Great-West Investments Capital Markets Perspective

Week in Review: June 12th – 19th

INDEX/ SECURITY	ASSET CLASS	LEVEL (CLOSE)	% CHANGE (THROUGH FRIDAY'S CLOSE) 1 WK.	YTD	INDEX/ SECURITY	ASSET CLASS	LEVEL (CLOSE)	% CHANGE (THROUGH FRIDAY'S CLOSE) 1 WK.	YTD
Dow Industrials	Lg. Cap Eq.	29,888.78	-4.79%	-17.75%	FTSE 100	UK Equity	7,016.25	-4.12%	-4.99%
S&P 500®	Lg. Cap Eq.	3,674.84	-5.79%	-22.90%	Nikkei 225	Japan Equity	25,963.00	-6.69%	-9.82%
NASDAQ Comp.	US Equity	10,798.35	-4.78%	-30.98%	EEM:US	Emkt. Equity	$39.67	-3.55%	-18.79%
S&P Midcap 400©	Mid-Cap Equity	2,220.49	-7.60%	-21.87%	EFA:US	Non-US Equity	$61.48	-4.96%	-21.86%
Russell 2000®	Sm. Cap Eq.	1,665.69	-7.48%	-25.81%	UST 10y (yield)	US Treasury	3.23%	+0.07%	+1.72%
Stoxx 50	Europe Eq.	3,438.46	-4.47%	-20.01%	B/Barc AGG	Fixed Inc.	2,084.80	-0.92%	-11.48%

Past performance is not a guarantee of future results. Investing involves risk, including possible loss of principal.

Easy math.

I've been out of the office (and pretty much off the grid) for two weeks. Based on a chance conversation early last week with a fellow traveler who just happened to manage a long/short strategy, I was vaguely aware that volatility had spiked in a pretty big way, but for the most part I was blissfully (and deliberately) unaware of what was actually going on. So you can understand that when I plugged back in this weekend, I was worried that I might have a whole lot of catching up to do if I had any hope of getting this week's market commentary out before midnight.

Turns out that that fear was misplaced, because even though last week represented maybe the worst week for stocks during the post-pandemic recovery, the paper trail is pretty easy to follow: the trouble started a little over a week ago on June 10th when the Bureau of Labor Statistics hit the market with a big stink-bomb in the form of a **higher-than-expected consumer price index (CPI) release.**[1] That was followed the same day by an equally stinky consumer sentiment release from the **University of Michigan**[2] (note to self: **it's never a good thing when the phrase "reaching its lowest recorded value" appears in a survey that spans more than five decades**.)

Old news, right? You would think so, but **all this inflation and consumer angst about it still seemed to catch the market a little off guard**. Sure, stocks were a little rough and rates moved up a little bit into the weekend in response to the CPI release, but the selling appears to have been fairly orderly, and you really had to wait until last week for the fun to *really* start. That's because **as we started last week, markets were still mostly taking the Fed at its word that it would boost rates by only half a percent during its meeting** on June 14-15 – something that had been part of Fed orthodoxy for weeks.

But something changed on the way to ball, as the saying goes. On Tuesday, rates traders suddenly made a 0.75% increase by the Fed their overwhelming base-case, with the futures-**implied probability of a three-quarter point**

[1] https://www.bls.gov/news.release/cpi.nr0.htm
[2] http://www.sca.isr.umich.edu/

increase by the Fed rising from less than 5% during the previous week to more than 95% by the time the dust settled on Tuesday[3], the day before Powell and his pals were scheduled to announce their decision.

A discouraging producer price index (PPI) report released on that day probably deserves some of the blame, and it's easy to imagine that a few of those investors who were skeptical that the previous week's CPI report was anything to worry about suddenly giving in to fear after the BLS reported that producers, too, were still feeling the sting of higher prices[4]. **But that probably doesn't explain the wholesale re-rating of Fed expectations that occurred last Tuesday**, not least of which because Tuesday's PPI report was a lot closer to consensus expectations that the previous Friday's CPI release. So for a full explanation of why the market suddenly broke in favor of a 0.75% increase, you have to look elsewhere: specifically, into what seems to have been **a reasonably well-coordinated effort in the press to suddenly reset expectations** away from 0.50% and toward 0.75%.

I realize that the phrase "reasonably well-coordinated effort by the press" puts me uncomfortably close to tin-foil hat territory, but the precipitating event seems to have been **an article by the *Wall Street Journal* suggesting that the Fed had been backed into a corner** by the twin CPI and PPI reports and would probably have to consider a three-quarter point boost – its first since the mid-1990s – to beat back inflation.[5] Other media outlets repeated the suggestion in eerily similar tones, and by the end of the day, voilà – expectations about Wednesday's Fed decision were reset.

Putting aside conspiracy theories (and a thorny discussion of how a Fed that has been hyper-focused on communicating its intentions gets the word out during its self-imposed pre-FOMC "blackout period",) the strategy – if that's what it was – seemed to work**. On Wednesday, the Fed made good on those newly-reset expectations** and boosted rates by three-quarters of a point in an almost-unanimous decision. Other notables from the release and the post-decision press conference included the fact that there was no mention of any change to the rate at which the Fed would continue to reduce the size of its balance sheet (so-called **"QT" will continue apace**,) **as well as a hint that an increase of 0.75% might be appropriate in July as well**[6,7]. During the Q&A session, Powell also made it quite clear that the CPI data was the primary reason the Fed made what he described as a "late-breaking decision" to boost rates more aggressively.

