CITY NATIONAL ROCHDALE
AN RBC/CITY NATIONAL COMPANY

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ON THE RADAR

FAQs on the Markets and Economy

Has inflation peaked?

The April consumer price index report came in 8.3% year over year (y-o-y), a slight decline from March's 8.5%. That is the good news. The bad news is that inflationary pressures will not be falling quickly toward the Fed's goal of 2.0%.

The main reason why inflation was lower in April was a temporary decline in energy prices and the base effect. There was no evidence that the underlying price pressures are easing. That said, there was some positive news that goods inflation is growing at a slower pace, but service inflation continues to grow (chart).

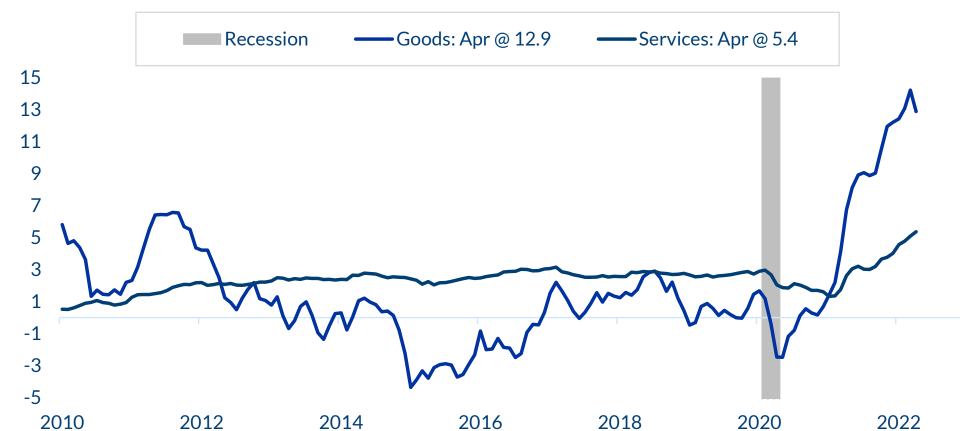
This is telling us that the supply chain problems and the strong demand for goods that occurred during the pandemic appear to be declining, but are being replaced by higher prices in the service sector. Higher housing costs and increased wages are keeping the heat high under service sector inflation.

Food and energy prices are expected to remain elevated for some time. The yearly change in food prices is the biggest since 1981 and includes record prices for chicken, fresh seafood and baby food. Energy prices, which had a slight reprieve in April with gasoline prices falling 6.1%, have since rebounded to a record high.

KEY QUESTIONS

- What is Fed Chairman Powell saying about the economy?
- Should investors fear bond market volatility?
- Is the S&P 500 headed for a bear market?

CPI: Goods and Services
% change, year-over-year, seasonally adjusted



Source: Bureau of Labor Statistics

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What is Fed Chairman Powell saying about the economy?

