



Fed's Inflation Fight Likely to Persist

September 2022



KEY INSIGHTS

- The cost of goods may be peaking, but the cost of services is steadily gaining momentum, which could be problematic for the inflation outlook.
- In our view, the Fed's inflation fight is far from over, and our Asset Allocation Committee remains underweight stocks relative to bonds.



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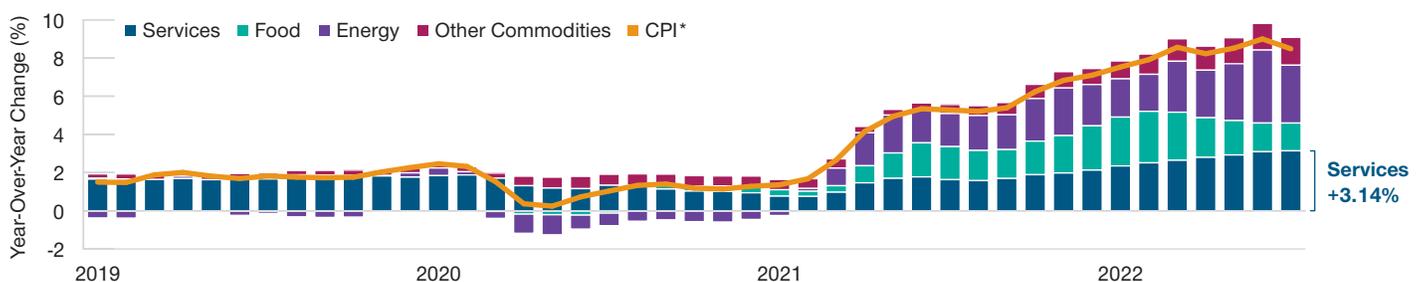
Despite a gloomy economic environment this year, equity markets enjoyed a period of very welcome optimism this summer. In the U.S., the S&P 500 Index staged a strong rally from mid-June to mid-August, bolstered by hope that inflation was peaking, which in turn raised expectations that the Federal Reserve (Fed) could pivot to a more dovish monetary policy stance. We believe this logic may be flawed and that expectations for a shift in Fed policy could be premature.

Overall, the cost of goods is showing signs of peaking. July 2022 inflation data showed that both food and energy costs have declined for two months in a row on a rolling 12-month basis (Figure 1). Commodity prices have also eased since the beginning of the year, and a forward-looking review of supply chains, inventory levels, and shipping costs supports a downward trend over the near term.

However, the cost of services—which has played a relatively minor role in

Component Parts of Inflation

(Fig. 1) Cost of goods may be peaking, but the cost of services has continued to increase



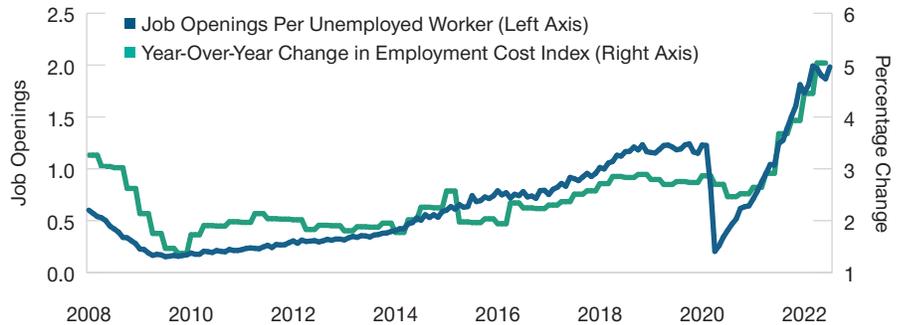
January 1, 2019, to July 31, 2022

Source: Bloomberg Finance, L.P.

* Consumer Price Index (CPI) measures the monthly change in prices paid by consumers and is a widely used measure of inflation.

No Relief From Wage Inflation

(Fig. 2) Ratio of job openings vs. unemployed workers is remarkably high relative to the historical average and has driven up employment costs



January 2008 to July 2022

Sources: U.S. Bureau of Labor Statistics/Haver Analytics.

the inflation uptick so far—is steadily gaining momentum. Services inflation is typically problematic because it tends to be “sticky” (the upward trend is more gradual and persistent), and it is highly sensitive to wage inflation. This is concerning given that sustained labor shortages are driving up labor costs (Figure 2).

In our view, the Fed’s fight with inflation is far from over, given the upward

pressure on prices from services inflation. Hawkish interest rate policy will likely continue to be a headwind for the economy and equity markets, as we believe the Fed will need to see a meaningful decline in inflation from current levels before changing course. As a result, our Asset Allocation Committee remains cautious and is maintaining an underweight allocation to stocks relative to bonds.

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