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The Economic Fundamentals Shift, Stirring the Bears

By Charles Sherry, MSc

The economic fundamentals were very favorable during the 2010s—low-interest rates, low inflation, modest economic growth and rising corporate profits. When the Fed began lifting interest rates, they embarked on a gradual trajectory.

It's not that we didn't see pullbacks. We know stocks don't move higher in a straight line. Corrections, both minor and more unsettling (but temporary), were inevitable; however, the favorable fundamentals guided stocks higher.

Over the last year, however, the fundamentals have shifted dramatically, generating stiff headwinds for equities.

Inflation is stubbornly high, and it is forcing the Fed's hand. Today, the Fed is playing catchup, jettisoning its zero-rate policy and QE in favor of the most aggressive stance in at least 30 years, and possibly the most aggressive since the Volcker days.

You see, higher rates and high inflation work against valuations. In addition, investors fear that rapid price increases and rate hikes could stymie demand and lead to a recession.

While a recession would likely slow inflation, corporate profits would take a hit, too.

On Monday, the S&P 500 Index closed in bear market territory, falling 21.8% from peak to trough. At 651 days, this bull market ranks as the shortest on record, according to Bloomberg News.

But it's unlikely that investors have fully priced in anything but a very mild recession.

What are investors looking for? Well, abating inflation pressures and a soft landing would take pressure off the Fed.

Given the huge number of job openings, the Fed is hoping to slow economic growth and ease pressures on prices without much of a rise in unemployment. But engineering a soft landing won't be an easy needle to thread.

1. Inflation: 1, Federal Reserve: 0

- During Powell's May press conference, he yanked a 75 bp rate hike off the table in favor of 50 bp hikes in June and July.
- But unsettling inflation may prod the Fed to surprise markets at its Wednesday meeting.

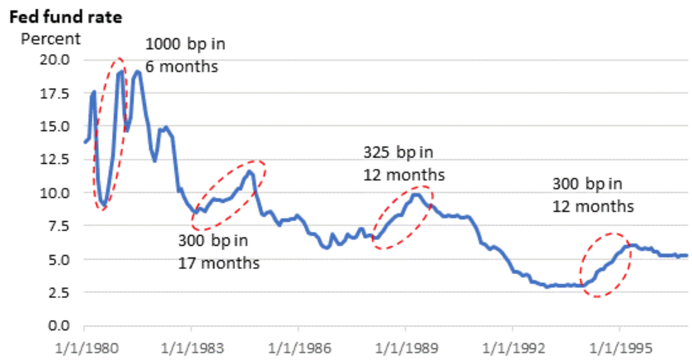
  –At Monday's close, fed funds futures put odds of a 75 bp increase at 26%.

  –Some folks are calling for 100 bp, but the probability is currently at zero.
- Unlike downside surprises, it would be highly unusual for the Fed to surprise with a larger-than-expected rate hike.
- In addition to an aggressive move this month and next, investors are also fretting over a 50 bp increase in September.
- Could we see consecutive 50 bp increases, assuming the Fed goes 50 in June? If so, the speed and magnitude would rival the policy responses of the 1980s.

A peek at history...

- Let's look at aggressive rate-hike cycles over the last 40 years, defined as a series of rate hikes greater than 25 bp.

Figure 1: When the Fed Takes Its Price Mandate Seriously



Source: St. Louis Federal Reserve Nov 1996

- In 1983-84 and 1994, the Fed preemptively moved against inflation and engineered soft landings.

  –Their success led to very favorable outcomes for stocks in 1985 and 1995.
- A late 1980s tightening contributed to the 1990 recession.
- 1980-81 saw then Fed Chief Paul Volcker slam on the monetary breaks with a series of rate hikes totaling 1,000 bp.

  –It led to a steep recession, but it snuffed out double-digit inflation.
- This isn't the mid-1980s or mid-1990s.

  –Today, the Fed is reacting, not preempting.
- But it's not 1980-81 either, which came after a decade of high inflation.

  –The CPI ranged from 3% to nearly 15% during the 1970s to mid-1980.

- In previous articles, I compared today's cycle to 1994—three 50 bp rate hikes and one 75 bp increase. But during 1994, the Fed paused between meetings that followed outsized hikes.

  –Final increase: 5.50%-6.0% in February 1995.

- Today, might the Fed be set to implement four consecutive 50 bp hikes (assuming it forgoes 75 bp in June). If so, the speed and magnitude would rival the preemptive tightening cycles of 1983-84 and the late 1980s.

2. Premature Talk of Peak Inflation

- Led by a 3.9% rise in energy and a 1.2% rise in food, the Consumer Price Index rose 1.0% in May.

