Market
Insights

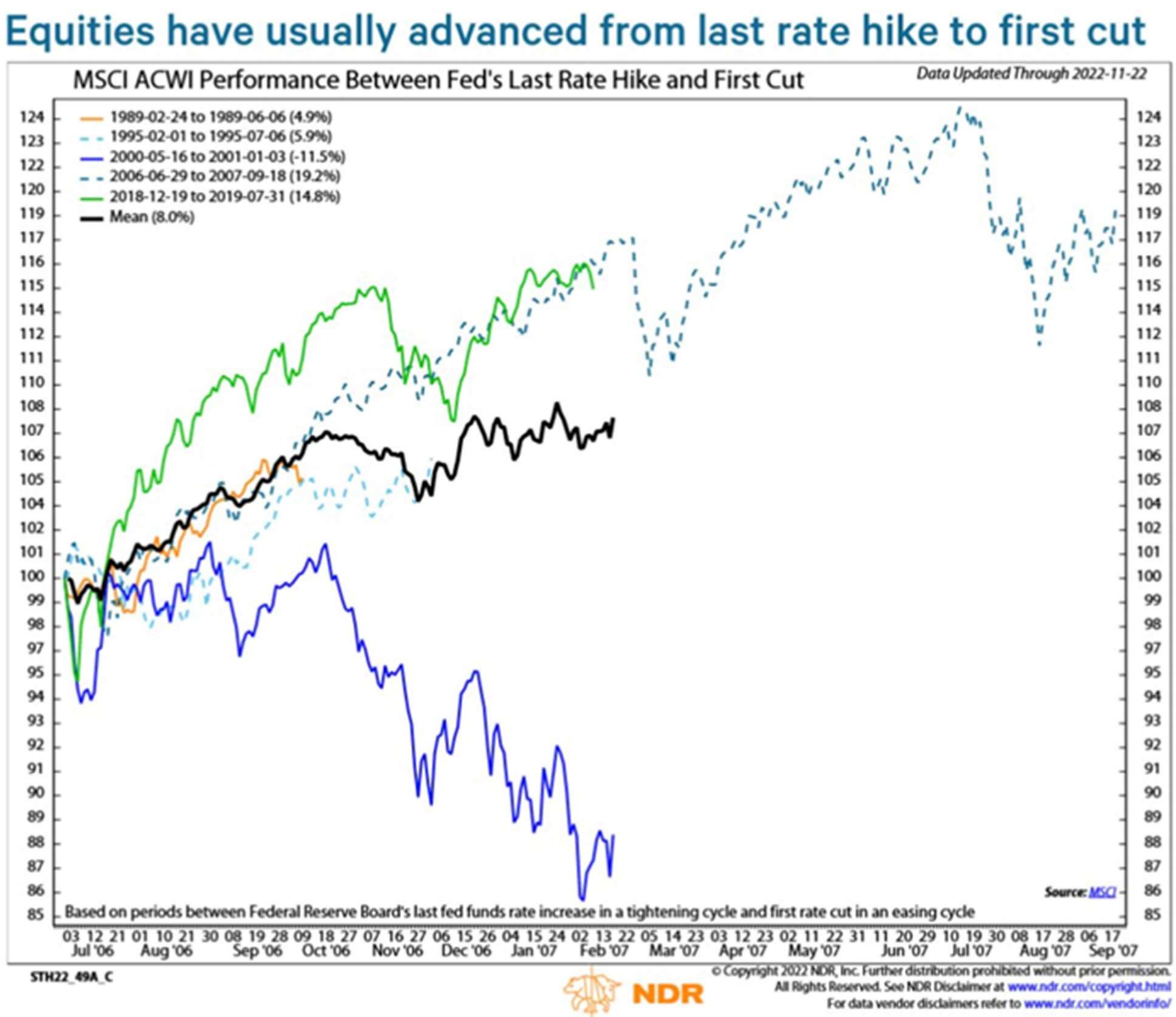
December 31, 2022

<u>What Happens To Stocks After the Fed Stops Hiking Rates?</u>

Hopefully, you are currently enjoying a quieter than normal period as 2022 winds down.

The Fed is most likely getting close to the end of their rate hikes, although our best guess is it could be a while before they cut rates.

