
**Oppenheimer & Co. Inc.** | 205 Town Center Drive, Suite 260 | Virginia Beach, VA 23462 *May v3.0 Newsletter*

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# Tough Start to 2022

It has been a rough start to the year, not simply for stocks, but bonds have been hit hard, too, leaving investors with seemingly few options.

The Fed's hawkish tilt, the ultimate path of interest rates, stubbornly high inflation, Covid lockdowns in China, the Russia/Ukraine war, and fears that a recession is unavoidable have created stiff headwinds for investors.

And it doesn't end there. Volatility in crypto markets and stablecoin rattled equity investors last week.

The tech-heavy Nasdaq is well into bear territory, and the S&P 500 Index lost 18.1% peak-to-trough through May 12. It's now 18.2% following Wednesday's steep sell-off. Historically, bear markets center around recessions, though the closely followed index came close to piercing the 20% barrier in 1998, 2011 and 2018 without an ensuing recession.

Notably, during an 18-month period that ended in March 1978, the index gave up nearly 20% against the backdrop of rising inflation.

Fedspeak during April was a wake-up call for investors. The Fed hiked 50 bp at the May meeting and appears set to hike another 50 in both June and July. Despite strong rhetoric from various Fed officials last month, 75 bp is off the table, at least for now.

On the earnings front, profits have been strong, but a double-digit gain of 11% (Refinitiv, with 91% reporting) isn't adjusted for inflation. Still, overall upbeat numbers have cushioned the downside, despite some high-profile misses.

## 1. THE FED TIGHTENS THE SCREWS

- The Fed hiked the fed funds rate by 50 bp to 0.75-1.00%, the first 50 bp rate hike since 2000.

  — The Fed will begin to shrink the balance sheet in June (QT or quantitative tightening as it is popularly called).

  — After three months, the Fed intends to allow $95 billion in maturing Treasuries and mortgage-backed securities to runoff each month.

- In all likelihood, the Fed is set to raise another 50 bp in June and again in July, as Powell suggested at the press conference.

  — Such increases would rival 1994's aggressive path.

- Still, taking 75 bp off the table surprised investors.

  — Powell said a "75 basis point increase is not something the committee is actively considering."

- Initially viewed as favorable, his remarks set off a negative reaction in the bond market and stocks followed.

  — It was if the so-called bond vigilantes briefly took the reins.

### Obstacles in the Fed's Path to a Soft Landing

- This isn't 1994, when an aggressive Fed acted preemptively against inflation.
- And this isn't 2018, when an investor revolt halted the Fed's gradual rate-hike path.
- The "Powell put" is gone, or at a minimum, it's not actively influencing Fed officials.
- For now, Powell wants to hit the monetary brakes through higher interest rates and QT.

  — By tightening the monetary screws, the Fed hopes to moderate demand and reduce the record number of job openings without a significant rise in the jobless rate.

- Reducing job openings and slowing economic growth should bring demand back in line with supply and reduce pressure on wages. In turn, it should slow inflation.
- But the Fed's instruments are blunt, no fine-tuning. In other words, a reduction in job openings AND higher layoffs could ensue.
- "I would say I think we have a good chance to have a soft or softish (my emphasis) landing or outcome," Powell said.

  — Softish? He didn't elaborate, but Powell is hedging on the soft landing.

  — It may have played a role in market weakness that followed.

- "If higher rates are required, we won't hesitate to deliver them," is not something investors are used to hearing.
- Powell discussed factors that are outside the Fed's control. In an interview last week with Marketplace, he said, "Whether we can execute a soft landing or not, it may actually depend on factors that we don't control."

  — The Fed doesn't control oil production, wheat harvests, supply chains, etc.

### Neutral

- Powell said the Fed won't hesitate to go restrictive if appropriate, but where is the neutral rate?
- Fed officials peg it around 2.5%, but with inflation running much higher, some analysts believe the neutral rate is much higher than 2.5%.

## 2. CPI GOOD NEWS, BAD NEWS

- April's CPI was a disappointment. Yes, there were some positive takeaways, but headline inflation did not fall as much as expected, and we are not yet at the ever-elusive peak.

— But a peak isn't enough. The rate could plateau. Investors are seeking a deceleration, a slowdown and a much-hoped-for soft landing.

- First, the headline numbers.
- The CPI slowed from 1.2% m/m in March to 0.3% in April, topping the consensus of 0.2%.

