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Investment Institute

Weekly perspective on current market sentiment **May 18, 2022**

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Last week's S&P 500 Index: -2.4%

Deterioration

Key takeaways

- Our work suggests the economy is in a late growth stage.
- The headwinds for the economy are growing, and we now see a mild recession as likely starting late this year.

Getting right to the point, our work has shown clear and increasing signs that the economic expansion is in a late stage of growth. Inflation and interest rates have risen, like a dial turning up the headwinds for the economy. We now believe that the dial's turn will reach a point where the economy crosses over into a mild recession likely at the end of this year and the beginning of next year.

Of course, the U.S. Federal Reserve (Fed), still early in its anticipated aggressive series of rate hikes, clearly needs demand to slow in order to help bring inflation down from the 40-year highs we have seen recently in the Consumer Price Index (CPI). The Fed can't directly control the supply chain or determine the outcome of the Russia/Ukraine conflict, but it can try to cut into the strong demand for imports and crude oil that has driven prices higher in this supply-restricted economy. The Fed has the unenviable job of trying to slow the economy while trying to avoid a recession. It looks now like the odds are against that outcome. As we have stated many times before in this publication, it is never easy to fine-tune a $22 trillion economy.

We continue to believe the fed funds target rate will be in the 2.5% to 2.75% range by the end of this year, up from the current 0.75% to 1% range. With two hikes under their belt after the March and May monetary policy meetings, our central bankers are likely to boost rates by 50 basis points (100 basis points equal 1%) at both the June and July Federal Open Market Committee (FOMC) meetings. Yes, we believe the Fed is "behind the curve" and will likely front-load rate hikes in an effort to catch up to surging inflation. Inflation has been the number one risk to our outlook over the past year or more, exceeding most expectations. The Fed has made it clear that bringing inflation down is its top goal.

Other signs indicating a loss in economic momentum include slumping consumer confidence, small business optimism, and mortgage rates and applications. Consumers are seeing their buying power erode as wages are not keeping up with inflation. Small businesses are having trouble finding workers, and input costs at nearly every level are on the rise, squeezing profit margins. Housing affordability has dropped as prices have soared, and the borrowing rate on a 30-year fixed mortgage loan has gone from 3% to 5.5% since the beginning of the year. These trends will not be easy to reverse in the near term.

In the near term, markets may still be underpricing the risk of an aggressive Fed and mild economic contraction. However, as has been the case historically, recessionary pullbacks in the market have provided opportunities to patient investors who can take advantage of big down days and weeks. Markets have recovered and moved higher every time they have fallen in the past. We do not believe this time around will be any different.

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Definitions

An index is unmanaged and not available for direct investment.

Consumer Price Index (CPI) produces monthly data on changes in the prices paid by urban consumers for a representative basket of goods and services.

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