When I was a kid, there was an oil embargo and remember waiting in line to get gas for my mom's purple AMC Gremlin (with that cool white stripe of course). As a single mom trying to raise three boys, she struggled mightily to make ends meet during the 1970s due to persistently high inflation. To this day, the sight of ring baloney or a powdered milk box makes me cringe. Unfortunately, the burden of high inflation has greater impact on those who can least afford it which is why the Federal Reserve (Fed) has repeatedly communicated their commitment to bring 40-year highs in inflation under control. That commitment was cemented late last quarter.

The Fed has a dual mandate of price stability (long-term inflation rate goal of 2%) and maximum employment. Because of lockdowns and economic stimulus responses to COVID, these two objectives are at opposite ends of the scale. The labor market remains one of the tightest or strongest in history, certainly in my lifetime, while inflation rates are at 40-year highs. To bring these two mandates back into better balance, the Fed is currently in the midst of its most aggressive monetary policy campaign in decades, and it is roiling stock markets.

Stock market volatility was high with each monthly Consumer Price Index (CPI) report as well as with the consensus opinion of the Fed's rate hike threshold and projected timeline to quell inflation. Stock markets finished the quarter moderately to sharply lower and in bear market territory.

Table 1 – Stock Index Total Returns – as of September 30, 2022

Equity	1-Month	3-Month	YTD	1-Year	3-Year	5-Year	10-Year
Dow Jones Industrial	-8.76	-6.17	-19.72	-13.40	4.36	7.42	10.45
S&P 400	-9.19	-2.46	-21.52	-15.25	6.01	5.82	10.04
S&P 500	-9.21	-4.88	-23.87	-15.47	8.16	9.24	11.70
Russell 2000	-9.58	-2.19	-25.10	-23.50	4.29	3.55	8.55
MSCI Developed	-9.35	-9.36	-27.09	-25.13	-1.83	-0.84	3.67
MSCI Emerging	-11.72	-11.57	-27.16	-28.11	-2.07	-1.81	1.05
NASDAQ	-10.44	-3.91	-32.00	-26.25	10.63	11.25	14.22

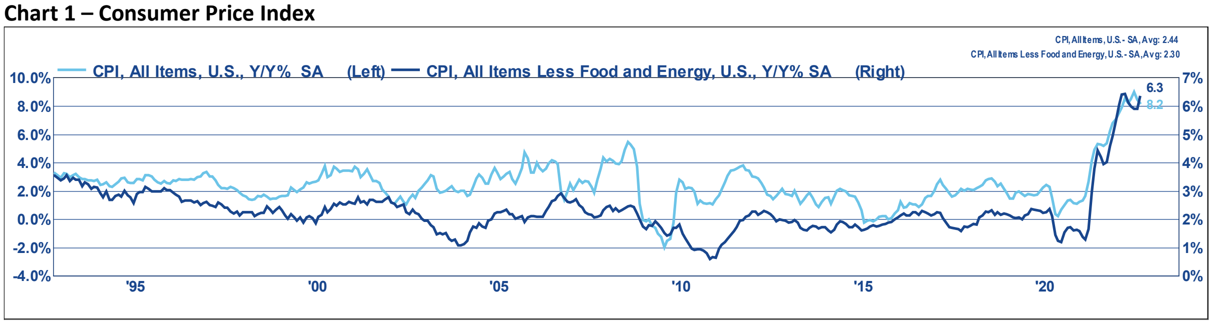
June's CPI report posted the highest 12-month inflation rate in 40 years at 9.1%. At the time of the June CPI release in mid-July, gas and commodity prices had already been trending lower and sentiment surrounding a peak inflation narrative quickly took hold and was subsequently further bolstered by an apparently less-than-hawkish Fed at the July FOMC meeting. These developments set the stage for a strong four-week-long stock market rally from mid-July to mid-August.

Because of the near-term guidance fiasco in which Fed members had been consistently pointing to a 0.50% rate increase heading into the June FOMC meeting and then did a 0.75% rate increase, Chair Powell and the Committee shifted course at the July FOMC meeting from providing near-term forward rate guidance to instead favor being data dependent. Meaning the level of the September FOMC rate hike would depend upon economic information gathered from July and August economic readings (roughly eight weeks of data), which included two inflation and labor market prints as well as other macro data. The Fed would not be giving guidance on which way they were leaning rate wise.

