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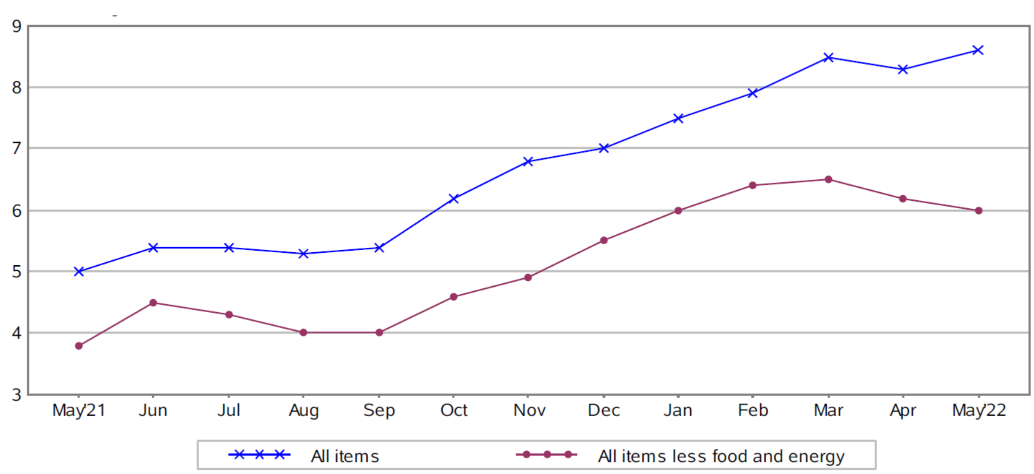
Inflation and Current Environment

Last week's inflation numbers were a big upside print (+1% for month, +8.6% year/year), and instead of a continuation of some lower trend numbers in April, May reversed course. Markets responded predictably to the news on inflation. Bonds priced in higher yields in anticipation of the Federal Reserve needing to tighten more than was discounted. Short term interest rates rose the most, 25 basis points on the short end (about double the 10-year increase). Equity markets also responded negatively, and now have dropped into bear market (-20%) territory for the year.

Looking at the data (in the rearview mirror):

- The largest increases in the month were energy and food related (energy up +3.9% for the month, driven by gas up +4.1% for month and +34.6% year/year and food +1.2% for month and +10% year/year). In and of itself these numbers are tough given that food and energy are core (pun intended) expenses for consumers. What is driving it? The continuation of issues we have written about pretty much all year. Supply, war, and cost flow throughs.
- Several trend reversals, like used cars and new cars, caused part of the one month increase and these could reverse right back. The PCE data (which includes substitution effects) are still showing a slowdown in the trend pricing for autos, we will get updates on PCE in late June.
- Although positive in the month, goods overall continue to show a trend to the downside as COVID purchasing mitigates. Services are showing larger increases. Some of this is the "getting back to normal" including airlines chock full of wanderlust travelers heading back out.
- Rents, an area we have continued to say we were concerned about, came in hot, much to our chagrin. As interest rate increases impact home buyers, this is an area that could be sticky.

12 month percentage change in CPI for All Urban Consumers (CPI-U), not seasonally adjusted



Source: Bureau of Labor Statistics

There has been some softening in real wages and if that continues, in tandem with high food and energy prices could lead to an unsustainable environment. Who of you has not gone to the grocery store and substituted for cheaper items? Who has not thought twice about getting in the car and running that one errand? We have seen indications of the inflationary effects on income and spending with increases in both consumer debt and a slow-down in mortgage applications. We have seen indications of margin pressures with first quarter earnings reports.

The Federal Reserve is committed to slowing inflation, so something must give. That something is likely the economy, meaning we get a slowdown in growth. As we have said in prior communications, how slow is still the question.

All in all, let's not get too concerned about one month. The markets year to date have adjusted to the change in the discount rate and are now pricing in deceleration of earnings. This often is seen as the second leg of a bear market, and as mentioned we have now entered bear market territory. It is important to remember that bear markets are normal, especially after three years of double-digit positive equity markets. Markets do go back up. As you can see in the table below, history shows us that, one year ahead (post a bear market), markets are most often up, by double digits. The big exceptions were crisis environments of 1973 and 2008. We don't think the current environment is a crisis environment, we think it resembles a bear market.

Date Bear Market Became Official	Subsequent S&P 500 Price Return					
	1 day	1 week	1 month	6 months	1 year	3 year
21 October 1957	0%	3%	2%	9%	31%	39%
28 May 1962	5%	4%	-5%	11%	26%	59%
29 August 1966	2%	3%	3%	18%	25%	26%
29 January 1970	-1%	0%	5%	-9%	11%	36%
27 November 1973	2%	-2%	2%	-9%	-28%	7%
22 February 1982	0%	2%	2%	1%	32%	63%
19 October 1987	5%	1%	8%	15%	23%	35%
12 March 2001	1%	-1%	-1%	-7%	-1%	-5%
09 July 2008	1%	0%	2%	-27%	-29%	8%
12 March 2020	9%	-3%	11%	35%	59%	?
13 June 2022	?	?	?	?	?	?
Average	**2%**	**1%**	**3%**	**4%**	**15%**	**30%**

Source: S&P Dow Jones Indices. Data as of June 13, 2022. Table is provided for illustrative purposes only. Past performance is no guarantee of future results. Sign up at bit.ly/spdjidd to receive index insights.

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