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Investment Institute

Market Commentary

Weekly perspective on current market sentiment **August 16, 2023**

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Last week's S&P 500 Index: -0.3%

Inflation matters

Key takeaways

- Many consumers and investors have trouble coming to grips with the concept of "topline" versus "core" inflation and why our central bankers are so highly focused on one and not the other.
- We believe the financial markets are underestimating the negative impact that higher rates will have on economic growth and corporate earnings.

Our elected officials and central bankers are often concerned when inflation is high and costs are on the rise. When their constituents are forced to pay higher prices for items they use every day like gasoline and food, legislators typically make an attempt to get to the bottom of what is causing the problem. Central bankers, on the other hand, tend to be trained economists who pay more attention to inflationary components that monetary policy can at least somewhat influence. Supply relative to demand is their key consideration.

Many consumers and investors have trouble coming to grips with the concept of "topline" versus "core" inflation and why our central bankers are so highly focused on one and not the other. Recall that the Federal Reserve (Fed) targets core inflation when setting longer-term goals. Core inflation excludes the effects of food and energy. The natural question is, why would the Fed not be more focused on rising cost pressures of items we all use every day? The reason is that monetary policy generally has little effect on food prices as people are going to eat whether the economy is good or bad. Plus, food prices like grains are largely tied to weather patterns, something Fed policy can't influence. Energy can also be a weather market. Think hurricanes knocking out oil and gas production. In addition, Organization of the Petroleum Exporting Countries (OPEC) cartel production decisions heavily influence oil prices.

How the Fed addresses inflation affects the financial markets. With its inflation goal of 2% over the long term, our U.S. central bankers adjust rates in an effort to influence demand. With inflation currently well above the long-term target, the Fed is hiking rates to slow the economy by cooling demand. A slower economy and easing demand typically result in less earnings for businesses. Stocks trade on earnings over the long haul. Investors know that when the Fed wants borrowing and spending to cost more, growth likely will eventually suffer in our credit-driven economy. That typically leads to headwinds for the equity market. For example, the current quarter looks set to post a third straight quarter of earnings contraction. That is why we focus on sectors where valuations and long-term revenue prospects look attractive.

Bonds also trade off of anticipated growth and inflation. A higher-for-longer inflation environment would typically be reflected by higher yields. The 10-year Treasury security is a good example. Yields have risen as the economy has continued to grow and core inflation remains "sticky." However, we anticipate that at some point over the next 18 months, growth, inflation, and yields will ease as the economy slips into recession. We currently favor adding fixed-income exposure to portfolios to lock in longer-term yields.

Inflation matters. We believe the financial markets are underestimating the negative impact that higher rates will have on economic growth and corporate earnings.

Risk considerations

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