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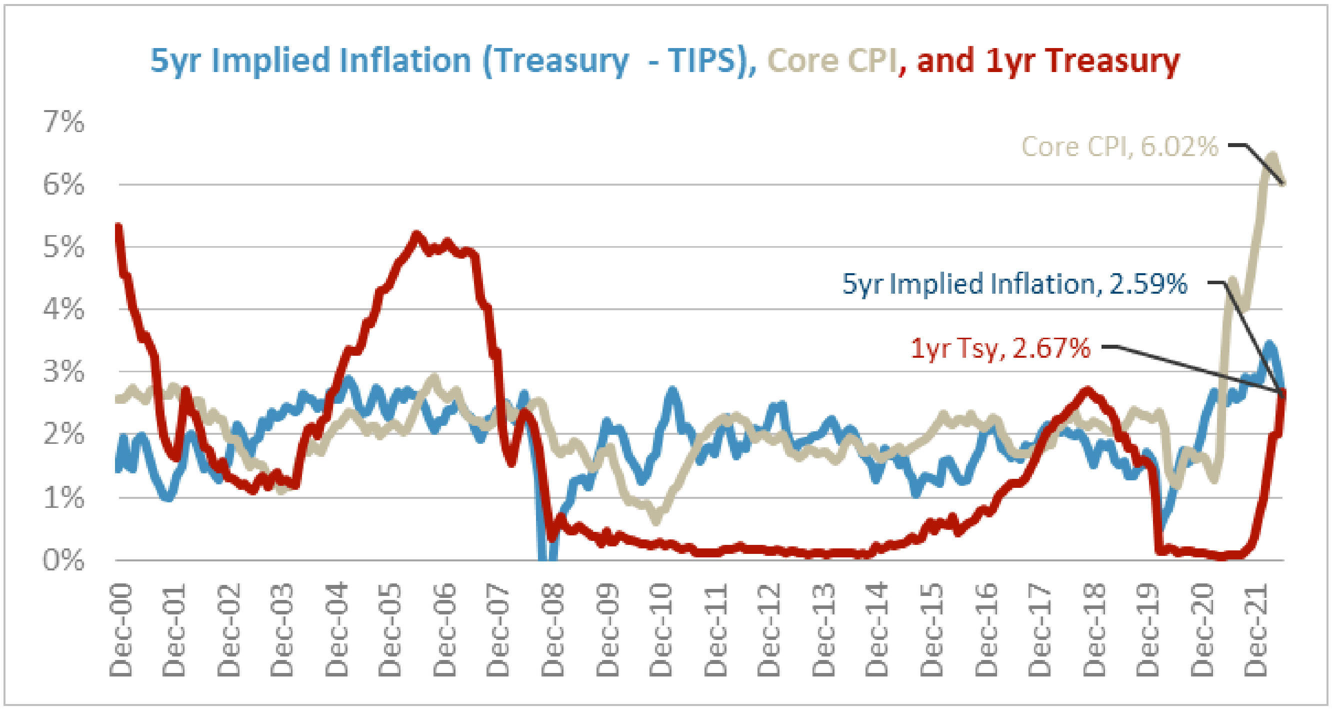
2022 Outlook Theme #1: Monetary Policy is Fed Up with Inflation

Benjamin B. Wallace, CFA – Portfolio Manager, Research Director

The Fed's accelerating rate hike timetable in response to the persistence of inflation has been the major market driver in 2022. As discussed in **3/31/22 Update Theme #1: Recurring Transitory Issues**, the Russian invasion of Ukraine and the resulting jump in oil prices has kept inflation in the markets focus, while China's zero-Covid policy has kept global supply chains under pressure. During Q2, as expected, the Federal Reserve continued to contend with inflation. Somewhat unexpectedly though, the May CPI report (reported on 6/10), showed a strong enough reading that it prompted the Fed to speed its pace of rate increases, and a 75 bps rate increase at the Fed's June 15th meeting. The overall shift in rhetoric from the Fed for further rate hikes weighed on the market in Q2.