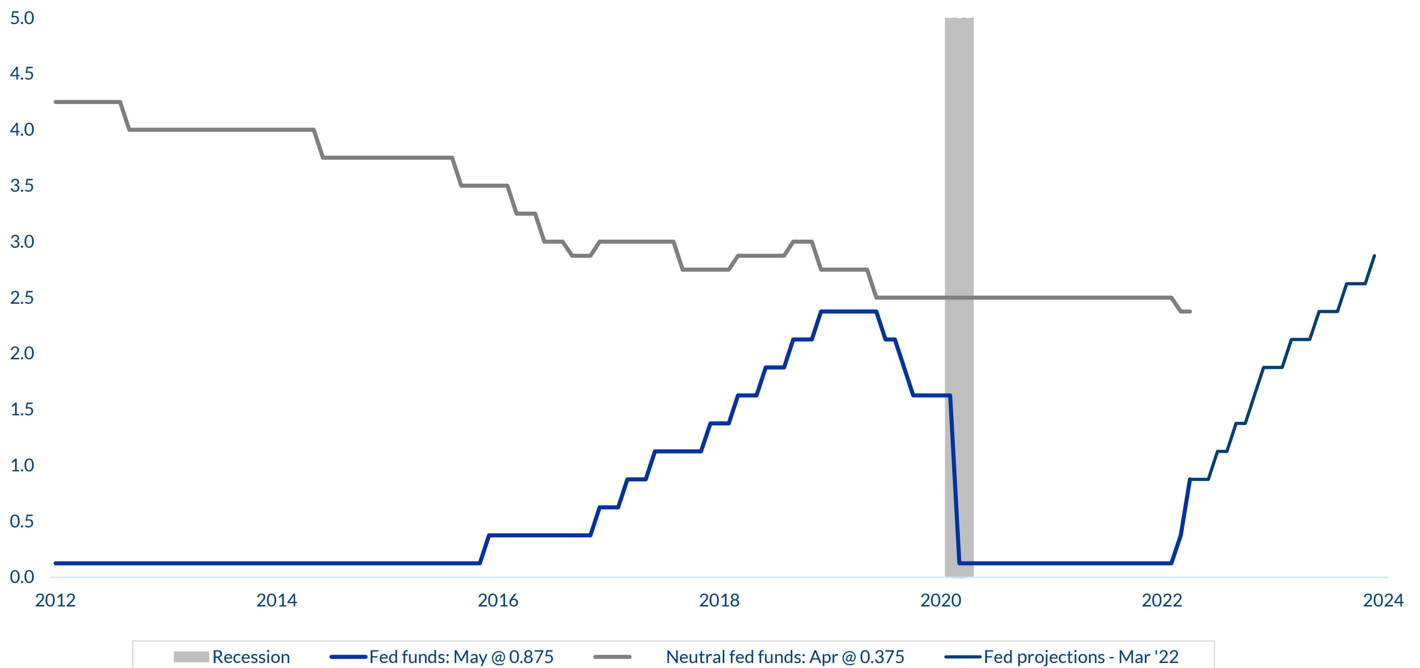
Powell is making it very clear that the Fed's resolve in combating inflation should not be questioned. With inflation near 40-year highs, taming it is the Fed's number one goal, even if it means pushing up the unemployment rate.

Price stability is needed for this economic expansion to continue for an extended period.

The Fed has been raising the federal funds rate to spur demand. They have already increased the rate by 75 bps, and expectations are for a 50 basis point (bps) increase at each of the Fed's June, July and September meetings. If that happens, the median fed funds rate would be 2.375, close to the neutral federal funds rate. That is the hypothetical rate that neither stimulates nor restricts economic growth.

Adjusting monetary policy to achieve a soft-landing economy is a difficult task. Powell concedes that it is more challenging because of global events, like the war in Europe and China's extreme response to COVID-19 with significant cities being locked down, resulting in exports being curtailed.

Fed Funds and Neutral Fed Funds (%)



Source: Federal Reserve

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Should investors fear bond market volatility?

It is no secret that the swift move higher in interest rates has resulted in uninspiring year-to-date (YTD) fixed income returns. The move higher in interest rates is coupled with an increase in overall treasury market volatility as indicated by the MOVE Index.