  –Food at home is up 1.0% or higher over the last five months.

  –Food at home is up 11.9% y/y.

- The core CPI, which excludes food and energy, rose 0.6%.

- Big disappointment as the CPI and core CPI exceeded expectations of 0.7% and 0.5%, respectively, per Dow Jones Newswires.

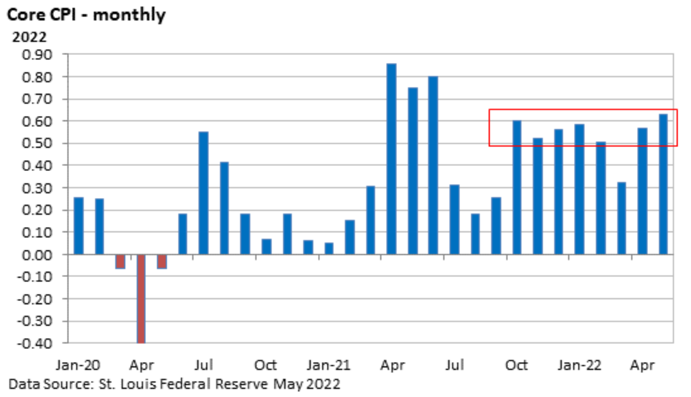
- Annually, the CPI hit a fresh 40-year high of 8.6%, versus 8.3% in April, and the core CPI slowed to 6.0% from 6.2% in April.

  –The slowdown in the core is misleading, as the annual rate stacks up against last year's outsized jump.

- The Fed doesn't have much control over energy unless it throws the economy into a recession. It has little control over food.

- The core CPI has been up between 0.5% and 0.6% per month in seven of the last eight months—no signs of slowing.

Figure 2: Steady Freddy



Source: St. Louis Federal Reserve May 2022

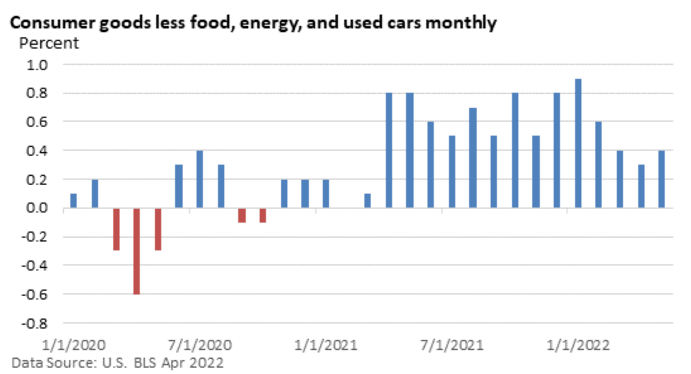
- March's 0.3% rise was primarily a product of a sharp drop in used car prices that month—no repeats.

  –In fact, used vehicles rose 1.8% in May.

- General themes didn't change much over the last month.

- A moderation in consumer goods outside food/energy/used autos is intact.

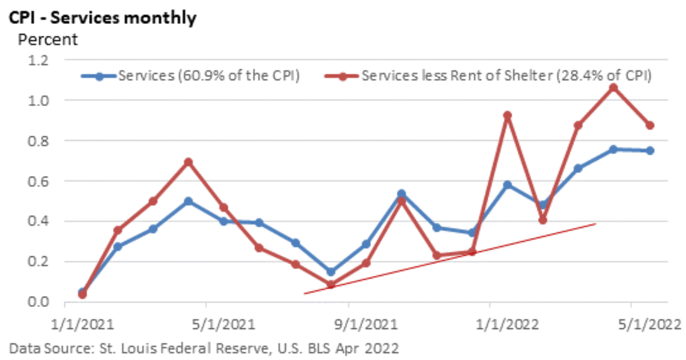
Figure 3: Consumer Goods—The One Bright Light in the Dark



Source: U.S. BLS Apr 2022

- Services, however, remain stubbornly high, with an upward bias.

Figure 4: Services Are Sticky



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

- And food and energy are big problems.

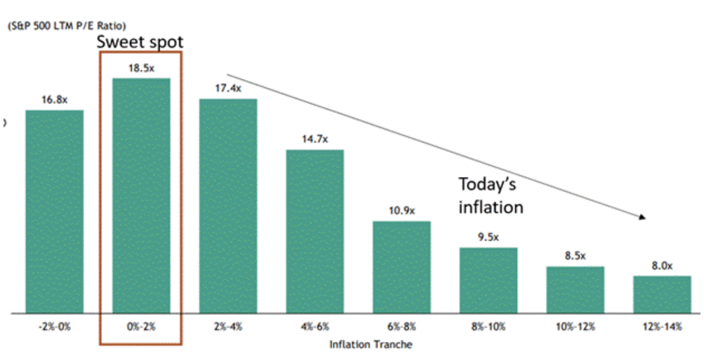
Rays of light

- [Bloomberg News](#) reported signs of moderation may be on the horizon with some relief in semiconductors, the spot rate for shipping containers, and North American fertilizer.
- There are also some favorable indications from the Producer Price Index, but it's still very early. Nascent signs of 'green shoots' on pricing could quickly wither.

