Legacy Trust

# Investment Perspectives

## Inflation, FOMC, and the Path Forward

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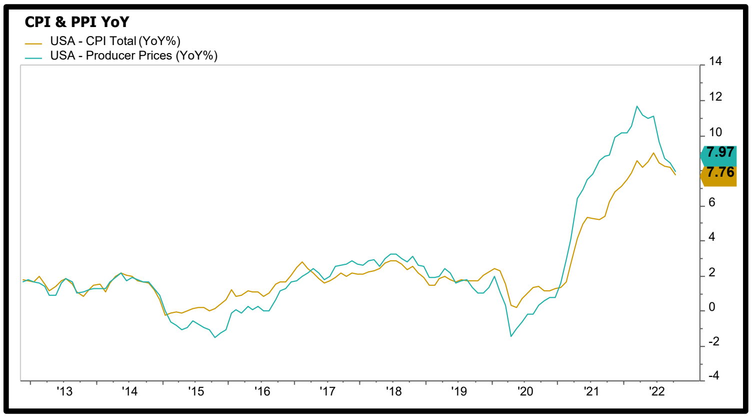
**Key Takeaways**

- U.S. Equity and Fixed Income market returns have been driven by inflation measured by the Consumer Price Index (CPI) and Producer Price Index (PPI).
- The Fed has front-loaded interest rate hikes in an effort to stabilize prices. The Upper Bound of the Fed Funds rate has gone from 0.25% to 4.00% in just nine months.
- The final FOMC meeting of the year is December 13th-14th. Policy makers will get November CPI and PPI data prior to the meeting. Investors will be focused on the magnitude of the rate hike, commentary from Powell, and the release of the dot plot.

October inflation data came in softer than expected, triggering a rally in equity and fixed income markets as investors hope that peak inflation is in the past. As the Fed tries to tame inflation without causing recession, all eyes will be on November inflation data and the final FOMC meeting of 2022 on December 13th and 14th. The magnitude of the rate hike and supplementary commentary from Fed Chair Powell will drive investor sentiment and returns into the new year.

**U.S. Equity and Fixed Income market returns have been driven by inflation measured by the Consumer Price Index (CPI) and Producer Price Index (PPI) :** Sentiment and market direction have largely been driven by inflation data and the resulting action and commentary from the Federal Reserve. This is a simplistic view of market action given there are still other overhangs contributing to YTD performance (geopolitics, China growth, Covid, just to name a few). However, one needs only to look at the correlation between U.S. Equity and Fixed Income returns YTD to see that the primary driver of performance has been the Fed's aggressive path of rate hikes coupled with hawkish messaging after an extended period of overly accommodative monetary policy. Going forward, investors will remain preoccupied with inflation data and look for clues from Fed Chair Powell about when rate hikes might moderate in magnitude or slow to a stop.

