PETERSON FINANCIAL SERVICES
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FINANCIAL FOCUS

INFLATION AND INTEREST RATES ARE FRONT AND CENTER FOR MARKET ACTION.

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- Markets are more seriously pricing in Federal Reserve actions to correct their previous inflation blunder and what that means for the depth of the recession.

Third Quarter 2022

October 3, 2022

QUARTERLY MARKET RECAP

The third quarter was a roller coaster ride, with large price swings in the major indexes. As has been the case all year, another new technical uptrend fell apart, making determination of a bottom impossible. Mid-June led to a bottom, with a healthy rise for two months, but that collapsed to a round trip.

Last quarter, the DJIA lost 6.66%, the S&P 500 shed 5.28%, the NASDAQ declined by 5.65%, and the small-cap Russell 2000 dropped 2.53%. Foreign equities fell 6.58%. Various corners of the market fared far worse. The Fed continued its interest rate tightening cycle and grew more hawkish, so the Barclay's Aggregate Bond Index lost another 4.99%. Rate increases will continue into next year. The question is whether the Fed will swing too aggressively in fighting inflation and cause a deeper-than-necessary recession.

The topping of inflation this summer should continue, but while the most recent figures are headed down, it has not been by enough to assuage fears. We are in a recession but what is being priced now is how bad it will be. Pessimism and fear are high, and from a contrarian standpoint, that has historically proven to be positive, but the timing is not reliable. The war in Ukraine has returned as a concern because the Ukrainians are winning and that might lead Putin to make rash choices.

THE FEDERAL RESERVE'S DELAY IN RECOGNIZING INFLATION THAT IS REAL IS MAKING IT MORE PAINFUL

Inflation pressures started appearing at the beginning of 2021, but at the time, the Federal Reserve maintained that was just a "transitory" condition due to emerging from the pandemic and supply chain disruptions, and as a result, it did not warrant attention. But while these may have been contributing factors to these price increases, the core reasons were ill-advised monetary and fiscal policies regarding rates and spending.

President Biden's early-2021 $1.9 trillion additional stimulus on top of the previous trillions, along with too-low rates for too long, flooded the economy with more liquidity than it could absorb, driving up demand and elevating prices. Because the Fed took so long to recognize this, the job of correcting it now is more painful than it needed to be. And, in August, another spending and tax law, given the Orwellian moniker of the "Inflation Reduction Act", along with a massive student loan forgiveness declaration, has added fuel to the fire.

Still, inflation is somewhat self-correcting because as prices rise, consumers cut back on spending, and in some cases, eliminate purchases they otherwise might have made. This decrease in demand, requires that lower prices are needed to flush out built-up supply.

Over the last quarter, we have witnessed this with fuel prices, as a barrel of oil peaked at over $120 in early June and now sits around $83. Prices at the pump have significantly fallen as a result, and continue their downward trajectory. As we explained in last quarter's letter, energy is consumed in every stage of the production and distribution of all goods and services, so this has a ripple effect on every item we buy. These factors have led to a steady, but somewhat slow, decline in year-over-year inflation data during the quarter, as June's 9.1% value fell to 8.5% in July, and further dropped to 8.3% in August. It was this last figure that clipped the summer rally (along with the tax and spending bill's passage), as expectations were for a larger decline to 8.1% and the month-to-month rate rose by 0.1% when it was expected to decline by that much. It will be a couple weeks before we see the September numbers, and they may well reveal continued declines, as aggregate demand is slacking and preliminary wholesale core data indicates continued price declines.

This is important because the Fed has made it abundantly clear that they are solely focused on slaying the inflation dragon, even at the expense of the economy. If inflation continues to moderate at a pace that comforts the Fed it will allow them to reduce the magnitude of further rate increases. For sure, rates will continue to rise into next year, but abandoning 0.75% jumps in favor of 0.50% ones, and eventually 0.25% ones will soothe the market.

But the Federal Reserve has a dual mandate, and the other side of price stability is full employment. They need to be considering that as well, and if they would just say this, these markets would calm down. So far, this is the strangest recession in memory, as employment has remained strong and corporate earnings have held up relatively well. So far. This has given the Fed plenty of leeway in aggressively raising rates. Even during the hyperinflation of the 1970s and early-1980s, there were not three successive 0.75% increases such as we have had this year. As a result, what the market is grappling with now is the distinct possibility that excessive rate increases will kill the economy entirely and a much deeper recession will occur. The Fed would be wise to take stock of the unprecedented level of increases they have already done to see the effect they are having on these metrics.

It is also important to note that this is a global phenomenon as central banks all across the industrialized world are ratcheting up rates aggressively. European inflation is worse than ours. Plus, as the leading central bank, the Fed impacts other nations' monetary situation disproportionately. Many smaller and emerging economies peg their currencies and rates to ours. And, the dollar has appreciated massively against other world currencies. The Euro dropped below parity with the dollar and the British pound sterling is at multi-decade lows, and not far off parity itself. So, what the Fed does needs to be considered in an overall global context because overdoing rate increases can have widespread negative implications. This is another reason why we think the Fed needs to not just automatically raise rates in such large increments at every meeting. Reduce the pace and reflect on the data.

So far, western nations are holding firm against Russia's aggression toward Ukraine. And, European nations are doing so at great cost to their own economic wellbeing as Putin has all but shut off gas supplies to them (a pipeline going through Ukraine is still operational, even though the Nord Stream line is shut down and being sabotaged). They are aggressively stockpiling for the coming winter, and working on permanent supply alternatives that will backfire on Putin in the long run. But that takes time. LNG terminals and alternative pipelines must be built to receive other sources. Delays in retiring nuclear power plants will help, but they should be made permanent and more of them built. We should do the same. Wind and solar are not up to the job and will not be for some decades, if ever, as exclusive sources. Being realistic about this is imperative. But Putin's war is going badly for him, and that could lead him to employ desperate tactics. Time is running out for Russia, so there should be some clarity on this last issue soon.

"The most terrifying words in the English language are: I'm from the government and I'm here to help."

- President Ronald Reagan

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