Per the chart below, we find that that in four out of the last five rate hiking cycles stocks were higher between the last hike and when the Fed began to cut rates.



The one notable exception was when the Fed last hiked in 2000, early in a secular bear market. There have been many comparisons with current times and the tech bubble. However, if we are not entering a major secular bear market stocks could benefit from the Fed getting closer to it's terminal rate.

The Potential Path For Inflation

Unfortunately, we have all had to try and become inflation experts over the past year. Despite a team of highly trained economists, the Fed has been about as wrong as possible with their inflation expectations over the past 12-18 months. So, instead of making a bold prediction ourselves, we offer a chart that projects the end result of CPI depending on the path it takes.

Focus on the bottom section of the chart and let's choose the column titled 0.1% MoM. That was the latest month over month CPI increase data (Nov 2022) we have. If we continue to get similar CPI numbers going forward, the year over year numbers that grab most headlines will decrease rapidly. As you can see, by April it would be under 4% and by June under 2%.

Potential Paths for YoY CPI Based on Constant MoM Changes

Month		Actual CPI YoY %	Fed Funds Rate (%)
Jun-21		5.39	0.08
Jul-21		5.37	0.07
Aug-21		5.25	0.06
Sep-21		5.39	0.06
Oct-21		6.22	0.07
Nov-21		6.81	0.07
Dec-21		7.04	0.07
Jan-22		7.48	0.08
Feb-22		7.87	0.08
Mar-22		8.54	0.33
Apr-22		8.26	0.33
May-22		8.58	0.83
Jun-22	Peak CPI (so far):	9.06	1.58
Jul-22		8.52	2.32
Aug-22		8.26	2.32
Sep-22		8.20	3.08
Oct-22		7.70	3.83

Future YoY CPI w/:	-0.1% MoM	0.0% MoM	0.1% MoM	0.2% MoM	0.3% MoM	0.4% MoM	0.5% MoM	0.6% MoM	0.7% MoM	Fed Fund Futures:
Nov-22	7.11	7.22	7.33	7.43	7.54	7.65	7.75	7.86	7.97	3.83
Dec-22	6.68	6.89	7.10	7.32	7.53	7.75	7.96	8.18	8.39	4.37
Jan-23	5.68	6.00	6.32	6.64	6.96	7.28	7.60	7.92	8.24	4.37
Feb-23	4.62	5.04	5.46	5.88	6.30	6.73	7.16	7.58	8.01	4.72
Mar-23	3.14	3.65	4.17	4.70	5.22	5.74	6.27	6.80	7.33	4.87
Apr-23	2.46	3.08	3.70	4.32	4.95	5.58	6.21	6.85	7.49	4.87
May-23	1.24	1.96	2.67	3.39	4.12	4.84	5.58	6.32	7.06	4.91
Jun-23	-0.23	0.57	1.38	2.19	3.01	3.84	4.67	5.50	6.35	4.90
Jul-23	-0.32	0.59	1.49	2.41	3.33	4.27	5.20	6.15	7.10	4.81
Aug-23	-0.38	0.62	1.63	2.65	3.68	4.72	5.77	6.82	7.89	4.81
Sep-23	-0.69	0.41	1.52	2.64	3.77	4.91	6.07	7.23	8.41	4.75
Oct-23	-1.19	0.00	1.21	2.43	3.66	4.91	6.17	7.44	8.73	4.75
Nov-23	-1.19	0.00	1.21	2.43	3.66	4.91	6.17	7.44	8.73	4.61

