed's balance-sheet reduction program will start to ramp up in the second half of the year, which may add upward pressure to bond yields and continue to remove excess liquidity from the system. Finally, we are heading into September and October – historically volatile months in markets – as economic and earnings estimates may continue to soften, which could also exacerbate market volatility.

Remember that midterm elections are upon us this year as well.

Nonetheless, investors could use any periods of market volatility to position themselves for a potentially more sustained rally ahead. This rebound could continue to run when inflation shows consistent signs of moderating, and economic and earnings measures have stabilized. Also, keep in mind that this may coincide with the period after midterm elections in the U.S. (which will occur on November 8). Historically, markets tend to do well in the six to 12 months after midterm elections, regardless of which party wins or who is in power at the time. And markets generally tend to prefer a "gridlock" outcome (split branches of government by party), as this poses less risk for corporations around the passing of new or restrictive legislation.

Figure 4. Markets tend to perform well in the six and 12 months after midterm elections, regardless of which party is in power

Year	President	Party	House Flips Control	Senate Flips Control	12 Months Before Election	3 Months After	6 Months After	12 Months After
1962	John F. Kennedy	D			-17.6%	17.1%	23.5%	30.9%
1966	Lyndon Johnson	D			-13.2%	8.0%	17.2%	17.1%
1970	Richard Nixon	R			-14.4%	15.1%	24.8%	13.0%
1974	General Ford (Nixon)	R			-31.8%	4.2%	18.1%	20.5%
1978	Jimmy Carter	D			0.9%	7.3%	9.2%	9.3%
1982	Ronald Reagan	R			9.7%	8.7%	23.0%	22.3%
1986	Ronald Reagan	R			28.5%	12.3%	18.2%	3.2%
1990	George Bush	R			-10.7%	13.1%	23.5%	29.1%
1994	Bill Clinton	D			1.0%	-0.4%	9.0%	23.1%
1998	Bill Clinton	D			20.1%	16.5%	21.5%	24.1%
2002	George W. Bush	R			-16.4%	-3.4%	3.5%	18.6%
2006	George W. Bush	R			14.2%	4.4%	7.6%	12.4%
2010	Barack Obama	D			14.2%	8.7%	15.2%	5.9%
2014	Barack Obama	D			14.9%	-1.1%	3.3%	3.0%
2018	Donald Trump	R			5.3%	-0.3%	8.6%	12.0%
				Average	0.3%	7.3%	15.1%	16.3%

Flip to Republican control
Flip to Democrat control

(Source: oXYGen & Jones)

Markets For The Week

INDEX	CLOSE	WEEK
Dow Jones Industrial Average	33,761	2.9%
S&P 500 Index	4,280	3.3%
NASDAQ	13,047	3.1%
MSCI EAFE	1,970	2.4%
10-yr Treasury Yield	2.85%	.1%
Gold	$1,802	1.58%
Bonds	$103.05	.3%

Earnings Highlights This Week

Rivian: Electric vehicle maker Rivian Automotive maintained its full-year guidance for deliveries Thursday. The automaker reported second-quarter revenue that was higher than Wall Street expected. But it trimmed its full-year financial outlook, saying that investors should now expect a wider loss and lower capital expenditures than it had previously forecast.

Warby Parker: Warby Parker joined the slew of retailers that have cut their financial forecasts for the year. The eyeglasses maker reported a narrower-than-expected quarterly loss and sales in-line with analysts' estimates.

Disney: Disney posted better-than-expected results on both the top and bottom line, bolstered by increased spending at its domestic theme parks. On Wednesday, the Walt Disney Company reported that total Disney+ subscriptions rose to 152.1 million during the fiscal third quarter, higher than the 147 million analysts had forecast.

Coinbase: Coinbase's revenue declined almost 64% in the quarter as cryptocurrency

prices fell. The exchange operator lowered its full year forecast for transacting users. Coinbase said during the quarter it was trimming 18% of headcount.

Roblox: Roblox reported results on Tuesday that missed analyst estimates on the top and bottom lines. Roblox reported 52.2 million average daily active users, about a million shy of the Street Account consensus.

News and Notes:

Are You Taking Out The Trash Wrong?

First, how can we rid of the gross odors or smell from the trash?

- Some people buy scented bags which may be the simplest thing to do.
- What you can do instead is buy low-cost scented dryer sheets and put them in the bottom of the can.
- Take a small-sized coffee filter and fill it with baking soda, close with a rubber band and place at the bottom of the can.

You say we are putting in the trash bags wrong into our garbage can?

- Yes, trash bags come in the packages inside out because you can see the seam if you look closely.
- Shaking the bag and putting in the can is WRONG
- Put the bag edges around the rim of the trash can. Push down and now the bag will be in the trash can properly.

What do you do with the scraps of food from dinner (meat, vegetables, etc.)?

- If you have a garbage disposal where it makes sense you can use that.
- You can also get an under the sink compost bin which will keep the food out of your garbage can.
- Consider keeping the plastic bags you may get from the grocery store, the pharmacy store, etc. and put the extra food in those bags (tie it up) before you drop it to the bottom of the can)

How do you keep your trash can clean overall for the long run?

- Not leaving your trash in overnight will help a lot.
- However, using a simple cleaning solution like Clorox Wipes and wiping down the inside and outside of your can biweekly is something that will really help.

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