At the July FOMC meeting, the Fed raised rates 0.75% as expected but they also reiterated their commitment to achieving price stability. With better-than-expected July CPI readings, the peak inflation narrative remained, and investors did not take very seriously the Fed's commentary surrounding their pledge of corralling inflation even if it meant pushing the economy into recession. That casual attitude ended abruptly on August 26th with the much-anticipated speech from Fed Chair Powell at the Jackson Hole economic conference, which rocked both bond and stock markets that day and set the tone for a brutal September.

Chair Powell stated, "The burdens of high inflation fall heaviest on those who are least able to bear them. Restoring price stability will take some time and requires using our tools forcefully to bring demand and supply into better balance. Reducing inflation is likely to require a sustained period of below-trend growth. While higher interest rates, slower growth, and softer labor markets will bring down inflation, they will also bring some pain to households and businesses. These are unfortunate costs of reducing inflation. But a failure to restore price stability would mean far greater pain." This statement put markets on notice short-term rates were not coming down anytime soon and increased the likelihood of a recession.

Chart 1 – Consumer Price Index



While markets were still reeling from the realization of the Fed's hawkish policy stance, August CPI was released which came in much hotter than expected, especially core inflation. Core inflation, which excludes food and energy, posted higher-than-expected readings of +0.6% indicating inflation pressures remained strong and stubborn. Investors and policy makers follow core inflation closely as a reflection of broad, underlying inflation and as a predictor of future inflation.

With the Fed now being data dependent on determining the level of rate hikes, the overall data of the last two months pointed towards being more aggressive and the quarter ended with the Fed raising rates 0.75% for the third consecutive time and with bond returns sharply lower.

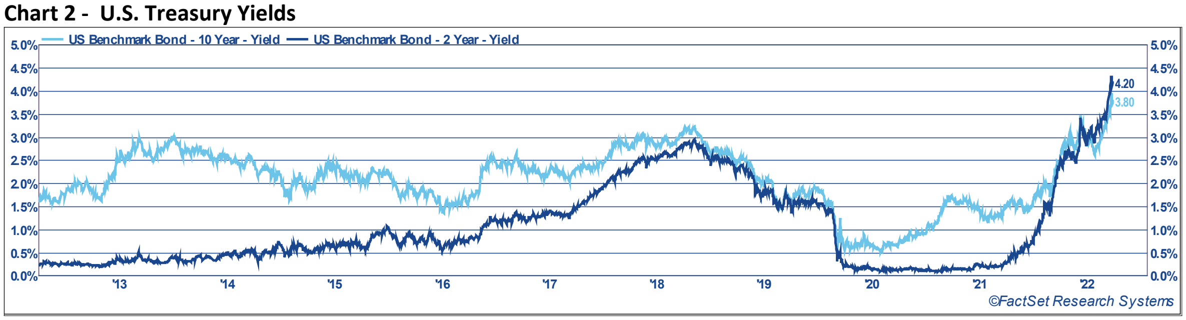
Table 2 – Fixed Income Index Total Returns – as of September 30, 2022

Fixed Income	1-Month	3-Month	YTD	1-Year	3-Year	5-Year	10-Year
Bloomberg Inter Gov't/Credit	-2.67	-3.06	-9.62	-10.14	-1.64	0.38	1.00
Bloomberg Municipal	-3.84	-3.46	-12.13	-11.50	-1.85	0.59	1.79
Barclays Michigan Muni	-3.73	-3.18	-12.17	-11.55	-1.73	0.84	2.06
Bloomberg Aggregate	-4.32	-4.75	-14.61	-14.60	-3.26	-0.27	0.89
Bloomberg High Yield	-3.97	-0.65	-14.74	-14.14	-0.45	1.57	3.94

Bonds were pummeled again last quarter as yields shot up across the entire yield curve. 2022 is shaping up to be one of the worst bond markets in history. Having been in investments for some 30 years now, I never thought it likely to write that intermediate bonds are in correction territory or that long bonds are in a bear market, not shown in table above but down -29%! Government bonds are outperforming investment grade and non-investment grade corporate bonds as credit spreads have widened but most of the credit spread damage was done earlier in the year.

Pressure on bond yields is coming from many directions including from inflation, Fed policy, European energy crisis, and global central banks. Due to Fed rate hikes, the U.S. dollar is at multi-decade highs against major foreign currencies. In response to dollar strength, many central banks around the globe have raised interest rates to prop up their currencies. Moreover, the Bank of Japan intervened in the foreign exchange market selling dollar dominated assets (treasury bonds?), using the proceeds to buy yen. Given the U.S. is a significant net importer of goods, dollar strength will help in the fight against inflation by lowering the cost of imported goods.

