Insights

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5 Burning Questions Give Investors Insight

Durable Rebound or More Pain to Come?

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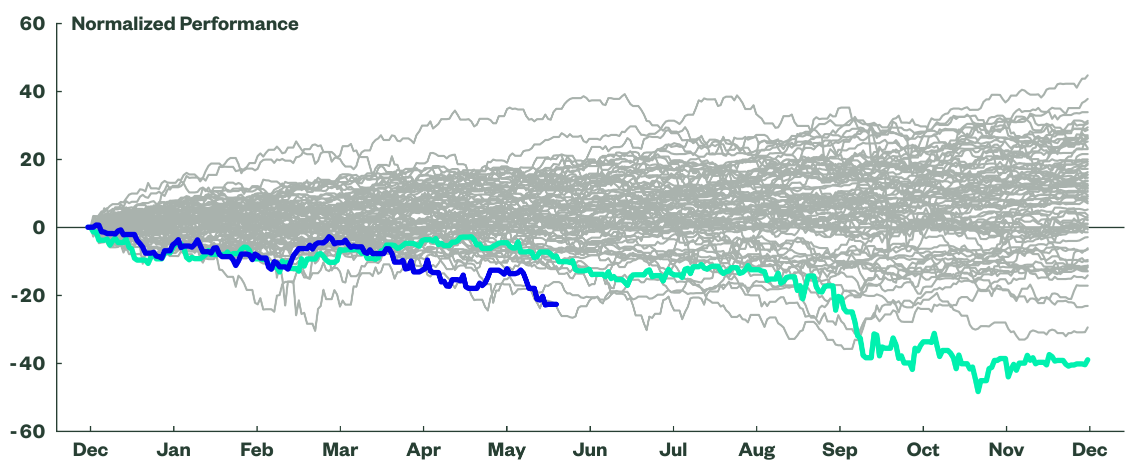
Will inflation moderate? Is all the bad news priced in? What will the second half of 2022 bring? SPDR Chief Investment Strategist Michael Arone shares his take on five questions that may offer investors insight.

Mercifully, a brutal first half of 2022 has come to a close. For investors, there weren't many places to hide from negative returns, as both stocks and bonds had one of their worst first-half performances in history.[1] As a result, nearly all manner of diversified portfolios — conservative, moderate, and aggressive — suffered losses for the first six months of the year.

Figure 1
S&P Calendar Year Normalized Performance



Source: Bloomberg Finance, L.P., as of June 30, 2022. Base = 0. **Past performance is not a reliable indicator of future performance.**

Rather than licking our collective wounds and bemoaning our bad luck, let's cautiously look forward to the second half of 2022 — when a durable rebound in risk assets hinges on the answers to these five burning questions:

1. Will inflation moderate?
2. What is the Federal Reserve's (Fed) terminal rate?
3. Will the economy experience a softish landing or recession?
4. How much will earnings estimates have to be cut?
5. Is all the bad news already priced into risk assets?

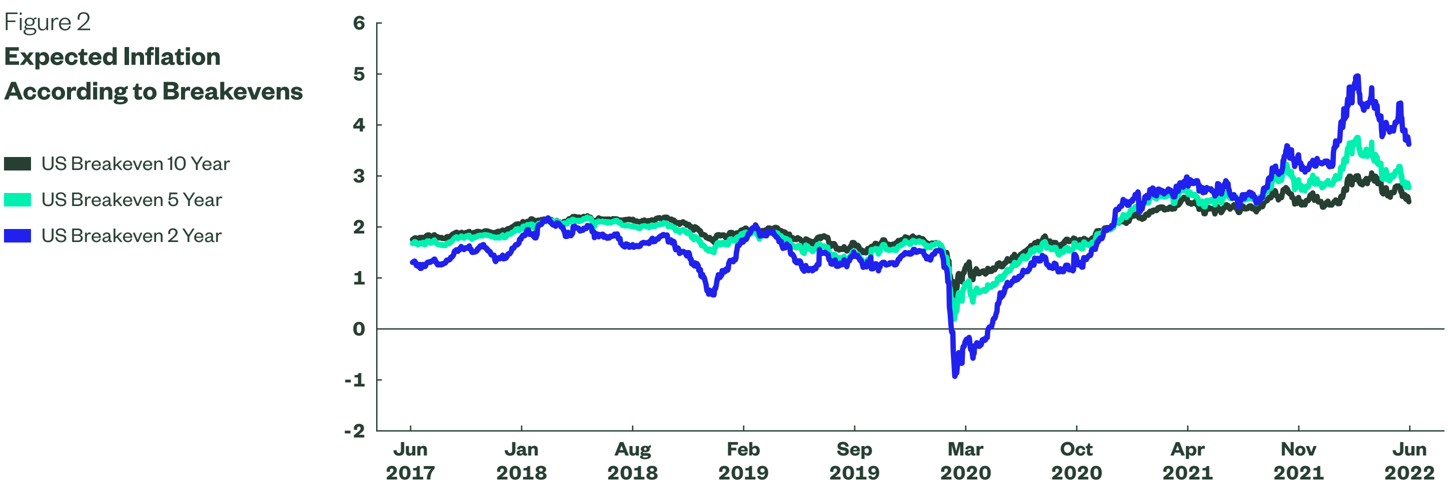
Here's my take on the five burning questions investors should ask now, as the second half of 2022 gets underway.