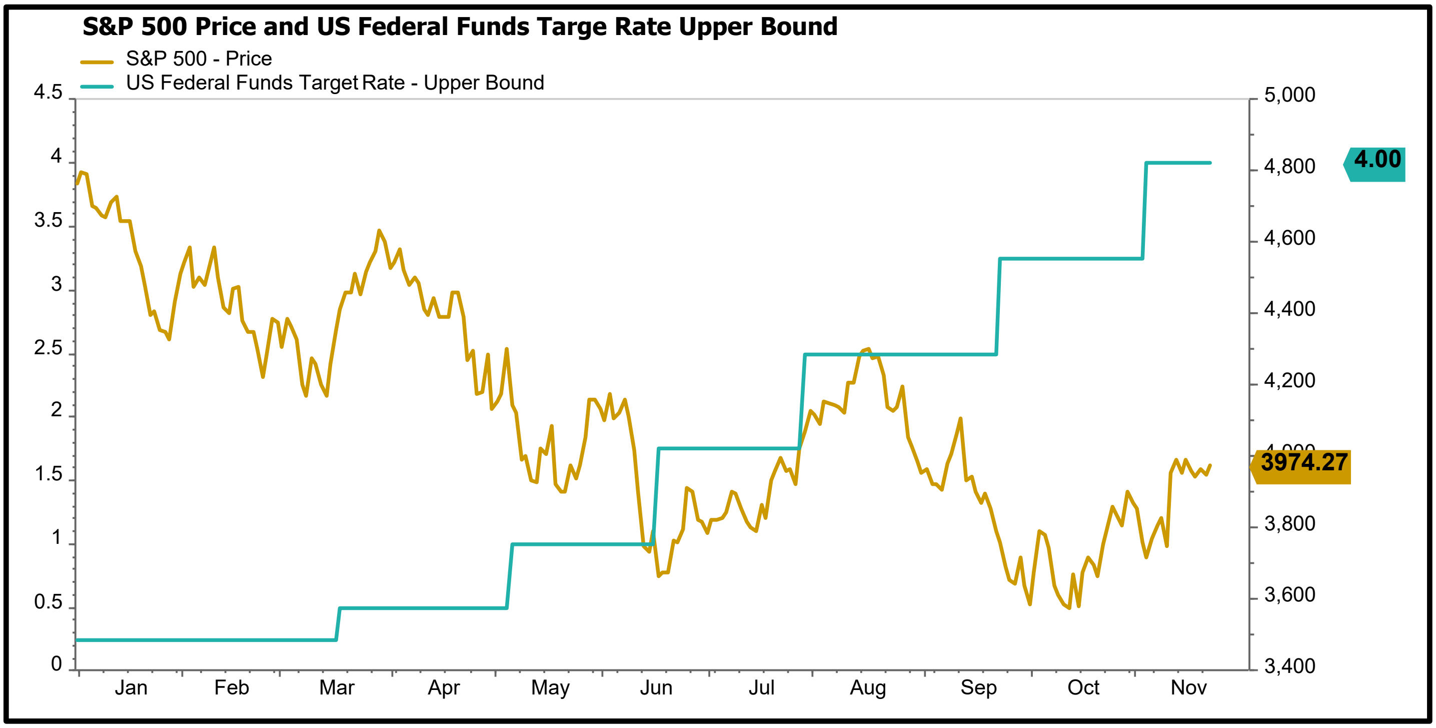
**Fed's dual mandate becomes a sole mandate- slow inflation first, worry about full employment later :** After initially viewing spiking inflation in 2H 2021 as "transitory", attributing rising prices to pandemic-driven dislocations, inflationary pressures began to look more persistent as 2021 came to a close. Rhetoric quickly changed as Powell was forced to act and hiked rates 25bp in March of 2022 and an additional 50bp in May. As labor markets remained overheated and wage inflation took hold, inflationary pressures continued to look stickier. The following four meetings through November 2nd saw four 75bp hikes bringing the Fed Funds Target Rate upper bound to 4.00% in an effort to front-load hikes and stabilize prices.




**Understanding which components contributed most to the CPI can help investors understand what might happen next:** Investors should consider the underlying source of the headline inflation print and think critically about pricing trends by segment in order to make an educated guess about what the future may hold.

CPI Categories by Weight: Housing 32.5%, Commodities 21.3%, Food 13.6%, Energy 8.2%, Health Care 6.9%, Transportation 5.9%, Education 5.3%, Other 6.3%.

Each category within CPI breaks down into many subcategories. For a moment, let's focus on Housing, both because it carries the largest weighting in the measurement of CPI and because it has intricacies in how it's measured by the US Bureau of Labor Statistics. Housing at 32.5% is broken down further with 7.4pp of the total coming from 'Rent of Primary Residence', 0.9pp from




Source: FactSet Research Systems

'Lodging Away from Home', and 24.2pp from 'Owners' Equivalent Rent of Residences' (OER). OER is the hypothetical rent homeowners would pay if they weren't homeowners. Essentially, OER is determined through surveys asking homeowners "If someone were to rent your house today, how much do you think it would rent for monthly, unfurnished and without utilities?".

One can imagine that problems can arise when nearly a quarter of the measurement of CPI comes from such an imprecise method. OER tends to be stickier than market-based rental pricing meaning that as real estate markets began to overheat, OER didn't sound the alarms to the Fed that it should have.

As other categories within CPI like Food and Commodities began to show double digit increases, the contribution from Housing remained relatively muted, likely due to reliance on OER.