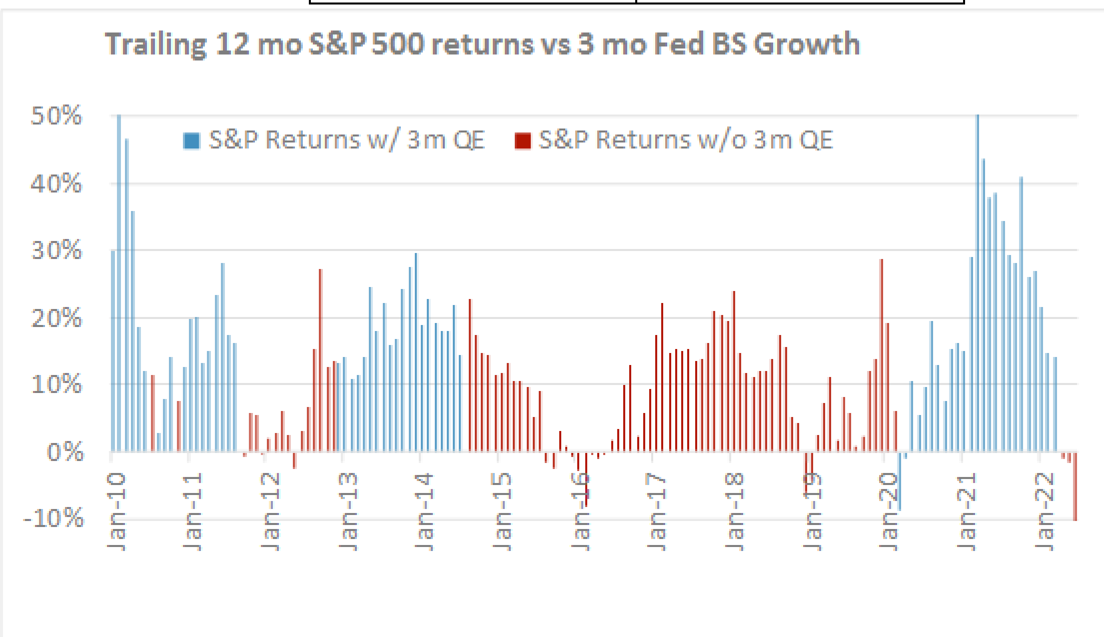
The chart shows Core CPI, implied inflation (from TIPS), and the 1 year Treasury yield (as a proxy for Fed policy). First, Core CPI initially jumped on factors that the Fed defined as transitory and the market, as shown by TIPS implied inflation, agreed. However, the second jump in Core CPI and implied inflation breaking above 3% at the end of Q1 (due to Russia's invasion of Ukraine), prompted a shift in Fed policy. This shift is evident in the 1yr Treasury. It has jumped from 0% to over 2.5%, in just six months. The prior rate hike cycle took 4 years, from 2014 to 2018. Before that, the 2003 to 2005 cycle took nearly three years to move by a similar amount. The point being that Fed expectations have shifted rapidly.

Entering Q2, core CPI had just reached 6.4% and implied inflation crossed above 3%, reaching 3.4%. Ironically, despite strong CPI readings and the overall market focus on inflation, Core CPI has tipped lower (now 6.02%) and implied inflation has come down from its spike higher, back to 2.59%. Meanwhile The Fed's accelerated pace of rate increases has pushed the 1 yr Treasury to 2.67% by the end of Q2, and it has rapidly converged with implied inflation expectations. In fact, the two are highly related. Precisely because of the Fed's accelerated commitment to slowing inflation, the markets have responded by lowering their expectations of how high inflation will get.

