INVESTMENT STRATEGY INSIGHTS

Fed Pivot No More

September 19th, 2022

Fed Ahead

- Investors should not underestimate the Fed’s resolve for material tightening to bring down inflation

Denting “Peak Inflation”

- The “peak inflation” narrative faltered in August, putting pressure on the Fed to maintain its rate hike path

Market’s Not-So-Good Week

- Markets reacted, pricing higher rates into both bonds and stocks, but room remains for further reaction

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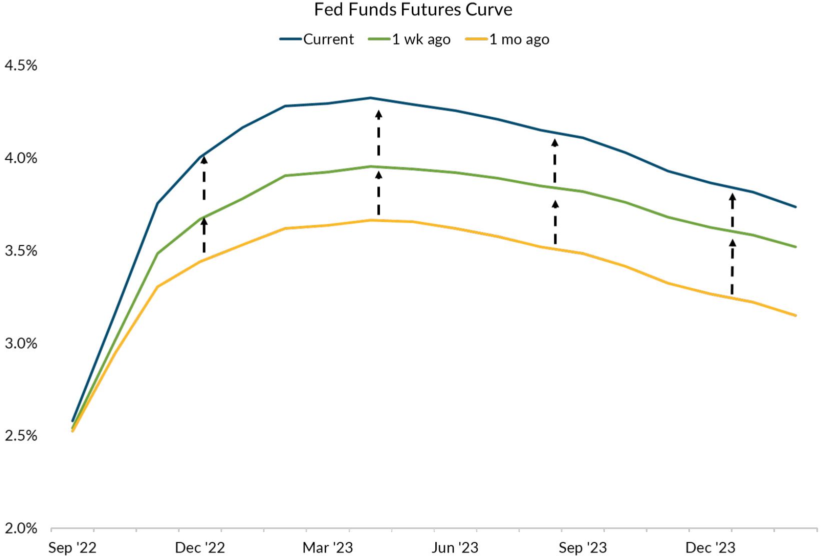
Fed Ahead

- **Another Rate Hike Coming.** The Federal Open Market Committee (FOMC) will likely take the next step in its policy shift this week with a third consecutive 75-basis point fed funds rate increase. Prodded by last week's hotter-than-expected inflation report, markets have shifted accordingly, with fed funds futures now weighing whether the Fed will raise rates by 75-basis points, with the potential for a 100-basis point rate hike. Realizing it's still behind the curve given recent inflation reports, the FOMC is likely to commit itself further to the goal of fighting inflation.
- **Projecting 4%+.** 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. Notably, futures market expectations for the fed funds rate by year-end rose to 4.2%, with a terminal funds rate of 4.4% by March of next year. It is important to note that 4%+ interest rates will sit firmly above the neutral level and should restrict the economy alongside inflation.
- **Expect a Hawkish Fed.** In the weeks leading up to the FOMC meeting this week, it appears that Fed officials have pushed a consistently hawkish message on the outlook for monetary policy. Chair Powell's press conference after the Wednesday meeting will likely repeat this rhetoric as Fed officials continue to push back against the dovish pivot narrative. While Fed Chair Powell has reiterated that that it will likely be appropriate to slow the pace of increases at some point, he also signaled that the Fed is willing to risk recession to lower inflation and will "keep at it until the job is done."

> *Investors should not underestimate the Fed's resolve for material tightening to bring down inflation*

Chart of the Week:

Federal Reserve rate hike expectations have risen quickly again



Source: Glenmede, FactSet Data through 9/15/2022
Fed funds futures are estimates of the fed funds rate at future points in time based on the fed funds futures market. Each line represents the market pricing at that point in time. Future rates may differ materially from projections.

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Denting "Peak Inflation"

- **August CPI.** Last week's CPI report put yet another dent in the "peak inflation" narrative, with core CPI (which strips out the more volatile food and energy components) increasing at a relatively hot 0.6% month-over-month clip in August. While the gain in headline CPI was lower at 0.1% month-over-month, consensus expectations were calling for outright deflation due to the prospect of falling energy prices. Instead, rising food prices helped push inflation higher last month to an 11.4% annual pace – the largest 12-month increase since 1979.
- **Still-Sticky Inflation.** With another upside surprise to core inflation, the underlying detail of August's CPI report suggests that inflation may be looking increasingly sticky, particularly with the rent and owners' equivalent rent components increasing 0.7% for the month. Typically, once those major shelter components begin to gather momentum, there is an element of inertia that tends to keep them hot for some time. This, in turn, risks inflationary factors becoming further entrenched and more difficult to rein under control.
- **Rising Recession Risks.** August's CPI report confirms that the Fed has a lot more work to do to satisfy its price stability mandate, which it should remain hyper-focused on in the near-term. Stubborn inflation pressures are likely to force the Fed to turn up the heat on its tightening campaign, which puts the broader economy at further risk of a material downturn within the next year. In recognition of these uncertainties, investors should maintain an underweight risk posture, particularly given the premium valuations still prevalent in equity markets.

The "peak inflation" narrative faltered in August, putting pressure on the Fed to maintain its rate hike path

Market's Not-So-Good Week

- **Yields On the Rise.** As investors weighed the prospect of larger rate hikes from the Fed at its meeting this week, U.S. interest rates reacted with fed funds futures now pricing in a rise in the fed funds terminal rate, putting upward pressure on U.S. Treasury yields to incorporate these expectations. The yield on the 2-year Treasury rose to a fresh fifteen year high of 3.9%, while 10-year Notes settled at 3.5%, up from 3.3% just before the inflation data was released. Municipal yields followed Treasury yields higher via Bloomberg Barclays Municipal Bond (1-10) Index, climbing to 3.0%, up from 2.8% to start the week.
- **From Bull to Bear.** Markets ended last week with the S&P 500 down 4.8%, which was largely a reversal of the prior week's rally. This decline follows Tuesday's hotter-than-expected inflation reading, which sparked the largest equities sell-off since June 2020, with the S&P 500 dropping 4.3%. While this may appear to be largely a valuation-adjustment reaction, it may be difficult to distinguish that from concerns about the economic impact.
- **Still-High Valuations.** After rebounding from the June lows, markets have returned to levels at which they command significant premiums to fair value. However, with the recent decline, large cap stocks still do not appear to reflect the growing difficulty of the economic environment. According to Glenmede's Global Expected Returns Model, large cap stocks experienced a considerable decline within recent weeks, though remain near their 70th percentile. All else equal, expectations of persistent tightening from the Fed and the associated economic fallout should weigh on those premium valuations, suggesting the ongoing bear market has further room to fall.

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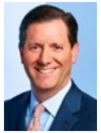

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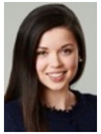

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