

June 13, 2022

MARKET MINUTE

Inflation soars, markets drop

What a way to start the week. The Dow dropped 725 points in the first four hours of trading on Monday morning, continuing the slide that started on Friday after the May Consumer Price Index (CPI) came in at a sizzling 8.6% annualized rate. Market watchers and commentators were expecting inflation to flatten or improve last month, with consensus estimates running between 8.2-8.4%. Inflation hit 8.5% in March, then ticked down in April – only to pop back up to a new high in May.

The persistent rise in gas prices was a clear signal CPI would remain high. The only reason April CPI was lower than March's was because gas price increases slowed during the month – then resumed their surge in May. The markets engaged in some wishful thinking, believing “if” inflation slowed the Federal Reserve would “pause” raising rates.

The Fed has raised rates twice so far this year, moving from 0% to 0.75%. U.S. equities were off 12-13% on expectations the Fed would raise rates another 50 basis points (.50%) during both their June and July meetings. These increases would move rates to 1.75%, at which point the Fed would “pause” during their September meeting.

But as Scottish poet Robert Burns said, “The best laid schemes o’ mice an’ men. Gang aft a-gley.” In other words: Even the most carefully made plans can go wrong. With inflation at 40-year highs and consumer sentiment at all-time lows, the “pause” narrative is out the window.

The big question now: How much more aggressive will the Fed need to get? If it raises by 50 basis points twice and maintains the course it's laid out, we risk remaining at prolonged and elevated levels of inflation and drifting along in a stagflationary environment. If the Fed gets more aggressive, markets will sell off even more and we will drive the economy into a recession. This time last year we were talking about two or three interest rate hikes in 2022; with nearly half of 2022 behind us, there is talk of many more hikes by the end of the year.

This volatility will persist until we get a new plan from the Fed on Wednesday following this week's meeting, which should include details about how they will fight inflation. If the actions aren't appropriate or overly aggressive, we will likely see continued selling in equities markets.

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