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MARKET PERSPECTIVE

High Inflation: Relief, but Not Yet Defeat

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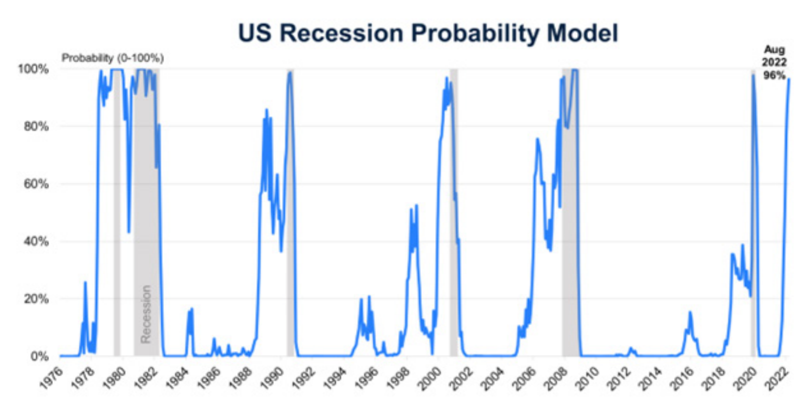
DASHBOARD

- Business Cycle
- Trend
- Valuation

The annual inflation rate in the United States fell to 7.7% in October, further declining from the peak of 9.1% in June. Stocks surged on the news, with the S&P 500 up 5.5% the day the data was released. Investors cheered the prospect that the Federal Reserve might not raise rates as high or quickly as previously anticipated—and perhaps the Fed might start looking ahead to cutting rates. As of this writing, it seems likely that the Fed will hike its benchmark rate by 0.5 percentage points at its December meeting, down from a series of 0.75-point increases. A month ago, the market was baking in another 0.75-point increase in December.

To be sure, overall inflation trends are headed in the right direction. But inflation is still too high for the Fed's comfort, and it seems unlikely they will reverse course anytime soon. We take our cue here straight from the Federal Reserve. In a recent policy speech, Fed Chairman Jerome Powell pointed out that "the historical record cautions strongly against prematurely loosening policy." And the Fed continues to eye a labor market that remains much too tight.

The concern is that the Fed continues to tighten as we potentially head into a recession. We note that it's difficult, if not impossible, to predict the next recession with any consistency or precision. That said, the Conference Board's U.S. Recession Probability Model has a good track record, as shown in the chart below left.



Source: The Conference Board, Clayton Wealth Partners.

Last month the Conference Board shared its Probability Model reading for August, which indicated that at the time, there was a 96% chance of a recession in the U.S. within 12 months. Notably, the model's probability crossed the 50% threshold in May, which suggests that if the U.S. hasn't entered a recession yet, it likely will sometime in the next six months.

If that's the case, the risk of a meaningful deterioration in corporate earnings remains high. As we wrote in last month's Market

Perspective, that would likely be a catalyst for further stock-market downside.

There's plenty of opportunity for continued, short-term equity gains from here. We're past midterm elections, which removes some political uncertainty. And we often see strong gains in the fourth quarter around a December "Santa Claus rally." But this has the potential to be another bear market rally in the context of an economic environment that continues to deteriorate.

For now, we remain cautious.

Bullish

- Significant pent-up consumer demand
- Strong jobs environment
- Relatively healthy consumer finances
- Reasonable equity valuations
- The most attractive yields for fixed income in years

Bearish

- Slowing global economic growth
- High global inflation
- Tightening by the Fed and other global central banks
- Russia-Ukraine war and other geopolitical concerns
- Equities in a downtrend

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As Partner & Chief Investment Officer, James Walden strives to maximize our clients' long-term, risk-adjusted portfolio returns. This includes determining strategic and tactical asset allocations, as well as specific investment analysis and prudent rebalancing. Jim is also a partner & management team member. His expertise includes advanced investment research and valuation, and he is passionate about his role in helping clients reach and exceed their financial goals.

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