INVESTMENT STRATEGY INSIGHTS

Summer's Peak ~~Heat~~ Inflation

June 13th, 2022

Fed in the Spotlight

- Recent market volatility reflects expectations of an even more aggressive Fed that is bringing rates ever closer to neutral

Inflation "Peak" Not Fast Enough

- Inflation's 2022 "peak," delayed again, appears in need of more Fed rate hike pressure

Earnings Outlook

- Earnings appear to be holding up, though there's several moving pieces that suggest more revisions may lie ahead

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Fed in the Spotlight

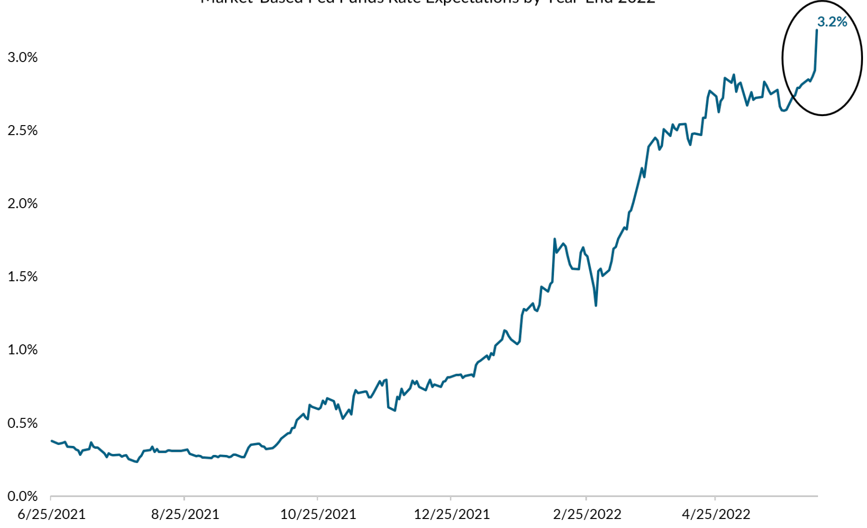
- **FOMC Meeting.** Following a volatile week in equity markets, which saw the S&P 500 decline 5.1% on the back of inflation fears, the Federal Open Market Committee (FOMC), prodded by last week's hotter-than-expected inflation report, is likely to take the next step in its policy shift this week with a half percentage point rate hike. Already on its steepest trajectory of interest rate increases in decades, the Fed has also proceeded with their quantitative tightening plans, which is now on pace to ramp up to a maximum of $95 billion rolling off its balance sheet per month via halts to reinvestment.
- **Fed's Path Ahead.** Futures markets are pricing in a near certainty that the FOMC delivers a 0.5% increase at the subsequent meeting in July, and last week's CPI report should extinguish any pretense that a "pause" in rate hikes will be appropriate by the end of summer. Still behind the curve given recent inflation reports, the FOMC is likely to commit itself further to the goal of fighting inflation. Investors should expect the Federal Reserve to continue with 50-basis point rate hikes until inflation shows meaningful signs of deceleration.
- **Neutral By Year-End?** Investors should pay close attention to the FOMC's dot plot published alongside the standard press release following the meeting, which gives clues as to where the Committee's members see the fed funds rate heading over the next few years. Expectations via the futures markets for the fed funds rate by year-end rose to 3.2%, a level quite close to neutral , as estimated according to the Laubach Williams model. While still not the base case, it is possible that the Fed will need to push rates beyond this neutral level to contain inflation despite the impact on economic growth or markets.

Recent market volatility reflects expectations of an even more aggressive Fed that is bringing rates ever closer to neutral

Chart of the Week:

The latest CPI report has boosted expectations for rate hikes by year-end

Market-Based Fed Funds Rate Expectations by Year-End 2022



Source: Glenmede, Bloomberg

Data through 6/10/2022

Data shown is the progression of expectations through time for the number of rate hikes that investors are predicting by the December 2022 Federal Open Market Committee (FOMC) meeting in blue. These figures are estimates based on pricing in federal funds futures markets. Actual results may differ materially from expectations.

*Represented by the Bloomberg Barclays U.S. Aggregate Bond Index

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Inflation "Peak" Not Fast Enough

- **May's CPI Print.** Inflation appeared to show scant signs of slowing down in May, with the headline and core CPIs registering 8.6% and 6.0% inflation, respectively, on a year-over-year basis. Core CPI, which may be stickier in nature, saw a 0.6% increase, with many of the major subcomponents registering monthly gains in price. Even used cars and trucks, which had been on a three-month trend of outright deflation, picked back up with a 1.8% rise in prices for the month.
- **Sticky vs. Flexible CPI.** Persistently high inflation has naturally had some market participants drawing comparisons to the 1970s, when inflation was the predominant macroeconomic issue facing the U.S. However, there are meaningful differences between that period and now. For example, breaking CPI down into its flexible and sticky components (i.e., those that change prices relatively frequently and infrequently, respectively), both measures rose in tandem during the 1970s as hotter-than-normal inflation became ingrained in the prices of a variety of goods and services. This time around, inflation is showing mostly in the volatile components; meanwhile, the sticky CPI has risen too, but has not quite matched the price gains of its flexible counterpart.
- **Inflation Expectations.** Inflation expectations had begun to show signs of easing, with 5-year inflation, as implied by TIPS* and inflation swaps, hitting 2.9% at the beginning of last week, down from its peak in April of 3.5%. However, 5-year inflation expectations began to rise again to 3.1% at the end of the week, as the prevailing theme of "peak inflation" appeared to lose some steam following the May CPI report.

Inflation's 2022 "peak," delayed again, appears in need of more Fed rate hike pressure

Earnings Outlook

- **Earnings Revisions.** Though earnings have remained relatively resilient, upward revisions have stalled as it appears that analysts have been lowering earnings estimates. On a 90-day basis, the percentage of analysts who are raising guidance for the average of years 2022 and 2023 (across all sectors in the Russell 1000) fell to 50% from 61%, with slightly greater reductions seen in revenue estimates as the current reading sits at 47% down from 63%. Given the inflationary backdrop and expectations for an aggressive Fed tightening cycle, forward guidance will be an important factor to observe throughout the year.
- **2022 Growth.** 2022 consensus earnings growth for the S&P 500 has jumped to 10.3%, higher than its 7.3% estimate as of the end of last year. The energy sector is expected to report the highest (year-over-year) earnings growth of all eleven sectors at ~115% for 2022. Notably, when stripping away the energy sector, which accounts for a 6% contribution to headline earnings growth, the 2022 growth estimate for S&P 500 earnings drops to ~4%. Meanwhile, full-year growth expectations for consumer discretionary have declined ~85% as of the end of last year, currently sitting at ~3%.
- **Economic Catalysts.** The economy has shifted to the late stage of this economic cycle, as inflationary pressures begin to weigh on prices and spending trends. The latest round of retail earnings reflects slowing demand as consumers grapple with higher costs and pivot their spending from goods to services. Companies that primarily target lower-income consumers have pared back profit estimates as a decline in sales weighed on results in the first quarter.

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*Treasury Inflation Protected Securities

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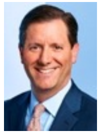

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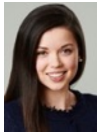

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