This is also reflected further out the yield curve. The 10yr Treasury continued to rise in Q2, reaching as high as 3.48% on 6/14, though closing the year just below 3%, at 2.97%. The peak date is notable: it was the day before the Fed raised rates 75 bps. Just as the 1yr Treasury converging with implied inflation shows how rising rates impact market inflation expectations, the Fed's faster pace of rate hikes, somewhat counterintuitively, caused longer term rates to fall, as markets began to price the potential for the Fed's moves to slow inflation and/or slow the economy. It is this latter point that the market is thinking about as we enter Q2.

While rate hikes get a lot of Fed coverage, the other policy the Fed has been adjusting is its balance sheet. The process of buying bonds and adding to its holdings was known as Quantitative Easing, or QE. As of March, it has shifted to allowing its holdings to run off at maturing (shrinking its balance sheet), ramping up to $95B per month.

	Rolling 12m S&P		Rolling 3m S&P	
	QE	No QE	QE	No QE
Average	20%	9%	3.5%	1.9%
Periods	87	63	87	63
Negative	7	11	21	18
% Negative	8%	17%	24%	29%



QE supported asset prices. As the chart and table shows, periods with QE have 20% average 12 month returns, compared to 9% without it. And anecdotally from the chart, 2016 (QE taper) and late 2018 (the only other period of QT) are the two periods when the Fed slowed QE, and both were rocky markets. This is illustrated by the "% Negative" calculation, which is the percentage of periods when returns were below zero. For rolling 12-month periods, it goes from 8% during QE periods, to 17% in non-QE periods. QE has afforded markets a smooth ride since it was restarted in April 2020, despite the ongoing volatility in the economic numbers.

The Fed has just started QT, but the balance sheet is already declining on a three month basis, and for the three recent periods on the chart, the bars are red and negative. The QE to QT shift is clearly impacting asset prices.

Inflation has remained elevated longer than expected, as the impact of the Russian invasion of Ukraine has pushed oil prices higher and China's Zero-Covid policies have kept inflation pressures in place. The has prompted the Fed to raise rates faster than expected which, along with starting QT, has broadly impacted asset prices. Thus, *Monetary Policy is Fed Up with Inflation*.

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-The Standard & Poor's 500 is a market capitalization weighted index of 500 widely held domestic stocks often used as a proxy for the U.S. stock market. The Standard & Poor's 400 is a market capitalization weighted index of 400 mid cap domestic stocks. The Standard & Poor's 600 is a market capitalization weighted index of 600 small cap domestic stocks.

-The NASDAQ Composite Index measures the performance of all issues listed in the NASDAQ stock market, except for rights, warrants, units, and convertible debentures.

-The MSCI EAFE Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada. The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of 21 emerging markets. The MSCI All Country World Index is a free float adjusted market capitalization index designed to measure the performance of large and mid and cap stocks in 23 developed markets and 24 emerging markets. With over 2,800 constituents it represents over 85% of the global equity market.

-The Barlcays Aggregate Index represents the total return performance (price change and income) of the US bond market, including Government, Agency, Mortgage and Corporate debt.

-The BofA Merrill Lynch Investment Grade and High Yield Indices are compiled by Bank of America / Merrill Lynch from the TRACE bond pricing service and intended to represent the total return performance (price change and income) of investment grade and high yield bonds.

-The S&P/LSTA U.S. Leveraged Loan 100 is designed to reflect the largest facilities in the leveraged loan market. It mirrors the market-weighted performance of the largest institutional leveraged loans based upon market weightings, spreads and interest payments.

-The S&P Municipal Bond Index is a broad, comprehensive, market value-weighted index. The S&P Municipal Bond Index constituents undergo a monthly review and rebalancing, in order to ensure that the Index remains current, while avoiding excessive turnover. The Index is rules based, although the Index Committee reserves the right to exercise discretion, when necessary.

-The BofA Merrill Lynch US Emerging Markets External Sovereign Index tracks the performance of US dollar emerging markets sovereign debt publicly issued in the US and eurobond markets.

-The HFRI Fund of Funds index is compiled by the Hedge Funds Research Institute and is intended to represent the total return performance of the entire hedge fund universe.