  — Year-over-year, the CPI slowed from 8.5% to 8.3%, ahead of the forecast of 8.1%.
- The core CPI, which excludes food and energy, rose 0.6%, ahead of the 0.4% estimate and 0.3% in March. Year-over-year, the core slowed from 6.5% to 6.2% versus a 6.0% estimate.

  — March's big drop in used cars didn't repeat in April.

  — So-called baseline effects are now coming into play.
- The core CPI has been up 0.5%-0.6% per month in six of the last seven months.

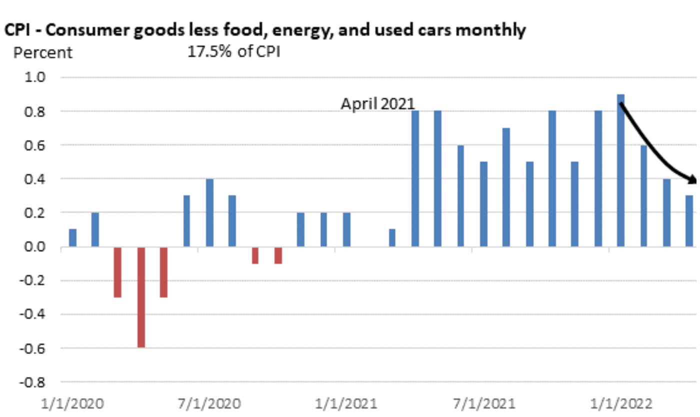
  — It's a plateau.

### The Good News—Consumer Goods

- After peaking in January, inflation in consumer goods outside food, energy and used autos has slowed over the last three months—see Figure 1.
- It's rising an annualized rate greater than 2%, but the slowdown is encouraging.

  —March and April are both below the surge that began April 2021.

**FIGURE 1: SLOPING LOWER**

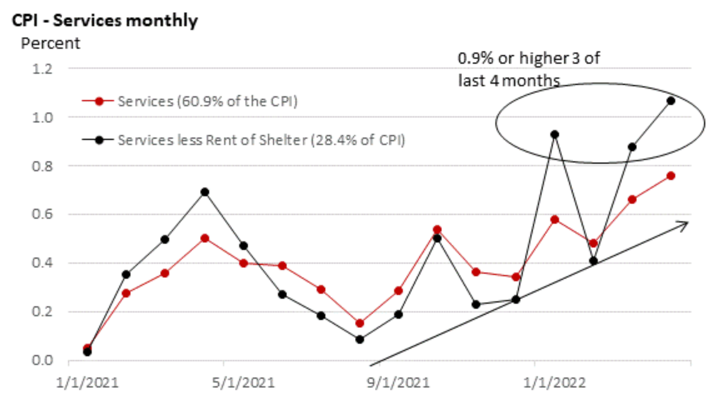



*Source: U.S. BLS April 2022*

### The Bad News—Services

- After temporarily bottoming in August 2021, the rate of inflation for services is accelerating—see Figure 2.
- As the graphic illustrates, rents are playing a role, but inflation in services has broadened beyond rent, which argues against supply-side constraints.

**FIGURE 2: ACCELERATING**




*Source: St. Louis Federal Reserve, U.S. BLS April 2022*

### Other Troubling Numbers

- Food rose 9.4% versus one year ago (Food at home 10.8%, food away from home 7.2%).

  — Food at home is up 1.0%-1.5% per month over the last four months.
- While energy prices fell in April, gasoline touched a new high in May.

  — As of May 16, regular hit a new high of $4.49, according to GasBuddy.
- Natural gas prices are rising. Natural gas is the number one generator of electricity.

## 3. SLOWING MONEY SUPPLY GROWTH

- The Fed dismisses the money supply as an important component of economic growth and inflation, but record growth in 2020 and fast growth last year may be an important factor for the robust economic recovery, which the Fed failed to project, and high inflation.

- During much of 2021, M2 exceeded 10%, well above its historical growth rate of 6.7% -see Figure 3.
- Since February, growth has slowed significantly.
- Monetary policy works with a lag. Continued slow M2 growth would theoretically restrain inflation.

**FIGURE 3: FOLLOW THE MONEY**


*Source: St. Louis Federal Reserve, U.S. BLS April 2022*

## 4. ARE CREDIT CONDITIONS REALLY GETTING TIGHTER?

**Not According to one Important Indicator**

- On April 22, the St. Louis Fed Financial Stress Index fell to -1.45, its lowest weekly reading ever -see Figure 4.

  — The index is comprised of 18 weekly economic indicators that measure stress in the financial system.

  — A reading above zero suggest above average financial stress. A reading below zero suggests below average financial stress.

