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Inflation, The Fed, & Midterm Elections

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Stocks had their third consecutive weekly decline as investors continue to digest the implications of hawkish messages from Federal Reserve officials. Last Friday (Aug 26), Fed chair Jerome Powell told investors at Jackson Hole that the Fed is committed to raising rates and fighting inflation until it "gets the job done," and financial markets have struggled to find footing ever since. In addition to September traditionally being a weak month and the upcoming midterm elections, many investors see little upside in stocks because:

- The Fed just told us that the bar is set pretty high before they back off their aggressive stance on interest rates
- Inflation needs to make considerable progress towards the 2% range (2% is what the Fed considers a "neutral" rate of inflation)
- Labor markets are still tight, so further economic slowing is needed
- Europe is about to enter a recession
- China still implementing zero-COVID policy, potentially affecting supply chains
- Russia causing problems with global energy supplies

This is a considerable list of concerns, and we are not blind to these issues. But the first three (above) are what matters most to US markets – the Fed, inflation and slowing economic growth. Given this list of worries, one might wonder how we maintain our positive outlook for the second half of 2022. Here is some insight into our perspective, which would seem to run counter to consensus:

- Many leading indicators continue to point to deflation/disinflation – over 40% of the components that make up CPI (Consumer Price Index) have declined from their recent highs
- US corporations remain impressively resilient, emerging from the global pandemic more efficiently and with better cost discipline
- US corporations are weathering the inflation surge impressively
- The US economy has managed to absorb rapid Fed rate hikes thus far
- Labor issues are improving, evidenced by Friday's jobs report showing an increase in the participation rate
- Investor sentiment remains near rock bottom – worse than the Great Financial Crisis by many metrics
- Drop in energy, housing and commodity markets are supportive of the lower inflation outlook. Remember, many expected oil to hit $140 (per barrel) this summer yet it is currently at $86, even below pre-Russia/Ukraine levels
- Last week's ISM manufacturing prices paid index fell to the lowest levels of the year, in-line with pre-pandemic figures

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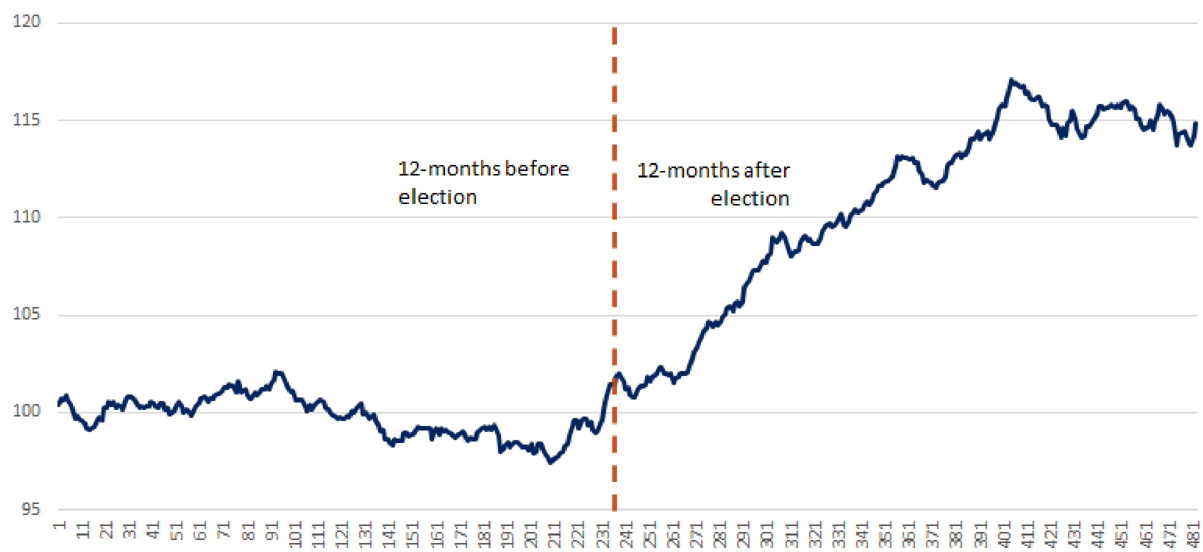
In other words, there are many counterpoints that suggest inflation could fall faster than consensus expects. This, of course, would mean that the market is doing the Fed's work and the Fed could do far less tightening (rate hikes) than most expect. If inflation continues to moderate through year-end, then the Fed is more likely to pause its rate hikes and assess the impact on the economy and inflation. A Fed pause will be welcome by markets as a sign of easing financial conditions ahead.

There is another reason for the positive outlook for the remainder of 2022 and that has to do with the upcoming midterm elections, which will be held on Tuesday, November 8th this year. In the 12 months prior to election day, market performance has historically been muted at best and can be volatile, much like this year. However, in the year after midterms, market returns have averaged over 16%, regardless of which party is in power:

Stock Performance Before & After Mid-Term Elections (S&P 500, since 1930)



Source: FactSet. Past performance does not guarantee future results. Market indexes are unmanaged and cannot be invested into directly.

As a matter of fact, the S&P 500 has produced positive returns in every 12-month period after a midterm election since 1940. And this includes the horrible inflationary era of the late 1960s and 1970s. As per usual, past performance does not guarantee future results, but history seems to be on the side of markets in midterm years.

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With summer nearing an end, investors will remain keenly focused on the big 3 – the Fed, Inflation, and the US Economy. And there will be plenty of opportunity to do so with four CPI inflation readings and three Fed meetings on tap for the remainder of 2022. In our view, signs point to peak inflation being behind us while the U.S. economy remains healthy and has some cushion to absorb the ongoing interest rate increases. While we expect some softening in the economy, we do not share the view of many expecting a deep or prolonged downturn in the U.S. There will be a lot of data to digest in the coming months and we will be certain to keep you updated every step of the way.