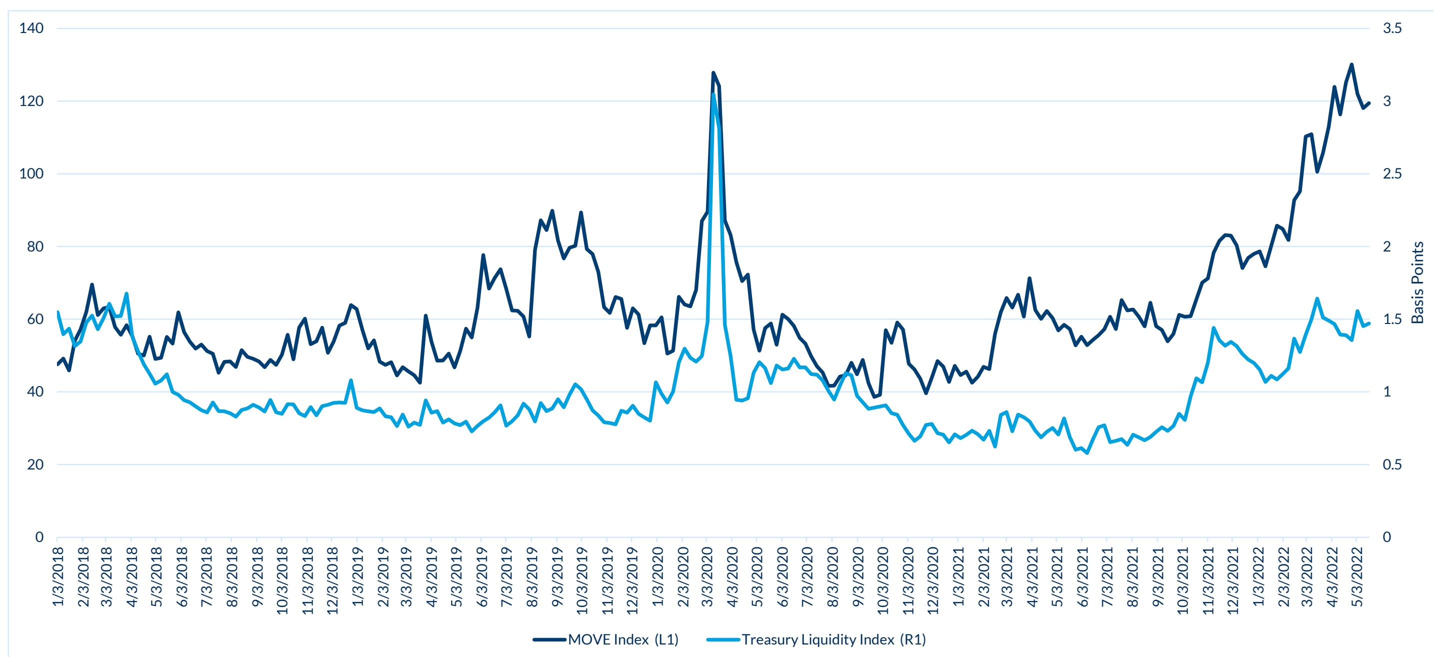
The MOVE Index is a tool that measures the implied volatility of U.S. Treasuries options and is commonly used as a measure of bond market sentiment. Given this material increase in bond market volatility, it was prudent for broker-dealers to reduce the number of bonds held in inventory and thus reduce the number of securities available to sell to market participants.

This broad downturn in broker-dealer inventory best shows its face as an uptick in bid-ask spreads and thus a reduction in overall Treasury market liquidity. bid-ask spreads had been calm for a few years *(see chart below)* before the March 2020 pandemic-induced liquidity crunch, with the Fed announcing market placating policies soon thereafter.

Now that the Fed has pivoted to a strong stance on fighting inflation and outlined the plan for quantitative tightening, we anticipate continued levels of heightened bond market volatility and bid-ask spreads leaking wider and wider.

To paraphrase an old investing adage: volatility creates opportunity. Treasury and corporate yields are at or near the highest level in more than a decade. The current yield environment, the low level of dealer inventories and continued levels of heightened volatility result in an attractive entry point for bond investors. Investing cash now and at a measured pace over the next several months will provide strong levels of income for years to come.

Bid-Ask Spreads



Source: Bloomberg

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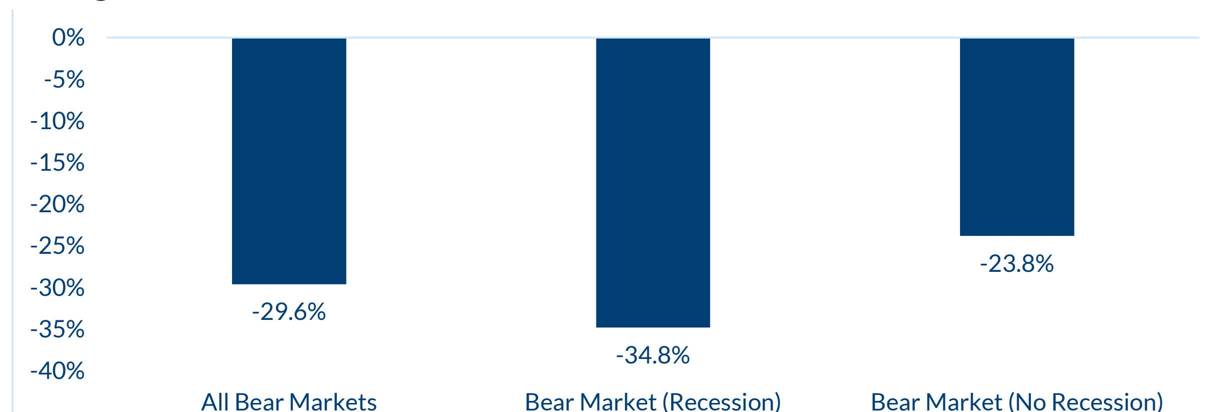
Is the S&P 500 headed for a bear market?