**The final FOMC meeting of the year is December 13th-14th. Investors will be focused on the magnitude of the rate hike, commentary from Powell, and the release of the dot plot. What investors glean from the December meeting will set the stage for the environment heading into 2023.**

Demand destruction has begun to flow through the economy, and it has shown in the October CPI (+7.7% vs +8.0% expected) and PPI (+8.0% vs +8.3% expected) reports in November. The day CPI was released, the S&P 500 rallied +5.5% and the Nasdaq +7.5% as investors thought peak inflation may be in the past. Still, the Fed has made it clear that one month of encouraging data does not mean inflation has been sufficiently dealt with.

We'll get another round of inflation data before the Fed meets for its final meeting of the year on December 13th and 14th. November PPI data will be reported December 9th and November CPI on December 13th.

In response to the on-going demand destruction and cooling wage growth, interest rate futures are pricing for an 71% chance for a 50bp hike in December (vs 29% for 75bp) followed by three 25bp hikes in 2023, leaving the terminal rate at 5.25%. Should the inflation readings come in hotter than expected leading up to the December meeting, the Fed may be tempted to elect for a 5th consecutive 75bp increase.

| | Seasonally adjusted changes from preceding month | | | | | | | Un-adjusted 12-mos. ended Oct. 2022 |
|---|---|---|---|---|---|---|---|---|
| | Apr. 2022 | May 2022 | Jun. 2022 | Jul. 2022 | Aug. 2022 | Sep. 2022 | Oct. 2022 | |
| All items | 0.3 | 1.0 | 1.3 | 0.0 | 0.1 | 0.4 | 0.4 | 7.7 |
| Food | 0.9 | 1.2 | 1.0 | 1.1 | 0.8 | 0.8 | 0.6 | 10.9 |
| Food at home | 1.0 | 1.4 | 1.0 | 1.3 | 0.7 | 0.7 | 0.4 | 12.4 |
| Food away from home(1) | 0.6 | 0.7 | 0.9 | 0.7 | 0.9 | 0.9 | 0.9 | 8.6 |
| Energy | -2.7 | 3.9 | 7.5 | -4.6 | -5.0 | -2.1 | 1.8 | 17.6 |
| Energy commodities | -5.4 | 4.5 | 10.4 | -7.6 | -10.1 | -4.7 | 4.4 | 19.3 |
| Gasoline (all types) | -6.1 | 4.1 | 11.2 | -7.7 | -10.6 | -4.9 | 4.0 | 17.5 |
| Fuel oil(1) | 2.7 | 16.9 | -1.2 | -11.0 | -5.9 | -2.7 | 19.8 | 68.5 |
| Energy services | 1.3 | 3.0 | 3.5 | 0.1 | 2.1 | 1.1 | -1.2 | 15.6 |
| Electricity | 0.7 | 1.3 | 1.7 | 1.6 | 1.5 | 0.4 | 0.1 | 14.1 |
| Utility (piped) gas service | 3.1 | 8.0 | 8.2 | -3.6 | 3.5 | 2.9 | -4.6 | 20.0 |
| All items less food and energy | 0.6 | 0.6 | 0.7 | 0.3 | 0.6 | 0.6 | 0.3 | 6.3 |
| Commodities less food and energy commodities | 0.2 | 0.7 | 0.8 | 0.2 | 0.5 | 0.0 | -0.4 | 5.1 |
| New vehicles | 1.1 | 1.0 | 0.7 | 0.6 | 0.8 | 0.7 | 0.4 | 8.4 |
| Used cars and trucks | -0.4 | 1.8 | 1.6 | -0.4 | -0.1 | -1.1 | -2.4 | 2.0 |
| Apparel | -0.8 | 0.7 | 0.8 | -0.1 | 0.2 | -0.3 | -0.7 | 4.1 |
| Medical care commodities(1) | 0.1 | 0.3 | 0.4 | 0.6 | 0.2 | -0.1 | 0.0 | 3.1 |
| Services less energy services | 0.7 | 0.6 | 0.7 | 0.4 | 0.6 | 0.8 | 0.5 | 6.7 |
| Shelter | 0.5 | 0.6 | 0.6 | 0.5 | 0.7 | 0.7 | 0.8 | 6.9 |
| Transportation services | 3.1 | 1.3 | 2.1 | -0.5 | 0.5 | 1.9 | 0.8 | 15.2 |
| Medical care services | 0.5 | 0.4 | 0.7 | 0.4 | 0.8 | 1.0 | -0.6 | 5.4 |

Source: US Bureau of Labor Statistics