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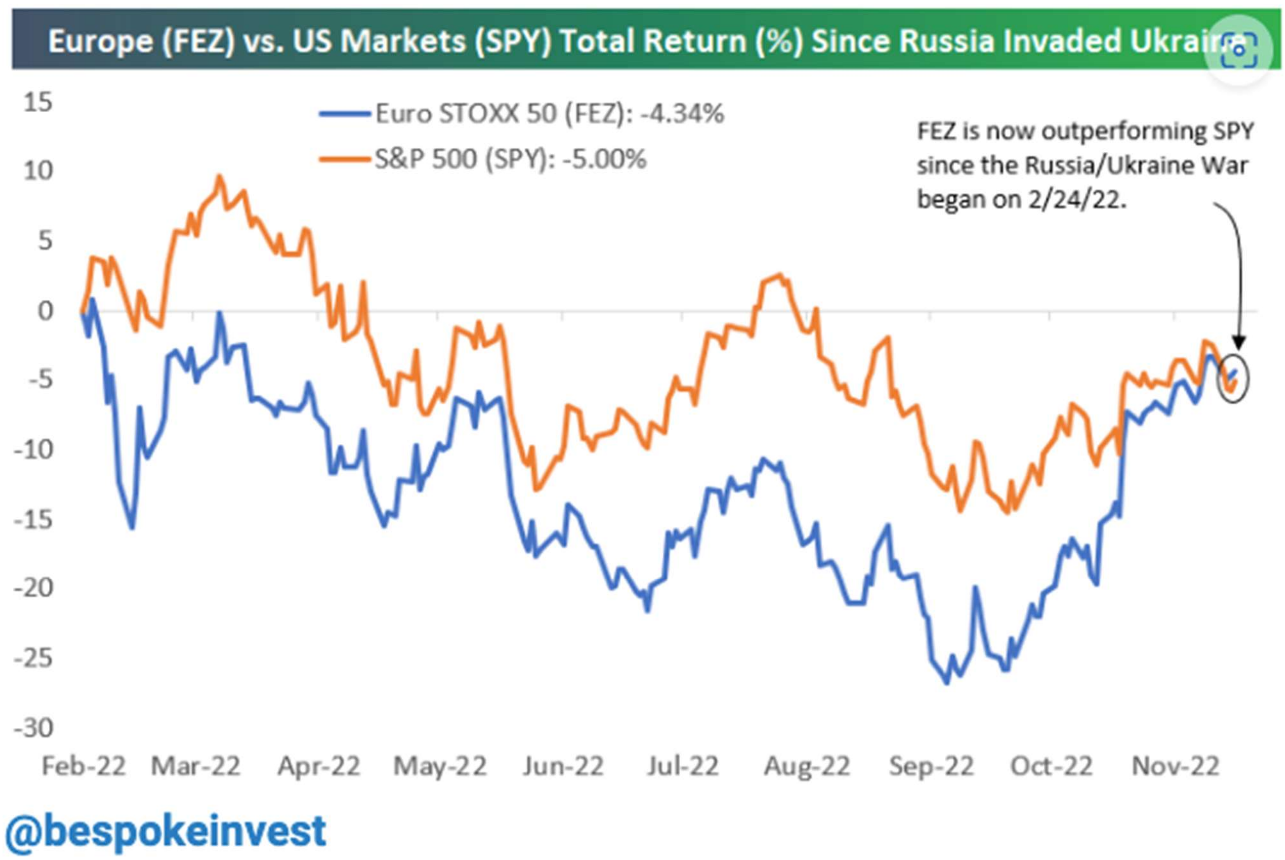
Of course, it is unlikely that inflation will move in such a smooth path. However, the most difficult comparisons fall off as the calendar turns and improving secondary numbers hitting the government data. With that being said, we could soon see inflation numbers that are much less shocking than have occurred throughout 2022.

Investing Does Not Always Make Sense

It is nice when everything is easily understandable and makes logical sense. Unfortunately, investing does not always meet that criteria. Think about all that Europe has had to endure since the war in Ukraine began. For one, enormous inflation, largely from energy costs, have far exceeded what we have witnessed in the U.S. Additionally, we have seen significant weakening in the Euro relative to the US dollar, and like the Fed, the European Central bank continues to raise rates.

Despite those potential headwinds, the chart below shows that the broad Europe stock market has slightly outperformed the U.S. market since the war began.

