CONWAY • JARVIS LLC
Investment Outlook

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Update

Inflation Fight Weighs on the Economy and the Markets

In Q1 of this year, we witnessed the movement of capital among sectors *within* the market as traders traded and investors rebalanced portfolios. The predicted result was a contraction of P/E multiples among some high-profile NASDAQ stocks and superior price performance from a number of value/income issues within the DOW and S&P 500. Last week, the P/E compression of the NASDAQ widened to include most, and on some days all, sectors of the stock market. It was the first time since the bear market of 2020 that we saw capital move to the sidelines. Stocks were highly correlated in their decline and the sporadic rallies that followed. Investors evidenced a RISK OFF state of mind triggered by fears of what *might* happen to the economy in the months ahead rather than what's expected.

A number of media and market experts predict that the Fed will fail in its endeavor to curb inflation while avoiding recession, defined as a "soft landing" for the economy. There's no shortage of such opinions from those who seemingly "know" the future. In reality, we're all making educated guesses in unprecedented conditions, based on currently available information. While we'll acknowledge the possibility of a worst-case outcome (hard landing), we'll argue that it's too soon to trot out such predictions, let alone act on them. The Fed is navigating through uncharted waters. It enacted monetary policy at an unprecedented and extreme level during the pandemic and must now retrace a path back to a neutral stance and a return to normal conditions. The uncertainty that results should come as no surprise.

Just as the Fed used multiple tools in addressing the pandemic's effects, they've now emptied the tool box as they reverse course. Quantitative Easing has ended and bonds purchased during the pandemic are now rolling off the balance sheet, pushing interest rates back toward the *neutral* zone. These measures are coincident with the Fed's recent hike of key rates with more to come. We're among those that view the strategy and the speed at which it's being executed as appropriate. The majority of talking heads on CNBC rail against a clueless FOMC that has fallen far behind the curve in steering the recovery. Apparently, the events of the past two years are not unprecedented for *them*. They promote aggressive tightening and killing *demand* as a solution. History has proven that approach kills both demand and growth. We prefer waiting for the inevitable increase of *supply* as the proper cure for this post-pandemic form of inflation.

That would appear in the form of *peak inflation,* signaled by a leveling off of metrics that currently point to higher prices due to supply constraints. The first signs of that were seen in the recent decline of monthly core inflation, defined as CPI *less* food and energy prices. A second data point was Thursday's GDP growth number that surprised at -1.4% below the prior quarter. Peak inflation raises the possibility of peak earnings for this stage of the cycle and could explain the weakness of the Tech sector where P/E multiples were stretched to the extreme. We expect multiples to expand once again, albeit slowly, after the Fed completes its work of normalizing rates.

It's critical that investors distinguish this slowing economy from one headed into recession. Diversified investors with liquidity set aside can navigate through this pullback without making major changes to allocations. We should gain more clarity on conditions from next week's Fed meeting. We'll be increasing the frequency of our Updates as conditions warrant. Stay tuned.