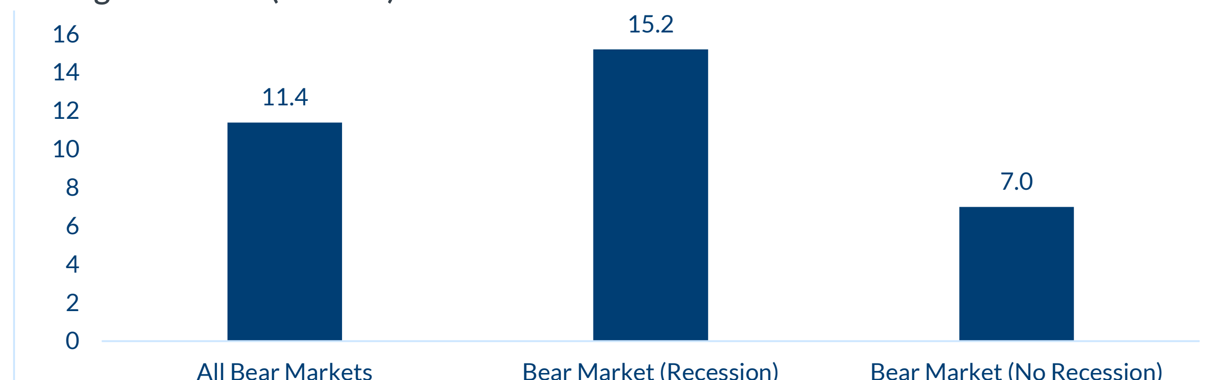
Despite what turned out to be a generally good earnings season, the correction in equity markets has continued for a seventh straight week, the longest streak in over 10 years.

With the S&P 500 flirting with official bear market territory (i.e., a 20%+ decline), many other major U.S. equity indices are already there, and further downside is possible. Investors remain concerned over the potential impact rising rates and inflation, as well as slowing global growth and high geopolitical uncertainty, will have on the economy and corporate profits in the quarters ahead.

While we agree that the risk to the outlook has grown, the recession is not our base-case scenario over the next 12 months. We continue to see broader support for stock prices over time. Economic fundamentals remain solid, and corporate earnings, while moderating, will likely remain in the mid-single digits. Encouragingly, bear markets without recessions have historically been much shorter and less severe than those accompanied by recessions.

At this point market declines have likely priced in much of the risk of an economic downturn ahead. Still, it remains too early to signal the all-clear just yet. Although the risk-reward ratio for equities has now improved, with valuations adjusted lower and sentiment reflecting a more bearish outlook, it will likely require greater clarity on the path of inflation for markets to find a durable bottom.





Source: Federal Reserve

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INDEX DEFINITIONS

S&P 500 Index: The S&P 500 Index, or Standard & Poor's 500 Index, is a market-capitalization-weighted index of 500 leading publicly traded companies in the U.S. It is not an exact list of the top 500 U.S. companies by market cap because there are other criteria that the index includes.

Bloomberg Barclays U.S. Corporate High Yield Bond Index: measures the USD denominated, high-yield, fixed-rate corporate bond market.

CalPERS: The California Public Employees' Retirement System, also known as CalPERS, is an organization that provides numerous benefits to its 2 million members, of which 38% are school members, 31% are public agency members, and 31% are state members.

CPI: A consumer price index (CPI) is a price index, the price of a weighted average market basket of consumer goods and services purchased by households. Changes in measured CPI track changes in prices over time.

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