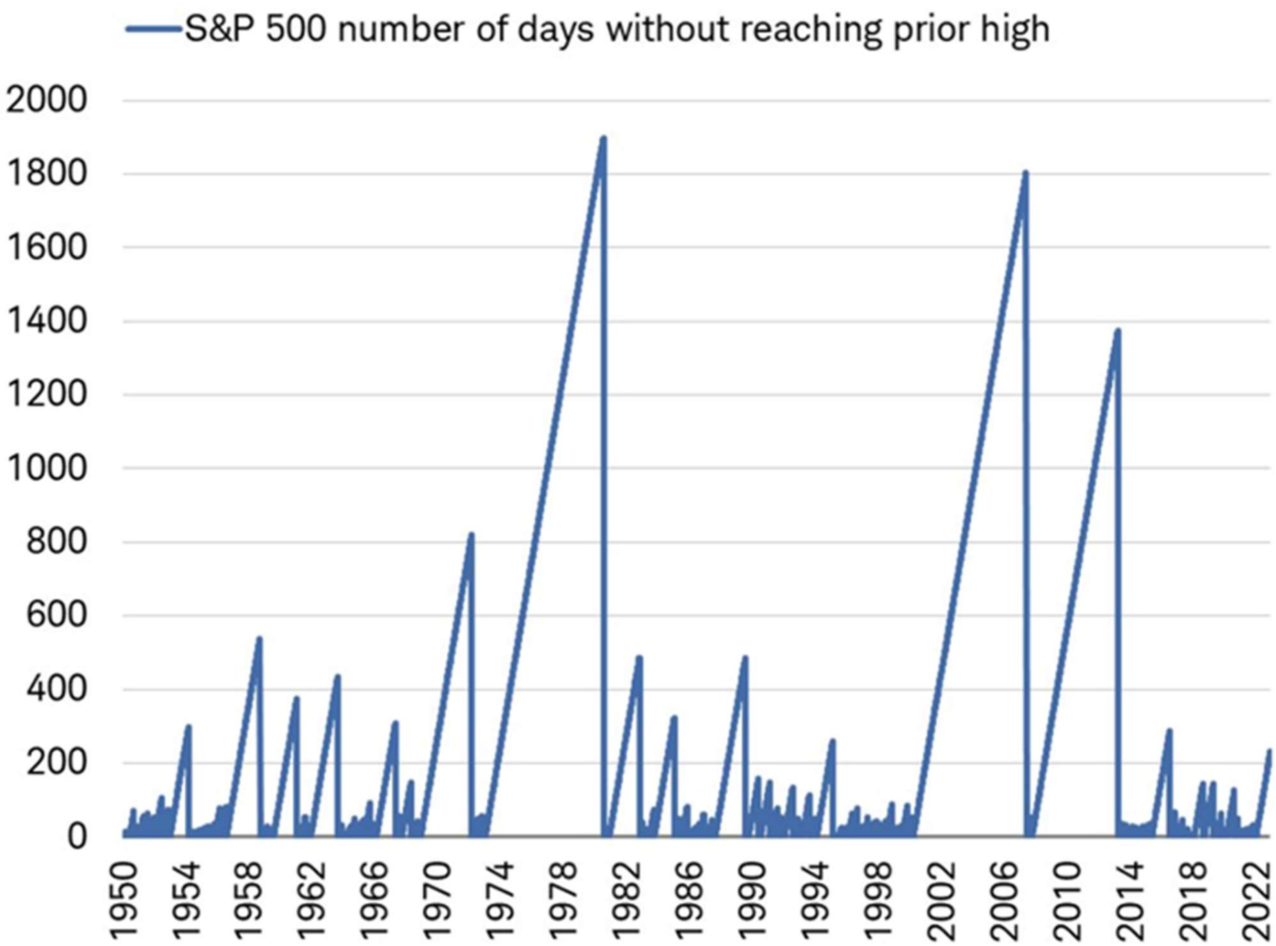


There are a number of potential reasons for this, but that is not our point. We simply believe that this is the latest example of why investors should not always think they need to try and have the answers for everything. Many things will seemingly not make sense on the surface and that is okay. Instead, follow your financial and investing plans.

How Long Until We Make New Highs?

One of our highest conviction beliefs this year has been the likelihood of stocks needing a significant amount of time to work through a changing environment before eventually reaching new highs. Over the past few years, investors had been accustomed to any selloff quickly recovering to new highs. Since stocks peaked at the start of 2022, fiscal and monetary stimulus have been removed and interest rates have risen substantially. We are in a much different environment.

We are now more than 200 days without reaching new highs. The chart below, shows how long past bear markets took to reach prior highs.



Source: Charles Schwab, Bloomberg, as of 12/2/2022. Past performance is no guarantee of future results.

The length of a bear market does not necessarily mean the depths of the decline have to go significantly below this year's lows. We can picture a market with plenty of starts and stops frustrating investors, while also creating both tactical and long-term opportunities.

Investors should stay open-minded to various potential outcomes, as financial markets have a tendency to surprise in both directions.