Will Inflation Moderate?

The simple and incomplete answer is, yes, inflation will moderate in the second half of the year. The more important and elusive answer is at what level inflation will settle. Regardless of which measure you prefer, inflation is likely to remain far higher than the Fed's average 2% inflation target.

By the Fed's own admission in its Summary of Economic Projections released on June 15, its preferred inflation measure, the Core Personal Consumption Expenditures (PCE) Index, is forecasted to be 4.3% this year. Shockingly, in the same report, the Fed predicts that the Core PCE will fall to 2.7% in 2023 before reaching 2.3% in 2024. At every turn, the Fed has miscalculated inflation in the aftermath of the global pandemic. And despite its recent flawed forecasts, the Fed continues to underestimate inflation.

Figure 2
Expected Inflation According to Breakevens



Source: Bloomberg Finance, L.P., as of June 30, 2022. **Past performance is not a reliable indicator of future performance.**

The Core US Consumer Price Index (CPI) is comprised of 20% food & energy, 20% core goods, and 60% services. Inflation driven by core goods is likely to get some relief in the second half of the year, as supply chain bottlenecks improve and retailers unload bloated inventories. This is fueling the peak inflation narrative.

However, the Russia-Ukraine War is likely to drag on for months, keeping upward pressure on food and energy prices. A tight labor market will lead to continued wage increases. And in the US, rents are rising 15% year-over-year. All of this is to say soaring wages and rents will likely keep the 60% services component of US CPI elevated for the next few quarters.

Inflation to Remain Higher Than Investors Would Like

As a result, investors should be wary of the peak inflation narrative throughout the second half of the year. Inflation may have peaked but it will remain far higher than market participants would prefer and that's likely to result in continued market volatility in the near term. The surprisingly strong top-line US CPI data released on June 10 is the perfect cautionary example for investors. Much to the chagrin of market prognosticators, inflation didn't peak but continued to accelerate.

What Is the Fed's Terminal Rate?

The Fed's terminal rate, frequently referred to as the neutral rate, is the interest rate at which monetary policy is neither accommodative nor restrictive. Simply put, it's the interest rate that isn't boosting growth or slowing it down and is consistent with the Fed's dual mandate of full employment and stable prices.

So far during this Fed tightening cycle, the terminal rate has been a moving target, resulting in market indigestion. At the outset of the Fed's tightening conversations, market participants concluded that the terminal rate might be 2.25%–2.50%. But continued aftershocks from the pandemic, China's zero-COVID policy, and the Russia-Ukraine War prolonged supply chain disruptions and kept inflation measures elevated. As a result, investors raised their target for the Fed's terminal rate to 2.75%–3.00%. This unexpected repricing of the terminal rate wreaked havoc on markets, especially for bonds and unprofitable technology companies.

Despite a growing chorus of market experts suggesting that inflation had peaked, US CPI data released on June 10 suggests otherwise — top-line inflation actually accelerated. The University of Michigan consumer sentiment survey, also released on June 10, compounded fears that inflation is becoming entrenched. These two unexpected inflation surprises prompted the Fed to aggressively raise rates by 0.75% on June 15 and notably increase its own expectations for the terminal rate to reach 3.8% in 2023. This most recent upward revision to the Fed's terminal rate sent more shockwaves through capital markets.

Market-Shocking Terminal Rate Increases May Not Be Done

If the Fed is truly committed to stabilizing stubbornly high inflation, unexpected increases to the terminal rate might not be over. The Fed must raise the terminal rate above inflation to finally defeat surging prices.

If the Fed is underestimating inflation, isn't it also underestimating how high it will have to increase interest rates to stabilize prices?

In 2023, the Fed terminal rate may very well be above its current estimate of 3.8%. The Fed and market participants are getting closer to pricing in a terminal rate of roughly 4.00%–4.25%, but until we get all the way there, expect more market volatility.

Will Economy See Softish Landing or Recession?

The softish-landing hopefuls are holding on tightly to US consumer strength, increased business spending, outstanding corporate profitability, the solid labor market, and manufacturing and services data that point to the continued expansion of the US economy. But all of those inputs are backward looking, with many beginning to show signs of weakening.