- The Fed is raising interest rates, and QT will begin in June.
- Currently, financial conditions are encouraging, not restricting, economic activity.

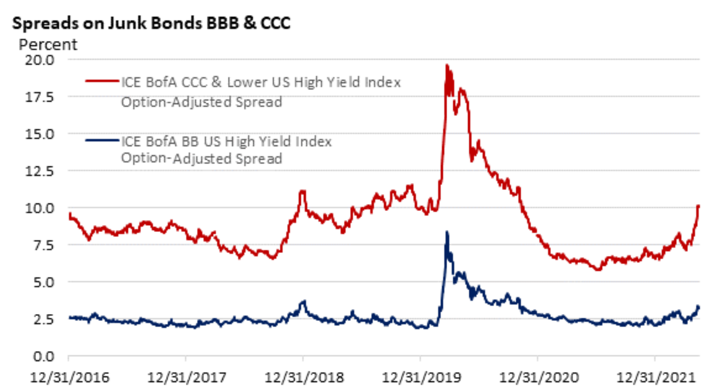
**FIGURE 4: STRESSED OUT**


*Source: St. Louis Federal Reserve, NBER Shaded areas mark recessions, 5/6/2022*

## 5. BUT SPREADS ON THE LOWEST RUNG OF THE LADDER ARE RISING

- CCC bonds are the most speculative and would be the first to react to tighter credit conditions, tighter monetary policy, and any concerns (warranted or not) about a recession.
- Figure 5 illustrates that investors are starting to move away from the lowest quality bonds.
- Spreads are still within a reasonable range, but gathering clouds in the high-yield credit market could eventually put limits on the Fed's hawkish tilt.

**FIGURE 5: TAKING THE TEMPERATURE OF JUNK**




*Source: St. Louis Federal Reserve 5/16/2022*

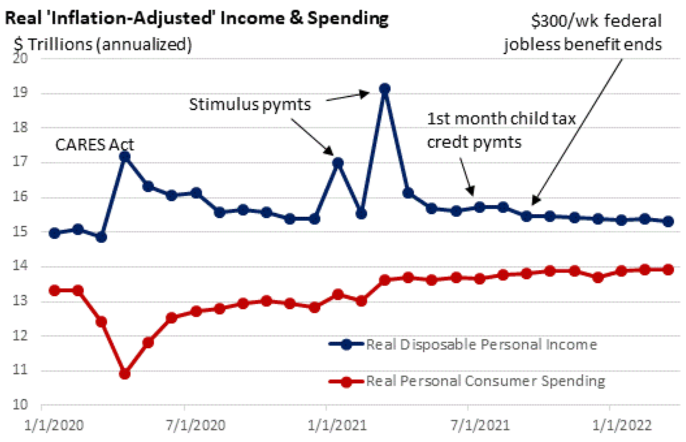
## 6. THE RECESSION ARGUMENT–FALLING REAL INCOME

- Real (inflation-adjusted) consumer spending has been up six of the last eight months including three consecutive increases through March (latest data available).
- But consumers are relying, at least in part, on cash saved from stimulus payments.
- Real disposable income has been down 11 of the last 12 months.

  — Income is up but isn't keeping pace with inflation.

  — Falling real DPI could put the brakes on spending.

**FIG 6: INCOME-FAILURE TO KEEP PACE WITH INFLATION**




*Source: St. Louis Federal Reserve 5/16/2022 St. Louis Federal Reserve March 2022*

- Consumers have cash to spend via stimulus checks in the bank.
- The latest retail sales data for April reflected solid growth and a significant upward revision to March's numbers.

  — In part, higher prices are pushing up sales as retail sales are not adjusted for inflation, but it also appears consumers are tapping savings to fuel higher volume.

- For now, spending patterns have shifted to services, which have grown at a robust inflation-adjusted pace of 0.4%, 0.6%, and 0.6% over the last three months.

  — Real spending on goods is down over the last two months: -0.8% and -0.5% for February and March.

*A peek ahead...*

### Recession Watch

- There has been no shortage of recession talk. The latest Bloomberg survey from May 11 puts the odds of a recession over the next 12 months at 30.0%.
- Too high? Maybe.
- A fed funds rate of 0.75%-1.00% is still stimulative.
- Leading indicators are not pointing to a recession.
- The 10-year/2-year inverted for just two days—it's likely noise—before normalizing.
- The 10-year/3-months has not inverted and is not approaching an inversion.
- The consumer is strong.
- But we aren't without headwinds.
- Higher oil prices are exacerbating inflation and incomes aren't keeping pace.