So the *Journal* got it right, and the **initial market reaction to the hike wasn't all that bad**: equity markets actually finished "Decision Day Wednesday" solidly higher, no doubt thanks at least in part to the *Journal's* early warning. But the optimism, if you can describe a 1.5% bounce after markets have already mostly dropped into bear market territory that way, didn't last. **The sell-off resumed on Thursday**, with the S&P 500 Index notching its second 3%-plus decline of the week while the Nasdaq composite booked its second *4%*-plus drop. **Markets, it seems, aren't so sure that even a surprise 0.75% increase in rates will be enough to stop inflation** in a world struggling with commodity price pressures related to the war in Ukraine and China's increasingly untenable zero-COVID policy (both of which were mentioned multiple times in Chair Powell's comments.)

Alternatively, **markets** may also simply be moving past their obsession with the path of the Fed Funds rate itself and instead **focusing on the prospect that the Fed might not be able to engineer a soft landing after all**. Specifically, a 0.75% increase in June, followed (perhaps,) by another 0.75% increase as early as the July 27th meeting, might be just what the doctor ordered to cure the economy of its bout with inflation, but the potential side effects are severe enough to cause investors to question their risk positioning in wholesale fashion.

Said a little differently, **the Fed seems to be tightening policy aggressively into a weakening economy** – something that Powell's Fed (or really any modern Fed, for that matter,) has virtually no experience with. And **make no mistake, the economy *is* slowing**. The latest evidence came last week in the form of a 0.3% **decline in retail sales in May**,[8] a drop in the Conference Board's index of **leading economic indicators**[9], a slow but steady rise in weekly **unemployment claims**

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[3] CME.com, GWI calculations
[4] https://www.bls.gov/news.release/ppi.nr0.htm
[5] https://www.wsj.com/livecoverage/stock-market-today-dow-jones-bitcoin-fed-rates-06-14-2022/card/markets-price-in-supersized-rate-increase-f1tD70xBura4x3FIpq0h
[6] https://www.federalreserve.gov/newsevents/pressreleases/monetary20220615a.htm
[7] https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20220615.pdf
[8] https://www.census.gov/retail/marts/www/marts_current.pdf
[9] https://www.conference-board.org/topics/us-leading-indicators

and a pair of weaker-than-expected **regional Fed manufacturing reports** that each suggested conditions are weakening.[10,11]

So although **the Fed's actions might be wholly necessary** given the its specific Congressional mandate to achieve "price stability" (a mandate Powell referenced more than once in his post-FOMC comments,) this whole thing is starting to feel a little, uh, experimental. Markets seem to be fretting over the idea that **the cure in this case might be just as bad (or worse,) than the disease, and that the doctors might just be winging it**.

What to Watch This Week: June 20th – 27th

Notable economic events (June 20th – 26th)

Monday: *Juneteenth Holiday - US markets closed*

Tuesday: Existing home sales, Chicago Fed/CFNAI

Wednesday: *No planned economic releases,* Powell congressional testimony (Senate)

Thursday: Flash PMIs, weekly jobless claims, Powell congressional testimony (House)

Friday: New home sales, UofM consumer sentiment

Source for index data: Bloomberg.com; GWI calculations.

It should be **a fairly quiet week**, with Chairman **Powell's semi-annual testimony to congress** promising to be the biggest event on the schedule. Powell's twice-yearly visit to Capitol Hill – previously called "Humphry-Hawkins" testimony and required by federal statute since 1978 – will be **the first opportunity for him to openly defend last week's 0.75% increase** in rates since last week's press conference. In the past it was reasonable to expect something new and interesting from the Chair's bi-annual field trip to Congress, but the Fed's policy of doing as much as it can to clearly telegraph its intentions to markets ahead of time has removed much of the mystery and **lately the whole affair seems like little more than an opportunity for political point-scoring by members of Congress**. Said a little differently, market participants do a much better job of pulling salient information out of the Fed chair than elected officials do and the Fed realizes it, so I wouldn't spend too many brain cycles worrying about this week's testimony (and if you've ever watched or read any of this testimony, you've probably realized that some of those asking questions certainly don't spend too much intellectual bandwidth on the exercise themselves…) **Still, where markets are concerned it's never wise to say "never," so its possible that something interesting might mistakenly make its way out of the Capitol building this week**.

Next to Powell's appearance on the Hill, **Thursday's flash PMIs** might hold the most promise for something relevant. As discussed above, **the economy clearly seems to have lost some of its momentum**. **The PMIs do a pretty good job of capturing inflection points**, so Thursday's first look at June PMIs could be relevant as confirmation of that idea.

A pair of housing market statistics might also be worth a look: **existing home sales on Tuesday and new home sales on Friday**. The housing market is clearly in a funk, pressured by a rapid advance in **mortgage rates**. 30-year, fixed-rate mortgages started 2022 just above 3% but are now quickly making their way toward 6%[12], which has **clearly dampened both sentiment and transaction volumes** (even as prices have remained stubbornly firm.) This week's data will probably suggest a continuation of those trends.

Finally, Friday's final release of the **University of Michigan's consumer sentiment** index for June will be worth a read. Consumers caught on to the caustic effects of inflation long before the Fed, and inflation has continued to take the air out of consumer attitudes, even if it has yet to fully express itself in consumer behavior. Look for any evidence of that in Friday's release.

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[10] https://www.newyorkfed.org/medialibrary/media/survey/empire/empire2022/esms_2022_06.pdf?la=en
[11] https://www.philadelphiafed.org/surveys-and-data/regional-economic-analysis/mbos-2022-06
[12] Freddie Mac, FRED St. Louis Federal Reserve