The US economy suffered a rare negative first quarter GDP surprise, contracting an annualized -1.6%.[2] Many economists quickly dismissed this as an anomaly, pointing to the strength in consumption and business spending as reasons not to worry. However, the Federal Reserve Bank of Atlanta's GDPNow forecast from June 30 suggests the US economy may contract by -1% annualized in the second quarter. If that happens, it would meet the technical recession definition of two consecutive quarters of negative GDP growth. Perhaps the US economy is already in recession. Only time will tell. But interest-rate-sensitive sectors of the economy, like housing, are already softening.

Garden-Variety Recession Could Restore Economy's Health

A cyclical economic slowdown has started already, and a recession is likely to follow in the not-too-distant future. The natural occurrence of a recession in the economic cycle, while painful, can be healthy as it eliminates marginal businesses and acts as a clearing mechanism for the economy.

It may not be a popular opinion, but a typical garden-variety recession could result in a healthier economy overall and provide investors with more profitable opportunities in the future.

How Much Will Earnings Estimates Have to Be Cut?

Despite a cyclical slowdown in the economy, monetary policy tightening, and rampant inflation, analysts are miraculously still forecasting S&P 500® earnings growth of 10.4% and revenue growth of 10.7% for calendar year 2022. Clearly, earnings estimates will have to be slashed, but by how much?

Typically, during bear markets that coincide with economic recessions, earnings estimates get cut by roughly 30%. Many companies, including Target, Microsoft and Intel have already started to warn investors of falling future profits.

Stocks Might Look Deceptively Cheap Right Now

Price-to-earnings multiples have plummeted alongside stock prices, leading some market observers to conclude that stocks are cheap. But, until the earnings estimates are reduced to reflect today's reality, stocks may appear deceptively inexpensive. Investors should proceed with caution as analysts go through the process of cutting earnings estimates.

Is All the Bad News Already Priced In?

If this all sounds like doom and gloom, there is a silver lining.

Because stocks suffered their worst first-half performance since 1970, and most bonds posted notable negative returns this year too, a lot of bad news may already be reflected in asset prices. Positive surprises from the Fed, inflation data, the Russia-Ukraine War, or China could result in a second-half rebound in risk assets.

One of the lasting investment lessons from the pandemic is that the economy is not the market. The market is a forward-looking mechanism. Investors were reminded of this when risk assets rallied aggressively during the height of the pandemic's challenges. Investors were already pricing in a strong recovery.

Rebound Could Start After US Midterm Elections

The poor performance of risk assets these past six months may already reflect tighter monetary policy, higher interest rates, soaring inflation, a cyclical slowdown, and falling corporate profits. If so, it's likely risk assets will begin to reflect a recovery sooner than the economic data will. If you're searching for a better entry point, this rebound may start shortly after the midterm elections in early November.

In the meantime, the key barometer for market sentiment will be the closing of the gap between inflation figures and the Fed's terminal rate. If that starts to happen, markets may begin to rally. If the gap remains stubbornly high or, worse, it widens — expect continued volatility with risks skewed to the downside.

Endnotes

1 Bloomberg Finance, L.P., as of June 30, 2022.

2 Reuters as of June 29, 2022. https://reuters.com/markets/us/record-trade-deficit-weighs-us-economy-first-quarter-2022-06-29/.

ssga.com/etfs

Glossary

Consumer Price Index (CPI) A widely used measure of inflation at the consumer level that helps evaluate changes in cost of living. The CPI is composed of a basket of consumer goods and services across the economy and is calculated by the US Department of Labor by assessing price changes in the basket of goods and services and averaging them. Core CPI is the same series, but excluding food and energy prices, which are considered to be volatile enough to distort the meaning and usefulness of so-called headline CPI. The absence of food and energy, means the core series reflects long-term inflation trends more accurately.

Core Personal Consumption Expenditures Index (PCE) Measures the prices paid by consumers for goods and services without the volatility caused by movements in food and energy prices to reveal underlying inflation trends. The PCE is the Federal Reserve's favored inflation gauge.

Inflation An overall increase in the price of an economy's goods and services during a given period, translating to a loss in purchasing power per unit of currency. Inflation generally occurs when growth of the money supply outpaces growth of the economy. Central banks attempt to limit inflation, and avoid deflation, in order to keep the economy running smoothly.

Recession A contraction in economic activity as profits decline and consumer expectations begin to bottom out that typically leads to accommodative monetary policy. Recessions have been characterized as at least two consecutive quarters of economic contraction, but definitions vary and the concept is subjective.

Important Risk Information

The information provided does not constitute investment advice and it should not be relied on as such. It should not be considered a solicitation to buy or an offer to sell a security. It does not take into account any investor's particular investment objectives, strategies, tax status or investment horizon. You should consult your tax and financial advisor.

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