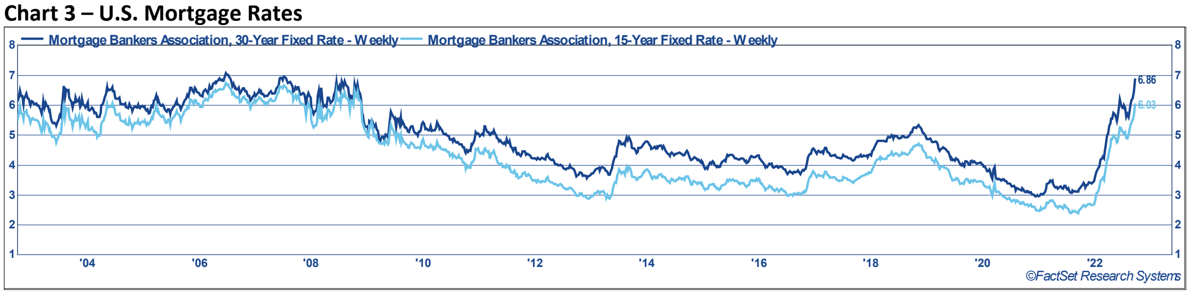
Chart 2 - U.S. Treasury Yields



Hurry up and wait. This is the Fed's rate strategy right now. They are going to raise rates aggressively into year end and perhaps early next year and then wait to see how much the economy and inflation slows down. Their updated September projections show rates increasing another 1.25% by year end and then only 0.25% next year. If this is their strategy, the main question becomes when will the Fed be done raising rates? The Fed is focusing on four main things. First, below trend growth. Second, a softening of the labor market. Third, clear and consistent evidence inflation is abating. Last, keeping long-term inflation expectations in check.

There are signs below-trend growth is already taking hold as GDP and corporate earnings estimates are moving lower. Additionally, with the sharp rise in mortgage rates, the housing market is quickly weakening as home prices are starting to fall, inventories are on the rise, home builder confidence has plunged, and monthly new and existing home sales have been trending lower. The Fed is looking for this weakness to expand into other areas of the economy hoping that it will lessen demand and soften the labor market as well.

Chart 3 – U.S. Mortgage Rates



COVID structurally altered the labor market with some six million workers dropping out of the labor force. Because of the structural change, this is an area rate hikes are going to take longer to affect. Right now, the labor market continues to be tight with roughly two jobs for every unemployed person. Labor market stats remain strong as there are still roughly 11 million job openings available, weekly initial jobless claims have not budged and remain persistently low, and monthly job gains have averaged 378,000 over the last three months and 438,000 so far this year through August. The Fed wants to see some meaningful signs of softening within the labor market.

Long-term inflation expectations are an area that the Fed takes very seriously and monitors closely via various surveys and indicators. Strong core inflation readings of late indicates inflation is embedded within the economy and the short-term mindset of consumers and businesses. The last thing the Fed wants is for long-term inflation expectations to rise, for it means inflation will linger along with prolonged rate hikes. Fortunately, surveys show supply chain challenges slowly improving along with pockets of input costs stabilizing.

The bottom line is that the Fed is raising rates in an effort to bring supply and demand back into balance and this is going to take a while. Each short-term rate hike the Fed makes increases the likelihood of a recession. Foreign central banks are simultaneously doing the same thing as inflation rates are high globally. It doesn't help that geopolitical risks are at extremely high levels right now with the war in Ukraine and China's provocative actions towards Taiwan and the Southeast Asia region. We expect market volatility to remain elevated near-term.

A while back when valuations were through the roof, we went underweight stocks and rebalanced accounts by selling into stock market strength. Last quarter, we went from underweight stocks back up to neutral as valuations are well below historical averages, especially in the small-cap and mid-cap spaces. Thus, we have begun rebalancing portfolios and buying into weakness. On the bond front, we continue to favor a shorter overall duration but have moved back to neutral on sector exposure.

At some point, core inflation will subside, and the market will anticipate the end of the Fed's restrictive monetary policy. When that happens, the market will trend higher for a likely extended period. When will the bottom be? Impossible to predict, but we do know that now is the time to take on risk, for investors are being fairly compensated (cheaper valuations/lower prices and wider spreads/higher yields) to assume the risk. As always during market downturns, the tough part is the willingness to take on risk, i.e., being nervous and worried and having the patience to see it through to the upside.

Prepared by Perry Adams – SVP & Director – West Shore Bank Wealth Management – October 4, 2022

Sources: FactSet, The Federal Reserve, U.S. Department of Labor, National Association of Realtors, Mortgage Bankers Association, U.S. Bureau of Labor Statistics, ISM, & National Association of Home Builders