3. Inflation and Valuations

- On average, multiples are the highest when inflation is low. Put simply, higher inflation works against valuations.

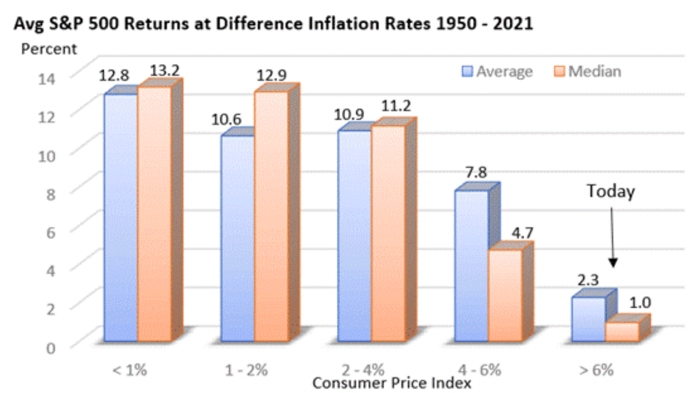
Figure 5: Valuations Sink With Higher InflationAvg S&P 500 P/E ratio by annual CPI tranche, 1950–present



Source: Blackstone: Past performance is no guarantee of future results.

- S&P 500 returns have historically been strong with low inflation, too, but languish when inflation accelerates.

Figure 6: Inflation and Returns



Source: St. Louis Federal Reserve, Yahoo Finance S&P 90 used as a proxy before the modern S&P 500 Index was developed in 1957. The Index cannot be purchased directly. Monthly data are used.
When inflation was below 1% between 1957-2021, the average return was 3.9% and the median return was 9.6%. Past performance is no guarantee of future results.

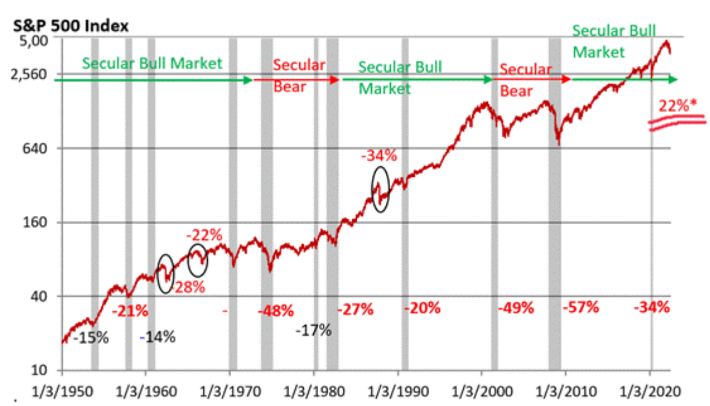
- Clearly, high inflation is a stiff headwind for stocks

4. Bears Wake up for Recessions

- With the exception of the 1987 market crash, we must go back to 1966 when the S&P 500 last slipped into a bear market without a corresponding recession.

  –In 1966, the yield curve briefly inverted and economic growth slowed sharply. Inflation was rising but below 4%.

Figure 7: Bears and Recessions



Source: St. Louis Federal Reserve, Yahoo Finance NBER, 6/13/2022. Shaded areas mark recessions. S&P 90 used as a proxy before the modern S&P 500 Index was developed in 1957.
Past performance is no guarantee of future results.
**Latest bear market through 6/13/2022*

A peek ahead..

Recession watch

- High inflation is leading to sharply higher rates. While the economy is expanding today and job growth is strong, investors are fretting over recession worries.

  –And it's not simply the rising cost of money.

  –Inflation leads to higher prices for goods and services, which could also restrict spending. It's a double whammy of a higher cost for money and a higher cost for goods and services.

  –Note: no one truly knows the neutral fed funds rate where it would neither stimulate not restrict economic growth.

- Real average hourly earnings are down 11 of the last 13 months; therefore, consumers are dipping into savings to finance purchases.

  –The savings rate fell to 4.4% in April, the lowest since 2008.

  –If stimulus cash runs low, spending could face stiffer headwinds, or consumers will be forced to use debt.

  –But the consumer isn't without tailwinds. Debt payment ratios remain very healthy.